Partnership in Pensions: An Assessment

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Published by

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7 Ridgmount Street
London WC1E 7AE
Tel: +44-171-291 4800
Fax: +44-171-323 4780
Email: mailbox@ifs.org.uk
Internet: http://www.ifs.org.uk

© The Institute for Fiscal Studies, March 1999

ISBN 1-873357-90-7

Printed by

KKS Printing
The Printworks
12–20 Rosina Street
London E9 6JE

Preface

This study is part of the research programme 'The changing distribution of consumption, economic resources and welfare of households' at the Institute for Fiscal Studies, funded by the Leverhulme Trust. Co-funding has been provided by the Economic and Social Research Council as part of the research programme of the ESRC Centre for the Microeconomic Analysis of Fiscal Policy at IFS. James Banks and Andrew Dilnot are thanked for useful discussion of issues relating to this research. Any errors are the authors' own.

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Executive summary

Last December, the government launched its consultation document on pension reform, *Partnership in Pensions*. This proposed a 'radical reform of the whole pension system' — the introduction of a Minimum Income Guarantee for poorer pensioners, the abolition of the State Earnings-Related Pension Scheme (SERPS) to be replaced by the State Second Pension (SSP), and the introduction of Stakeholder Pensions. Broadly, these changes follow the thrust of previous reforms over the past 20 years, which has been to shift the burden of secondary pension provision from the state to the individual. There will be some increase in the level of state support for pensioners, but it will be targeted at two groups — today's poorest pensioners and those whose low earnings, or caring responsibilities, make adequate private pension provision unfeasible.

The Minimum Income Guarantee commits the government (albeit loosely) to real increases in the future level of means-tested benefits for poorer pensioners. There is a danger that higher means-tested benefits could act as a disincentive to save for retirement. This problem will be mitigated by SSP, which will pay a higher state pension than SERPS to lower earners. However, there will be a long transition period from SERPS to SSP, the full benefits of which will not be felt until the middle of the next century. In the longer term, the government plans to remove the link between earnings and state pensions by making SSP a flat-rate top-up to the basic state pension for lower earners. All middle earners are expected to contract out of SSP into a private pension.

The proposed framework for the new Stakeholder Pensions has many sensible features, including benchmarking, increased workplace access and greater information. Making Stakeholder Pensions more flexible than existing private pensions will make them more attractive to people who are unable to contribute regularly. But the relationship between Stakeholder Pensions and other private pension schemes is unclear. Stakeholder Pensions are similar to many existing defined contribution schemes. Given this, the same end results could have been achieved by simple reforms to the current system rather than launching Stakeholder Pensions as a new type of pension. There is a danger of costly confusion and suboptimal switching from other private pension schemes. Evidence from the British Household Panel Survey shows that the majority of full-time employees earning between £9,000 and £18,500 already have a private pension and may be ill advised to switch to a Stakeholder Pension if they have paid up-front charges.

The evidence shows that people who earn between £9,000 and £18,500 who do not have a private pension are less likely to have stable employment and earnings than those who do. There may be some people whose earnings fluctuate a lot, particularly those who take time out of the labour market because of caring responsibilities, who may be better off under SSP than with a private pension unless the government continues to make a contribution into their pension fund as an alternative to credits for SSP. The evidence also shows that people who earn between £9,000 and £18,500 and do not have a private pension are less likely to have any other savings and, given less stable employment patterns, may prefer to hold any savings in a more liquid form than a pension. They may be more appropriate targets for the Individual Savings Account than Stakeholder Pensions.

A more integrated approach to Stakeholder Pensions, existing defined contribution schemes and Individual Savings Accounts (ISAs) can be found in recent proposals for what have unofficially been dubbed Lifetime Individual Savings Accounts (LISAs). However, the differential tax treatment of ISAs and pension saving could make the proposed transferability of savings between ISAs and LISAs very complex.

1. Introduction

The UK pension system has been reformed almost continuously since the State Earnings-Related Pension Scheme (SERPS) was introduced almost a quarter of a century ago. Many of these reforms have reduced the future generosity — and cost — of the state pension system, and kept projected future state spending on pensions at a relatively constant level as a proportion of GDP. Now a new set of reforms has been proposed by the government in order to provide greater assistance to today's poorer pensioners and to increase the level of secondary pension provision among current workers. The reforms are set out in the consultation document *Partnership in Pensions*[1] and contain three main strands:

- a Minimum Income Guarantee for poorer pensioners;
- the State Second Pension, which replaces SERPS and is aimed at individuals earning between the lower earnings limit (£3,432 from April 1999) and £9,000; and
- Stakeholder Pensions, which are an alternative to personal pensions and are aimed at those earning between £9,000 and £18,500.

In this Commentary, we consider the government's arguments for further reform to the UK pension system and whether its proposals are likely to achieve their stated aims. Section 2 describes the present pension system in the UK and the incomes received by the current generations of pensioners. Section 3 considers the impact of successive reforms made over the last quarter of a century and the arguments for further reform. Sections 4 to 6 look in detail at the three main elements of the government's proposals — the Minimum Income Guarantee, the State Second Pension and Stakeholder Pensions. Section 7 concludes.

[1]Department of Social Security, 1998a.

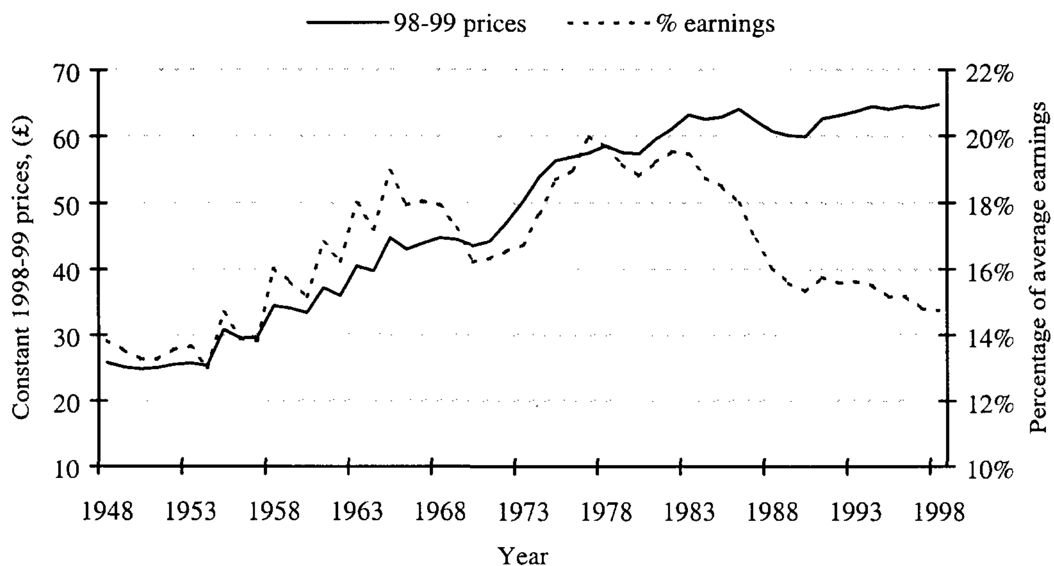
2. Current system of pension provision

The UK pension system is in two tiers. The first, provided by the state, consists of the basic state pension and a significant level of means-tested benefits. The second tier, compulsory for all employees with earnings above a certain floor, is made up of the State Earnings-Related Pension Scheme and a large and growing level of private provision. This section describes both tiers of coverage and looks in more detail at the characteristics of those contributing to private pension schemes in particular. It then looks at the level and distribution of the incomes of today's pensioners and how they compare with those of the rest of the population.

2.1 First-tier pension provision

The basic state pension is by far the major component of state provision and is received by 10.6 million individuals at a cost of £32 billion (4.7 per cent of GDP).[2] It is a flat-rate contributory benefit payable to those aged over the state pension age of 65 for men and 60 for women.[3] From April 1999, it will be worth £66.75 a week for a single pensioner, about 15 per cent of average earnings.[4] Couples in which one partner does not qualify for the basic state pension on the basis of their own contribution record receive a dependant addition, which from April 1999 will be worth £39.95 a week.

Figure 2.1. Value of the basic state pension, in 1998–99 prices and as a percentage of average earnings



Sources: HM Treasury, 1996; Office for National Statistics website.

[2]Department of Social Security, 1998a.

[3]The retirement age for women will be raised by six months each year from 2010 to 2020 so that equalisation is achieved in 2020.

[4]'Average earnings' refers to average full-time male gross earnings.

Box 2.1. Uprating the basic state pension

In the past, the choice for uprating pensions has been a price or earnings index. Uprating in line with prices means that the purchasing power of pensions remains constant over time. Given that pensioners' spending may be different from that of the rest of the population, a pensioner price index that measures the rise in prices of a typical basket of goods bought by pensioners may be more appropriate than the general retail price index. In fact, since 1981, the RPI has grown faster than the government's official pensioner price index and uprating the value of the basic state pension since 1981 in line with the pensioner price index would yield a pension of £55.89 in 1998–99. This is compared with £61.65 using the general RPI and the £64.70 it was actually set at in that year.

When there is real wage growth, uprating pensions in line with prices means that the value of pensions falls relative to average earnings and pensioners' standard of living slips behind that of the general population. In the consultation document, *Partnership in Pensions*, the case for uprating the Minimum Income Guarantee in line with earnings is that pensioners should 'share in the rising prosperity of the nation'.[5] An index of GDP growth could be an alternative choice for indexation, although earnings growth will be an accurate reflection of productivity growth where capital–labour shares are constant and the labour force is not growing. Over time, the choice of index can make a big difference to the amount of pension paid — and the total cost of the pension system. If the basic state pension had been uprated in line with earnings since 1981, it would have been £84.38 in 1998.

Further implications of the choice of prices or earnings indexation follow from the fact that both the lower earnings limit (LEL) and the upper earnings limit (UEL) of the National Insurance system are linked to the value of the basic state pension.[6] The LEL is approximately equal to the basic state pension, while the UEL is, by statute, between six-and-a-half and seven-and-a-half times the basic state pension. The fact that the basic state pension has been falling relative to average earnings means that more people earn above the LEL, making it more likely that they will receive the basic state pension and SERPS (assuming that wages are not set deliberately just below the LEL). This also means more revenue from National Insurance contributions (NICs) as more people are brought into paying NICs. At the same time, however, the UEL has been moving down the earnings distribution. This means a fall in the maximum value of SERPS pensions relative to lifetime earnings and also a slower growth in NIC revenue from higher earners compared with income tax revenue.[7]

Since 1981, the level of the basic state pension has been formally indexed to the increase in prices, whereas prior to 1981, it often increased in real terms. Figure 2.1 shows the generosity of the basic state pension from 1948 to the present day, both in real terms and

[5]Department of Social Security, 1998a.

[6]Employees pay National Insurance contributions on all earnings between the LEL and the UEL.

[7]For further discussion, see Disney and Whitehouse (1991).

Table 2.1. The current 'Minimum Income Guarantee': level of the basic state pension and income support in 1998–99

	Basic state pension (£ per week)	Income support (£ per week)	Gap (%)
Single, aged under 75	64.70	70.45	9
Couple, aged under 75	103.40	109.35	6
Single, aged 75–79	64.70	72.70	12
Couple, aged 75-79	103.40	112.55	9
Single, aged 80+	64.95	77.55	19
Couple, aged 80+	103.90	117.90	13

Source: Department of Social Security website.

as a percentage of average earnings. While being worth less than 15 per cent of average earnings in 1948, this grew to around 20 per cent by the early 1980s. Growth in real earnings experienced by the UK since has led to the basic state pension declining to around 15 per cent of average earnings today. Various ways of indexing the basic state pension, and their implications, are discussed in Box 2.1.

In order to qualify for the basic state pension, individuals need to have made or be credited with National Insurance contributions for 90 per cent of their working lives, equivalent to 44 years for men and 39 years for women. Credits are available for periods of illness, disability or unemployment. Around 86 per cent of men and 49 per cent of women over retirement age are currently entitled to the full amount.[8] Those with a less-than-full contributory record receive a portion of the basic state pension.[9] In future, more women are expected to qualify for the full basic state pension on the basis of their own contribution record. This is due to higher labour market participation amongst women, the introduction in 1978 of home responsibilities protection (HRP), which takes into account time spent looking after a dependant, and the removal of the right for married women to pay a reduced rate of National Insurance in return for giving up their entitlement to the basic state pension.

Means-tested benefits are an increasingly important part of the incomes of many poor pensioners. The income support level, which is the main benefit for those on low incomes, is higher than the basic state pension, as shown in Table 2.1. This gap has widened as a result of indexing the basic state pension in line with prices, since means-tested benefits have typically been increased in real terms.

Pensioners may also be able to qualify for the other main means-tested benefits, namely council tax benefit and, for those in rented accommodation, housing benefit. Income support recipients are automatically eligible for these benefits.[10] Expenditure on these benefits to the elderly in 1997–98 cost £8.9 billion (1 per cent of GDP).[11] Table 2.2 shows that means-tested benefits are currently received by more than one in three

[8]Department of Social Security, 1998a.

[9]This is subject to the individual qualifying for a minimum of 25% of the basic state pension.

[10]Those who live in properties that had a value of over £120,000 on 1 April 1991 are no longer able to qualify for the full amount of council tax benefit.

[11]Pension Provision Group, 1998.

Table 2.2. Percentage of pensioners in receipt of means-tested benefits, by age and marital status, 1996–97

	Age-group				*Total*
	60–64	65–69	70–74	75+	
Pensioner couple	n/a	22	20	31	*24*
Single male pensioner	n/a	38	41	44	*42*
Single female pensioner	46	46	48	55	*51*
Total	*46*	*28*	*30*	*43*	*35*

Note: Means-tested benefits are defined as income support, council tax benefit and housing benefit. Single pensioners include the divorced and widowed, while couples include both those married and those cohabiting. For couples, age is defined by the age of the oldest individual in the couple. Pensioner is defined as the head of the benefit unit being over the state retirement age and not working more than 16 hours per week.

Sources: Family Resources Survey, 1996–97; authors' calculations.

pensioners. The proportion receiving is higher amongst single pensioners, especially women, and also amongst older pensioners. This is because younger generations tend to be richer and also because they will have had more time to accrue SERPS entitlements since its introduction in 1978.[12]

2.2 Second-tier pension provision

Second-tier provision consists of the State Earnings-Related Pension Scheme (SERPS) combined with a substantial private sector. Secondary provision is compulsory for all *employees* who earn more than the lower earnings limit (LEL) — £66 a week from April 1999. Those in SERPS receive 20 per cent of their average lifetime earnings between the LEL and the upper earnings limit (UEL).[13] Alternatively, individuals can choose to 'opt out' into either an occupational pension (typically defined benefit scheme) or a personal pension (typically defined contribution scheme). In return for forgoing their SERPS entitlements, members of defined benefit schemes pay a reduced rate of National Insurance, while those in personal pension schemes receive a rebate paid directly into their fund.

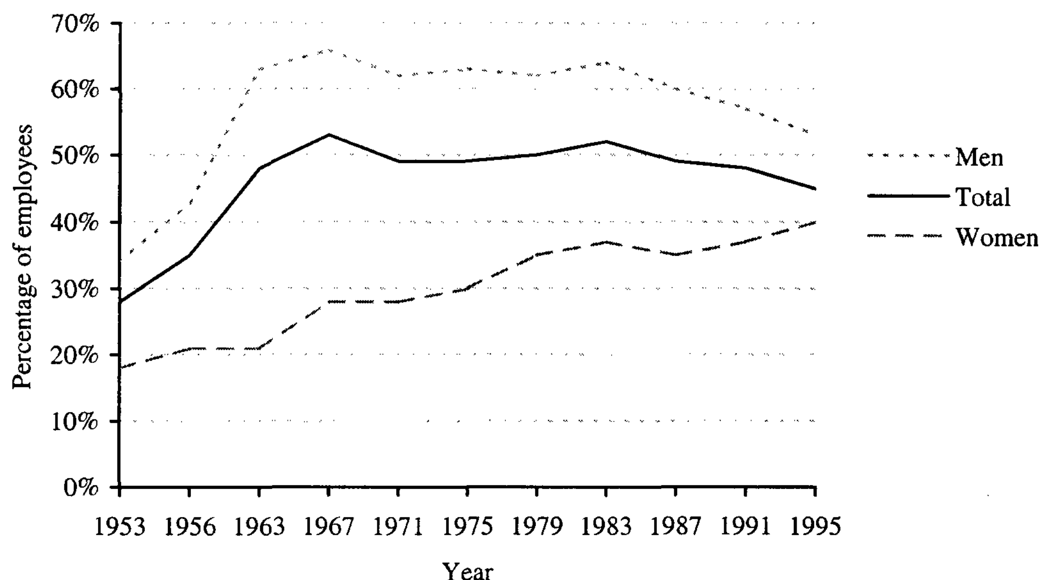
Membership of occupational pension schemes is substantial, peaking at over 12 million employees in 1967. However, overall membership has fallen to around 45 per cent of employees since its peak in the 1970s and early 1980s, as shown in Figure 2.2. Coverage among women has actually increased over the last 10 years, largely as a result of legislative changes that opened access to schemes to more women, especially those working part-time.[14] At least part of the explanation for the overall decline in membership since 1988 is that employees offered an occupational pension scheme can now choose to take out a personal pension, whereas previously they were compelled to join their employer's scheme. In addition, the number of employers offering

[12]In addition, legislation providing early leavers from occupation pension schemes with greater protection against inflation will have increased incomes from occupational schemes disproportionately amongst younger cohorts.

[13]The UEL will be £500 per week from April 1999.

[14]For further discussion, see Disney and Stears (1996) and Barrientos (1998).

Figure 2.2. Membership of occupational pension schemes amongst employees, by gender



Note: 1995 figure is provisional.
Sources: 1953 to 1991 — Pension Law Review Committee (1993, Appendix 4, p. 580); 1995 — Pension Provision Group (1998, p. 62).

occupational pension plans is likely to have fallen as the share of total employment by small and medium-sized firms increased between 1979 and 1991.[15] Moreover, recent changes in patterns of labour force participation are likely to mean that occupational pension plans are inappropriate for a growing number of workers. First, the proportion of male workers who were self-employed nearly doubled during the 1980s — from around 7 per cent to 13 per cent. Second, workers tend to be increasingly mobile, moving between several different jobs and into and out of employment and self-employment. For mobile workers, occupational pensions may not be appropriate because they are not portable.

Since 1988, individuals have been able to contract out of SERPS (and, more problematically, out of occupational defined benefit schemes) into defined contribution personal pension schemes. In contrast to defined benefit occupational schemes, personal pensions are portable and have become increasingly popular over the last 10 years. Initially, in order to kick-start these schemes, a bonus contribution of 2 per cent was paid by the Department of Social Security into the funds of those opting out. This was in addition to the contracted-out rebate and the fact that any additional contributions were made out of untaxed income. For many, especially the young, the tax treatment and the

[15]In 1979, 57 per cent of employees worked for firms employing under 500 people compared with 67 per cent in 1991. Source: Daly and McCann (1992) and McCann (1993).

NI rebates meant that personal pensions potentially offered much better returns than SERPS.[16] By 1992, around 6 million people had taken out a personal pension.

Analysis of second-tier provision by employment type

To look at which types of individuals have which second-tier pension arrangement, we use data from four waves of the British Household Panel Survey (BHPS) from 1992 to 1995. We look at people aged 20–59 who have been in work for at least one year over the sample period.[17] The final sample size is 4,147 — 2,052 men and 2,095 women. Table 2.3 summarises private pension provision among individuals in the BHPS between 1992 and 1995, broken down according to their employment status across the four waves of the survey. The groups we define are those employed full-time throughout (58 per cent of men and 33 per cent of women), those employed part-time throughout (16 per cent of women), those self-employed throughout (12 per cent of men and 3 per cent of women) and a group of 'other' who move between different employment states, including unemployment (47 per cent of women and 30 per cent of men). Individuals are defined as having a private pension if they say that they belong to an occupational or personal pension at least once during the period. Levels of private pension coverage are very high among those who are employed full-time across the entire period. Only 7 per cent of men and 12 per cent of women who are employed full-time each year from 1992 to 1995 do not have a private pension. A further 6 per cent have a personal pension but do not make any additional contributions above their NI rebates. Those in the former group earning above the LEL will, of course, be in SERPS, while those in the latter group generally are not.

Levels of private pension coverage are much lower among those who are not continuously employed full-time, as we might expect. Among women employed part-time, more than half have no private pension. While some of these will be members of

Table 2.3. Second-tier private pension coverage, by employment pattern, 1992–95

	Full-time employed throughout		Part-time employed thro'out	Self-employed thro'out	Other
	Men	Women	Women	All	All
No private pension	7%	12%	51%	30%	44%
Occupational pension	47%	43%	26%	0%	25%
Personal pen., no extra contribs	6%	6%	6%	0%	8%
Personal pen., extra contribs	12%	13%	8%	69%	10%
OP + PP	28%	26%	9%	0%	13%
Total	*100%*	*100%*	*100%*	*100%*	*100%*
No. of observations	1,194	701	352	311	1,600

Source: British Household Panel Survey, 1992–95.

[16]For more details, see Disney and Whitehouse (1992) and Dilnot, Disney, Johnson and Whitehouse (1994).

[17]We do not use all six waves of the BHPS since the first and last wave do not have sufficient details on private pensions for this analysis. Using only those individuals who appear in all four waves may lead to some sample selection bias. For a discussion of these concerns, see Taylor (1996).

SERPS, many will have earnings below the LEL and hence not be compelled to have any form of second-tier pension. Among those in 'other', who do not have stable employment over the period, 44 per cent do not belong to a private pension scheme. However, this is not surprising if those with unstable employment over the four-year period face greater uncertainty over their employment and earnings. If these people do save, they will be more likely to want to keep some of their savings in a more liquid form rather than tied up in a pension.

Among those who are self-employed, 30 per cent do not contribute to a private pension and are likely not to have any secondary pension at all unless they are making voluntary NI contributions. The big increase in the number of people who are self-employed in the 1980s has made the issue of retirement savings among the self-employed of much greater importance. However, whether or not the self-employed are saving adequately for their retirement is not a simple matter of whether they are contributing to a pension. First, the self-employed are likely to face greater uncertainty over their future incomes than those in continuous full-time employment and are more likely to want to keep wealth in a more liquid form. Second, many self-employed will effectively be seeking to provide for their retirement by building up the value of their business, a valuable asset that they will be able to sell before they retire. More detailed information on the incomes and assets of the self-employed is needed to address this issue.

Table 2.4 presents some more detail on levels of private pension coverage among full-time employees by their age in 1992 and shows that the proportion without a private pension is highest among the youngest and oldest age-groups. In addition, personal pension plans are more common amongst younger age-groups, which is perhaps not surprising since these people will have longer to accumulate interest in their funds and are also more likely to benefit from their flexibility. Hence the age profile is likely to change rapidly as these younger generations retain their personal pensions and new younger generations continue to take out schemes.

Personal pension plans may be unsuitable for those with intermittent and/or low earnings not only because they are a very illiquid form of saving but also because of the level and structure of their costs. A large part of the costs have been up-front, arising from selling personal pensions through brokers, and there are typically ongoing management charges as a fraction of the accumulated fund or contribution and a loading charge when the personal pension is annuitised. The Government Actuary's Department

Table 2.4. Second-tier private pension coverage, by age in 1992: full-time employees

	Age-group			
	20–29	30–39	40–49	50–59
No private pension	11%	6%	9%	11%
Occupational pension	40%	48%	48%	45%
Personal pen., no extra contribs	7%	6%	5%	7%
Personal pen., extra contribs	17%	12%	9%	9%
OP + PP	24%	28%	30%	27%
Total	*100%*	*100%*	*100%*	*100%*
No. of observations	564	590	549	192

Source: British Household Panel Survey, 1992–95.

Table 2.5. Persistence of additional personal pension contributions of those making an additional contribution in 1992, by employment status

No. of periods contributing, 1992 to 1995	Full-time employed throughout	Self-employed throughout	Other	*All*
1	39.6	45.8	58.2	*47.0*
2	13.9	8.3	20.4	*15.8*
3	12.5	12.5	7.1	*10.5*
4	34.0	33.3	14.3	*26.7*
Total	*100%*	*100%*	*100%*	*100%*
No. of observations	144	24	98	*266*

Note: 'Other' includes those moving into and out of work over the period and part-time workers.
Source: British Household Panel Survey, 1992–95.

has calculated average charges as equivalent to an initial expense loading of 6 per cent of the additional contracted-out rebate, a 0.8 percentage point reduction in the annual rate of return and a 2 per cent loading on the annuity purchase price.[18] Thus personal pensions are a rather expensive form of pension provision in terms of costs.

However, it should be noted that the contracted-out rebate is explicitly adjusted to account for the average level of charges, and therefore many of these costs are not directly borne by the purchaser. In any event, personal pensions will represent particularly poor value for people who contribute only for a few years. It is of some concern that, of those personal pension plans taken out in 1993, 30 per cent of policies appear to have lapsed by 1996.[19]

Again, the BHPS can be used to look at the persistence of personal pension contributions. Table 2.5 shows that, of those who were making an additional contribution to a personal pension plan in 1992, nearly half (47 per cent) did not make any additional contribution in the next three years. Only 27 per cent made contributions in all four years. Not surprisingly, those who were employed full-time throughout were more likely than other groups to contribute continually to a scheme over the period. Perhaps most striking is the fact that, of those in full-time employment throughout, only 34 per cent made additional contributions in all four years.

As well as the frequency of contributions, the size of contributions is also important. For example, it could be the case that those who contribute less frequently actually invest larger amounts each time. Table 2.6 shows the average contribution made, averaged over all four years, in pounds per month, and averaged over just the periods contributing, in both pounds per month and as a percentage of earnings. Those contributing in just the first year actually have *lower* average contributions in pounds per month than those who contribute more often. As a percentage of average earnings, contributions vary between 4.3 per cent and 5.3 per cent across individuals with different frequencies of

[18]HMSO, 1994.

[19]Source: Personal Investment Authority, 1997. For a discussion of this and other criticisms of personal pensions, see, for example, Disney and Johnson (1998).

Table 2.6. Level of additional contributions made to personal pensions, by persistence of contribution

No. of periods contributing, 1992 to 1995	Amount (£/month) averaged over four years	Amount (£/month) averaged over periods contributing	Amount (% of salary) averaged over periods contributing
1	11.31	45.26	4.8
2	31.90	63.80	5.3
3	39.90	53.21	4.3
4	61.70	61.70	4.3
No. of observations	266	266	218

Source: British Household Panel Survey, 1992–95.

contribution. There is no clear relationship between the frequency of contributions and the amount contributed each time.

2.3 Incomes of pensioners

The reforms to the UK pension system have made an impact on the level and the distribution of income received by the current generation of pensioners. Table 2.7 shows the income of the pensioners at the 25th percentile, median and 75th percentile by both age and marital status.[20] In all but one case, older pensioners are poorer. This is due to a

Table 2.7. Incomes of pensioners in 1996–97, by age and marital status

£ per week

	Age-group				*Total*
	60–64	65–69	70–74	75+	
Single males					
25th percentile	n/a	100	98	87	*93*
Median (50th percentile)	n/a	125	122	111	*116*
75th percentile	n/a	174	161	151	*158*
75 / 25 ratio	n/a	1.73	1.65	1.73	*1.70*
Single females					
25th percentile	87	88	82	78	*82*
Median (50th percentile)	113	109	106	106	*107*
75th percentile	148	145	136	134	*138*
75 / 25 ratio	1.70	1.66	1.65	1.73	*1.68*
Pensioner couples					
25th percentile	n/a	164	148	138	*149*
Median (50th percentile)	n/a	218	199	177	*196*
75th percentile	n/a	311	281	240	*276*
75 / 25 ratio	n/a	1.89	1.89	1.73	*1.85*

Note: Single pensioners include the divorced and widowed, while couples include both those married and those cohabiting. For couples, age is defined by the age of the oldest individual in the couple. Pensioner is defined as the head of the benefit unit being over the state retirement age and not working more than 16 hours per week. Income is taken before housing costs and is net of all taxes.

Sources: Family Resources Survey, 1996–97; authors' calculations.

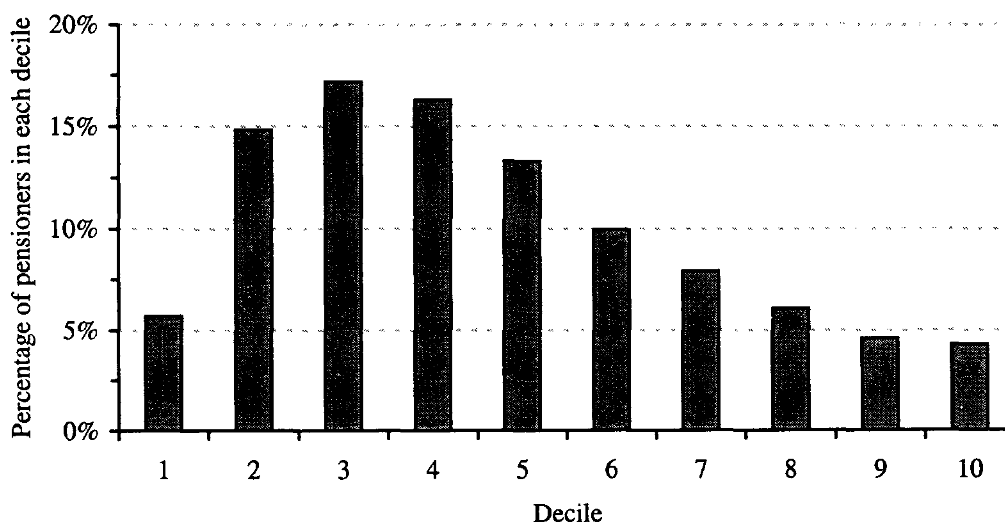
[20]The individual at the 25th percentile is richer than 25 per cent of individuals in that category and poorer than 75 per cent. The median is the individual with as many people richer as poorer, while the 75th percentile has 75 per cent of people poorer and 25 per cent richer.

combination of economic growth making younger cohorts richer and other changes, such as higher receipt of SERPS amongst those who have had longer to accrue entitlements since its introduction. Evidence of older pensioners being poorer is even more marked when the presence of differential mortality is considered, since poorer individuals will, on average, tend to die younger. So, as groups get older, average incomes will be observed to rise due to the changing composition. Single male pensioners tend to have higher incomes than single female pensioners. This is likely to be due to higher earnings during their working lives leading to, in particular, greater receipt of occupational pensions.

Looking at the ratio between the 75th and the 25th percentile provides an indication of the income inequality between individuals in each category. This shows that inequality is lowest amongst single female pensioners, since they tend to be homogeneously poor, and highest amongst pensioner couples. This is again not surprising, since in some cases the spouse will still have significant income from employment. Income inequality amongst pensioners fell from the early 1960s to the late 1970s, before rising sharply during the 1980s. As discussed in Johnson and Stears (1995), this rise was caused by a combination of an increase in inequality of income from investments and private pensions and a slight decline in the redistributive impact of social security spending.

Perhaps a better assessment of the economic status of pensioners is provided by a comparison of their incomes relative to those of the non-pensioner population. Figure 2.3 shows the percentage of pensioners in each decile of the income distribution. If

Figure 2.3. Location of pensioners within the income distribution, 1996–97



Note: Pensioner is defined as the head of the benefit unit being over the state retirement age and not working more than 16 hours per week. Incomes are equivalised using a scale of 0.7 for a dependent partner and 0.5 for each child. Income is taken before housing costs and is net of all taxes. Each decile contains 10 per cent of adults. Those in the first decile have equivalised incomes below £63.40 a week (i.e. below £63.40 if they are single and below 1.7×63.4=£107.78 for a couple). Those in the top decile have equivalised incomes above £293.30 a week.

Sources: Family Resources Survey, 1996–97; authors' calculations.

pensioners were evenly distributed across the income distribution, 10 per cent of pensioners would be found in each decile. This is not the case, with pensioners being less likely to be in the first decile, which since the start of the 1970s has increasingly been occupied by other unwaged groups such as the unemployed and single parents.[21] It is also important to note that pensioners are not all poor — a significant proportion are located in the top income bands. Pensioners are, however, much more likely to be in deciles two through to five. A disproportionate number of pensioners in the lower income deciles may be of more concern than for any other group. This is because, from a dynamic perspective, individuals who have reached retirement are likely to remain on the same level of real income, whereas other population groups are likely to experience more movement across the income distribution over time.[22] Of course, it could be the case that consumption by pensioners is actually much higher than their current incomes, due to dissaving. However, there is evidence that, upon retirement, consumption actually tends to fall faster than income.[23]

[21]Source: Goodman and Webb, 1994.

[22]Using evidence from the British Household Panel Survey, Jarvis and Jenkins (1997) found that, in the absence of changes to household composition, single pensioners are particularly likely to remain on low incomes.

[23]For more details, see Banks, Blundell and Tanner (1998).

3. Do we need pension reform?

The government's recent consultation document on pension reform, *Partnership in Pensions*, announced that it contained plans for a 'radical reform of the whole pension system'.[24] In fact, the pension system in the UK has been reformed almost continuously over the last quarter of a century. Box 3.1 summarises the key stages in the evolution of the current pension system over the last 50 years, with further details provided in Appendix A.

Pension provision in the UK today is very different from that intended by Beveridge, in two key respects. First, the social insurance scheme introduced in 1948, established on a contributory principle, has been eroded by subsequent reforms. The level of the basic state pension has been below that of the main means-tested benefit for those on low incomes for many years. Second, a compulsory secondary tier of coverage has been introduced, whereas Beveridge expected that additional provision should be voluntary.

In 1978, with the introduction of SERPS, second-tier pension provision was made compulsory for all employees with earnings above a certain floor. However, individuals were allowed to 'opt out' of SERPS as long as they were members of a private defined benefit pension scheme (typically an occupational pension scheme) that was at least as generous as SERPS.[25] In return, they and their employer paid lower National Insurance contributions. Since 1988, individuals have also been able to opt out of SERPS into a defined contribution scheme.[26] In return for them opting out in this way, the government pays a National Insurance rebate direct into the individual's pension fund.

The cumulative effect of these reforms, as Box 3.1 clearly shows, has been to add complexity to the system of pension provision. Another common effect has been to reduce the future generosity — and cost — of pensions paid by the state and to increase the level of private sector pension provision. These changes have included indexing the basic state pension to prices instead of earnings (1981), revising the SERPS formula and effectively halving the future value of SERPS pensions by 2040–41, reducing to half the amount of SERPS pension that can be inherited by surviving spouses (from 2000) and raising the pension age of women to 65 (between 2010 and 2020). These reforms have meant that the UK is in a very different position from that of many other OECD countries *vis-à-vis* future pension commitments of the state.

Like the UK, many OECD countries have reformed, or are in the process of reforming, their pension systems. However, unlike the UK, many of these reforms are occurring as a response to growing levels of state spending on pensions.[27] In most OECD countries,

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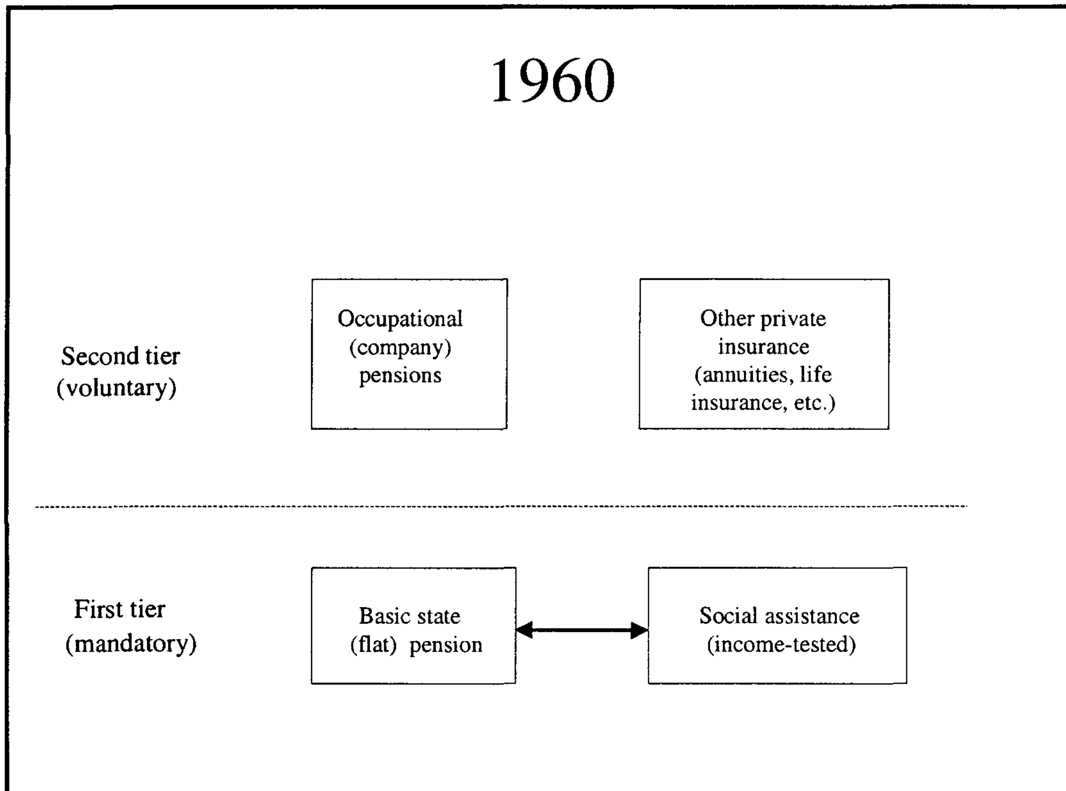
[24] Department of Social Security, 1998a.

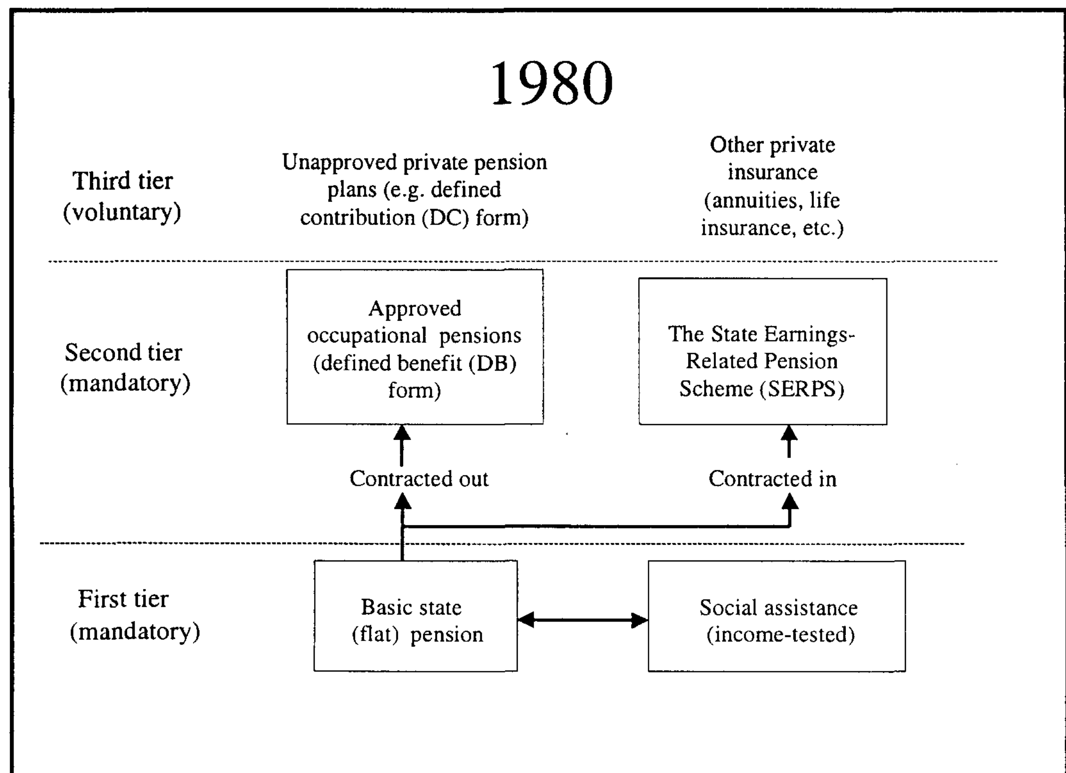
[25] A defined benefit scheme is one that provides a guaranteed level of pension linked to length of service and final salary.

[26] A defined contribution scheme is one that pays a pension that depends on contributions into the fund plus accumulated returns. In the UK, the fund must be used to purchase an annuity on retirement, with the exception of around one-quarter of the fund, which can be taken as a tax-free lump sum.

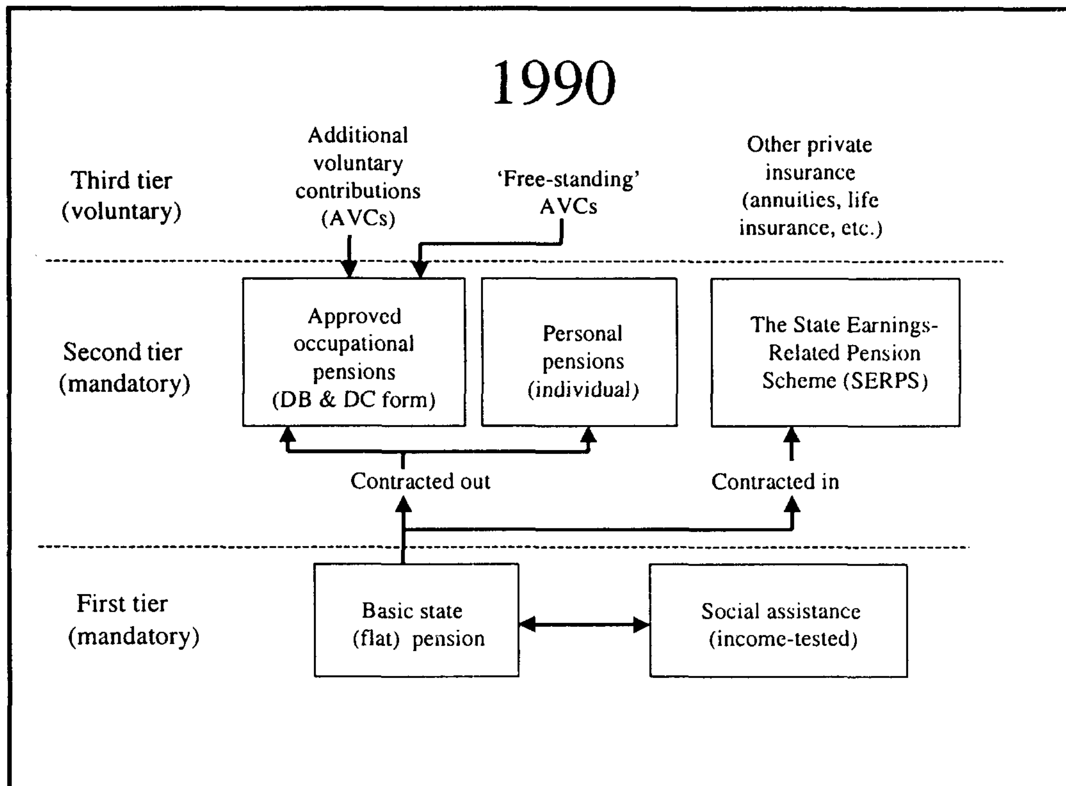
[27] Disney (1998) discusses the sustainability of pension schemes and the reform options.

Box 3.1. Ever increasing complexity?
The impact of various UK pension reforms





Box 3.1 continued



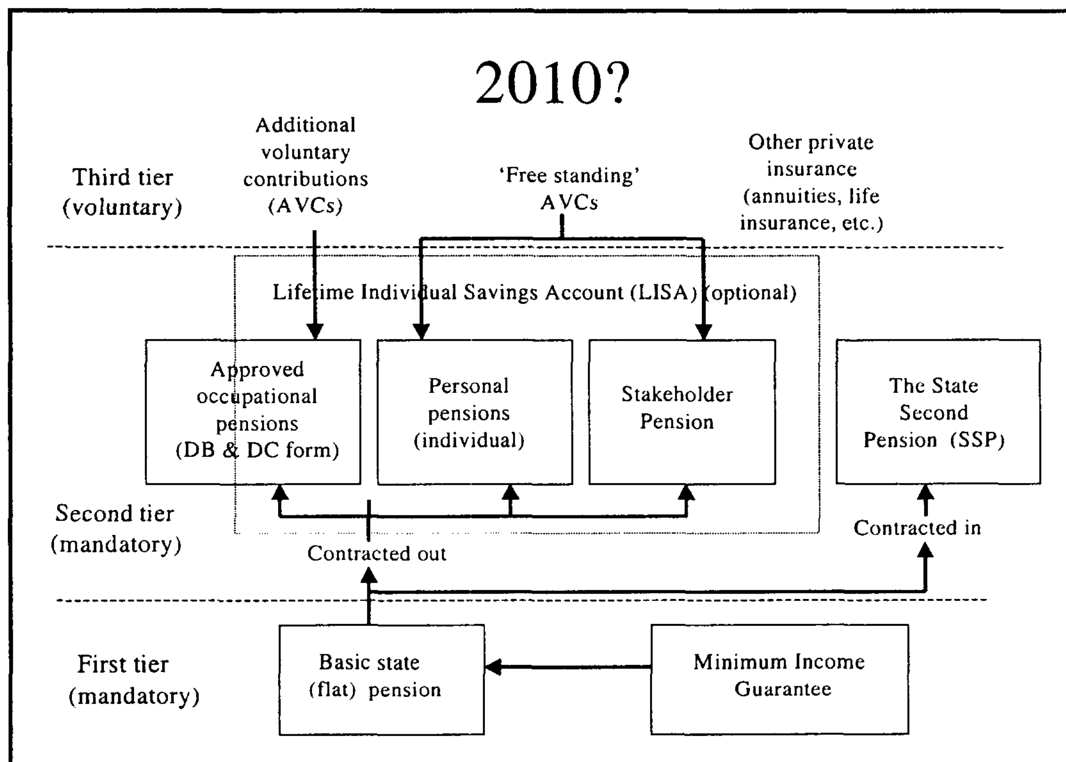


Table 3.1. Projected future state spending on pensions as a percentage of GDP

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
UK	4.5	4.5	5.2	5.1	5.5	4.0	4.1
US	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Source: OECD, cited in Johnson (1999).

future spending on pensions is projected to increase substantially as a proportion of GDP, as shown in Table 3.1, both because of demographic change and an increase in the proportion of the population over 65 and because of increasingly generous state pension systems. The one exception to this trend is the UK, where spending on pensions is expected to grow only very slightly as a proportion of GDP over the next three decades, and actually to have fallen as a percentage of GDP by 2050.

Successive reforms in the UK have kept projected future state spending on pensions at a relatively constant level as a proportion of GDP. But these reforms have created a different set of issues. First, there is a group of current pensioners who do not have any private pension income. The government itself admits that the level of the basic state pension 'will not provide a decent income in retirement'.[28] But it is too late for those who have already retired to build up an adequate secondary pension. Instead, they are increasingly reliant on means-tested benefits.

The second issue concerns current workers. The main thrust of past reforms has been to increase private pension coverage. But there is a significant minority of people who do not have a private pension. Many of them do not have access to occupational pensions, while personal pensions, with high up-front charges, may be inappropriate for those with low and/or intermittent earnings, including the self-employed. For people on low earnings, the current state secondary pension, SERPS, is also unlikely to provide an adequate secondary pension since the level of earnings on which it is based is low. Without reform to the current system to enable this group to build up an adequate second pension, many will be dependent on means-tested benefits in retirement.

Finally, as shown in the previous section, most people who do have a personal pension do not make regular additional contributions. This has led to some concern that people are not saving enough for their retirement and has raised the issue of whether the government should compel people to save more. Within the current system, some secondary pension provision is already compulsory for all employees earning above the lower earnings limit, who must belong either to SERPS or to a private pension scheme. But there has been some recent discussion as to whether the government should increase the level of compulsory secondary pension saving. Just because people are not currently

[28]Department of Social Security, 1998a.

making additional voluntary contributions to a secondary pension is not a sufficient reason for making a higher level of contributions compulsory. There will be occasions when individuals' incomes are relatively low and/or their consumption needs are relatively high and they would optimally choose to reduce their pension contributions. There will also be those facing uncertain future incomes who would prefer to keep their savings in a more liquid form. By increasing the level of compulsory secondary pension provision, the government may force households to save more than they would otherwise optimally choose to do, and in a different form.

A convincing economic case for the government to compel people to save more for retirement rests on there being a market failure that means that their current level of pension provision is suboptimal. Moreover, understanding the nature of the market failure is key to designing pension reforms that solve the problem of inadequate pension provision. One possibility is that people lack sufficient information about their level of income in retirement. For example, expectations of future state pensions may not have adjusted fully to take account of falling levels of state pension relative to earnings in the future. In this case, however, clearly the most direct policy response is to increase the level of information available. A second possibility is that people are myopic, although it is difficult to see why individuals would be more myopic than governments.

The most convincing case for compulsion arises from the moral hazard problem created by means-tested benefits. Typically, these are set at a fairly low level, meaning that most people are better off by making their own secondary pension provision. But, for some workers on relatively low earnings, means-tested benefits in retirement will be a disincentive to save. After retirement, it is impossible to distinguish the people who genuinely could not afford to save from those who simply chose not to. It could be argued that this is a reason for the government to compel those who can afford to save during their working lives to do so. But the government already does compel people to save for their retirement through the basic state pension and SERPS. Increasing the level of compulsory saving for people on low earnings would hit hardest those groups who may be able to least afford it. An alternative is to counteract the incentive not to save created by means-tested benefits with an increase in the benefits from working and saving.

There is a need for reform to the current system targeted at helping people who do not have adequate secondary pension provision — both among today's pensioners and among those who are working. The government's recent consultation document, *Partnership in Pensions*,[29] contains three key proposals for reform to the pension system, each directed at a particular group of individuals:

1. a *Minimum Income Guarantee* targeted at today's poorer pensioners;
2. a *State Second Pension* to replace SERPS for low earners (defined as those earning less than £9,000 a year); and

[29]Department of Social Security, 1998a.

3. *Stakeholder Pensions* targeted at middle earners (defined as those earning between £9,000 and £18,500 a year) to increase the level of private pension provision among this group.

The next three sections describe each of these proposed reforms in detail and provide an initial assessment of their likely impact.

4. The Minimum Income Guarantee

The government has pledged that the basic state pension will be retained as 'the foundation of retirement income'.[30] But its value will be uprated in line with prices, not earnings, and will continue to fall relative to average earnings. Currently worth around 15 per cent of average male earnings, by 2050 it will only be worth around 7 per cent.[31] Instead, means-tested benefits will play a greater role in alleviating poverty among poorer pensioners with the introduction in April 1999 of the Minimum Income Guarantee. This will be paid at a higher rate than the basic state pension — and at a higher rate than income support would have been paid if it had simply been increased in line with prices (see Table 4.1). It is worth pointing out, however, that the Minimum Income Guarantee is much less than the basic state pension would have been worth if the latter had been uprated in line with earnings since 1981 (£85.64 in 1999).

The Minimum Income Guarantee is a renaming of the income support premiums already paid to pensioners combined with a small increase in the level of those premiums. One of the problems that the government has identified with income support payments to today's poorer pensioners is take-up. An estimated 68–79 per cent of pensioners who are

Table 4.1. Comparing the Minimum Income Guarantee with the basic state pension and income support

	Basic state pension	Income support	Minimum Income Guarantee
SINGLE PENSIONER			
Aged 65–74			
April 1998	£64.70	£70.45	—
April 1999	£66.75	£71.95[a]	£75.00
Aged 75–79			
April 1998	£64.70	£72.70	—
April 1999	£66.75	£74.25[a]	£77.30
Aged 80+			
April 1998	£64.95	£77.55	—
April 1999	£67.00	£79.25[a]	£82.25
PENSIONER COUPLE			
Aged 65–74			
April 1998	£103.40	£109.35	—
April 1999	£106.70	£111.65[a]	£116.60
Aged 75–79			
April 1998	£103.40	£112.55	—
April 1999	£106.70	£114.95[a]	£119.85
Aged 80+			
April 1998	£103.90	£117.90	—
April 1999	£107.20	£120.40[a]	£125.30

[a]These numbers reflect the level of income support that would have been paid assuming uprating in line with the Rossi index, which excludes housing.

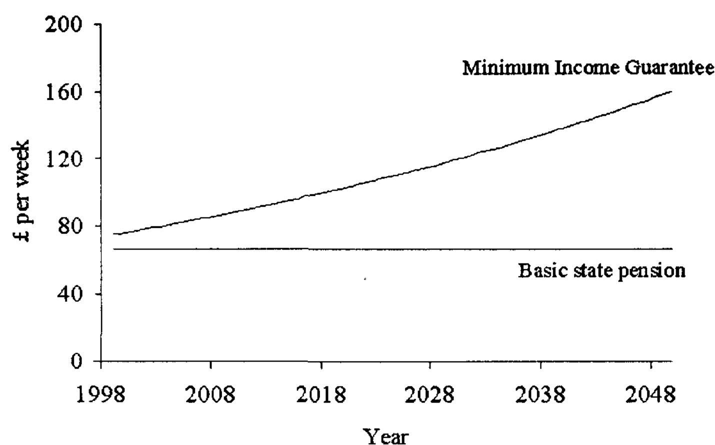
[30]Department of Social Security, 1998a.

[31]Assuming real wage growth of 1.5 per cent a year.

eligible to claim income support actually do so. This compares with take-up levels among the non-pensioner population of between 83 and 87 per cent.[32] Among the reasons identified for pensioners' failure to claim are a perceived stigma associated with means-tested benefits, a lack of awareness of entitlement and a perception that claiming is difficult and complex.[33] It could be argued that an increase in the level of the means-tested benefit will provide an additional incentive to claim. Also, renaming and relaunching the benefit may remove some of the perceived stigma as well as increasing awareness of entitlement. But without a fundamental change to the way the benefit is administered, it is difficult to see that the Minimum Income Guarantee will provide a complete solution to the current take-up problems.

Importantly, however, the government has said that 'over the longer term ... [its] aim is that [the Minimum Income Guarantee] should rise in line with earnings'.[34] In the short term, however, the commitment is simply to increase the level 'year by year as resources allow'.[35] In his 1999 Budget, the Chancellor has said that the level of the Minimum Income Guarantee in April 2000 will be uprated in line with earnings. If this continues, and assuming real wage growth of 1.5 per cent a year, the value of the Minimum Income Guarantee will increase relative to the basic state pension as shown in Figure 4.1. By 2038, for example, the Minimum Income Guarantee could be worth twice as much as the basic state pension. One way of measuring the value of the additional income provided by the Minimum Income Guarantee compared with the basic state pension is by the amount of capital that would be required to purchase an annuity paying the same amount of income each year. For a single male pensioner reaching pension age in 1999,

Figure 4.1. Comparing the future value of the basic state pension and the Minimum Income Guarantee (1999 prices)



Note: Assumes 1.5 per cent real wage growth per year.

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[32]Figures from Department of Social Security (1998b), revised in DSS Press Release 98/300.

[33]Department of Social Security, 1998a.

[34]Department of Social Security, 1998a.

[35]Department of Social Security, 1998a.

the estimated cost of purchasing an annuity paying the additional income provided by the Minimum Income Guarantee compared with the basic state pension is £10,746.[36]

The immediate effect of the Minimum Income Guarantee will be to increase the number of pensioners eligible to claim means-tested benefits — by 65,000 according to government figures.[37] As successive cohorts of people retire with higher levels of private pension incomes and, in the medium term, the State Second Pension, the number of pensioners eligible for means-tested benefits is likely to fall. But if the Minimum Income Guarantee is uprated in line with earnings, the number of pensioners *within a single cohort* who are eligible to claim is likely to increase over time since state and private pensions are typically uprated in line with prices after retirement. To give some indication of this rise in numbers, we look at whether pensioners[38] in a single cross-section of the 1996–97 Family Resources Survey would be eligible for the Minimum Income Guarantee in the future as they get older. We assume that pensioners' incomes remain constant in real terms after they retire, that the Minimum Income Guarantee increases by 1.5 per cent a year in real terms (in line with real earnings growth) and that capital (asset) tests do not reduce eligibility for the Minimum Income Guarantee to a greater extent in the future. The results are summarised in Table 4.2. The immediate effect of setting the level of the Minimum Income Guarantee higher than income support is a small increase in the number of pensioners who are eligible for means-tested benefits. As each cohort of pensioners gets older, a higher proportion of them become eligible for the Minimum Income Guarantee. In part, this reflects the higher premiums paid at ages 75 and 80. Also it reflects the fact that the value of the Minimum Income Guarantee increases

Table 4.2. Proportion of current pensioners who would be eligible for means-tested benefits in the future

Status in 1999	Income support	Minimum Income Guarantee		
	1999	1999	2010	2020
Single pensioners				
Aged 65–69	11%	13%	25%	48%
Aged 70–74	12%	16%	32%	53%
Aged 75–79	16%	21%	38%	56%
Aged 80+	25%	28%	40%	60%
Couples				
Aged 65–69	4%	5%	11%	28%
Aged 70–74	4%	6%	21%	36%
Aged 75–79	7%	10%	28%	44%
Aged 80+	11%	16%	28%	47%

Note: Pensioners' incomes are uprated to 1999 levels and then held constant in real terms. The Minimum Income Guarantee is assumed to increase by 1.5 per cent a year in real terms. We assume that pensioners become eligible for higher rates of Minimum Income Guarantee at ages 75 and 80.

Sources: Family Resources Survey, 1996–97; authors' calculations.

[36]This calculation is based on a real interest rate of 4 per cent net of costs and assumes that the Minimum Income Guarantee is uprated by 1.5 per cent a year in real terms.

[37]Department of Social Security, 1998a.

[38]Defined as those who are over the state pension age and working less than 16 hours a week.

relative to pensions. By 2020, nearly a half of single pensioners currently aged 65–69 and more than a quarter of pensioner couples in this age range, many of whom will still be alive, would be eligible for the Minimum Income Guarantee.[39]

The treatment of wealth in means tests

One area for consultation is the treatment of wealth in assessing eligibility for the Minimum Income Guarantee. Households with capital valued between £3,000 and £8,000 (excluding the value of their primary residence) have income support payments reduced on a sliding scale (currently a £1 reduction in benefits for every £250 of capital), while households with assets above £8,000 are not eligible for any income support. In practice, wealth and current income tend to be positively correlated, so few households whose incomes would make them eligible for means-tested benefits are disqualified on the basis of their wealth. If we look at households in the 1994 Retirement Survey whose incomes would make them eligible for means-tested benefits, for example, nearly 90 per cent have self-reported total financial assets worth less than £3,000. Less than 5 per cent have self-reported total financial assets of more than £8,000.[40]

However, it is not surprising that few people with incomes that would make them eligible for means-tested benefits have wealth above £3,000, since this is exactly what we would expect, given the capital test. A capital test will act as a disincentive to save for retirement, or at the very least an incentive to hold wealth in the form of housing. One suggested solution has been to get rid of the capital test altogether and only means-test income. But this will create a different disincentive effect, encouraging people not to annuitise their wealth. Given that people have ultimately to purchase an annuity with the accumulated fund in a personal pension, one likely result of abolishing the capital test would be people switching their retirement savings from personal pensions to direct holdings of financial assets. A more sensible reform would be to ensure that the current limits in the capital test are raised broadly in line with the level of means-tested benefits. This is not currently the case, given projected future higher levels of the Minimum Income Guarantee. We estimate that a single male pensioner aged 65 would need capital of £10,746 to purchase an annuity that provided an annual income equal to the additional income provided by the Minimum Income Guarantee compared with the basic state pension.[41] This is higher than the current £8,000 upper limit on the level of capital that would disqualify him from receiving any means-tested benefit. There is a clear incentive to annuitise, rather than continue to hold, capital.

Ideally, households with the same lifetime incomes (and needs) should be treated in the same way. The problem comes after retirement in distinguishing those who had low incomes throughout their lives and genuinely need government help from those who had

[39]Differential mortality — i.e. the fact that wealthier individuals are likely to live longer — may tend to make these figures overestimates of the proportion of surviving pensioners who will claim the Minimum Income Guarantee.

[40]These numbers correspond fairly closely to the *1997 Social Security Statistics* publication, which shows that, out of 1,764,000 people over 60 who received income support, 76,000 (4.3 per cent) had their level of income support reduced because they had assets worth between £3,000 and £8,000.

[41]Assuming a real interest rate net of costs of 4 per cent and uprating of the Minimum Income Guarantee by 1.5 per cent a year in real terms.

reasonably high incomes during their working lives but chose to spend and not save. A higher level of means-tested benefits, which provides more help to those who genuinely need it, creates a bigger incentive for people with higher incomes not to save for retirement. The most direct solution to this moral hazard problem lies either in compelling people with sufficiently high incomes to save during their working lives or in increasing the benefits from working and saving.

However, governments have rejected additional mandatory private retirement saving, both when the issue was raised in the 1985 Green Paper (HMSO, 1985) and when it was raised, in a more recent era, by Frank Field MP, the then Minister of Welfare Reform. The present government appears to have chosen the second option — greater incentives to work and save — by increasing the level of state pension paid to low earners through the State Second Pension. The implications of this will be discussed further in the next section. However, this policy will not resolve the issue for the current generation of pensioners. From an administrative point of view, it may not be possible to condition receipt of benefits on lifetime resources. But, at the very least, it might be sensible to set different wealth thresholds for households of different ages. Comparing young and old households with the same wealth, for example, younger households may be wealthier over their lifetimes, but simply not yet have had time to accumulate savings.

5. The State Second Pension

The State Second Pension (SSP) will replace SERPS from April 2002. Instead of the constant rate of accrual of SERPS on all earnings between the lower earnings limit and the upper earnings limit, SSP will accrue at three different rates depending on annual earnings:

- on annual earnings between the LEL and £9,000, SSP will be a flat-rate pension worth 40 per cent of £9,000, i.e. twice the current rate of SERPS for people earning £9,000;
- on that part of earnings between £9,000 and £18,500, SSP will accrue at 10 per cent;
- on earnings above £18,500 but below the UEL, SSP will accrue at 20 per cent.

The reason for this slightly strange structure of accrual rates is to increase the level of secondary state pensions for those on low earnings, while at the same time making high earners no better off (as they would be if the rates of accrual were 40 per cent and then 20 per cent) and no worse off (as they would be if the rates of accrual were 40 per cent and then 10 per cent) than they would have been under existing state secondary pension provisions (SERPS). In fact, setting the starting-point for the 20 per cent band at £18,500 would make high earners slightly better off under SSP than they were under SERPS, since the actual point of convergence between SERPS (accruing at 20 per cent) and SSP (accruing at 40 per cent of £9,000 and then 10 per cent) is £20,316. This discrepancy is likely to be ironed out before implementation. The effects of these different accrual rates are shown in Figure 5.1.

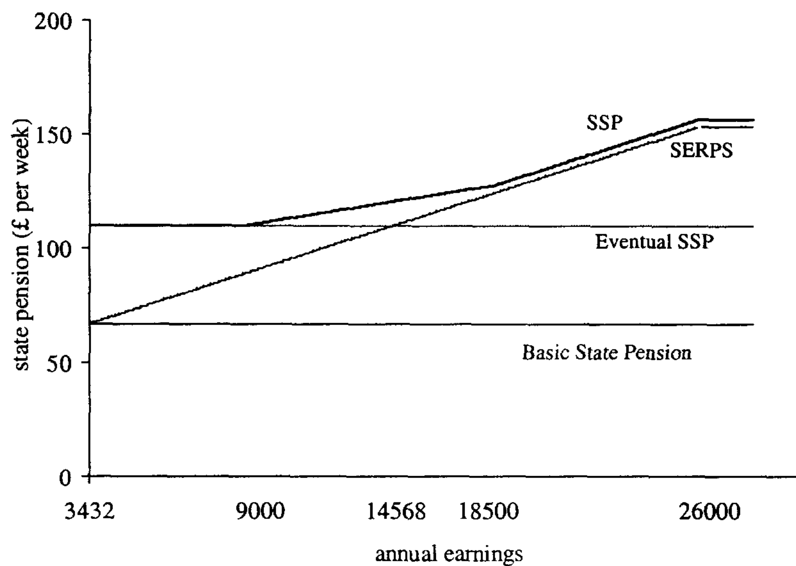
Figure 5.1 also shows the long-term level of SSP as a flat-rate pension. The consultation document[42] proposes that, in the longer term, SSP will become a flat-rate pension paid only to lower earners. In the short term, middle earners will have the option of remaining in SSP — where they will be better off than under SERPS, as Table 5.1 shows. In the longer term, according to the consultation document, they are expected to join a funded scheme, where they will continue to receive an earnings-related rebate. After the transition, SSP will effectively form a top-up to the basic state pension for those whose earnings are too low to make joining a funded scheme worth while. The proposed flat-rate SSP will be worth less than SERPS for everyone earning more than £14,568.

The transition to a flat-rate SSP will happen 'when stakeholder pensions have established themselves'.[43] This is expected to be after five years, according to the consultation document. This two-stage transition may cause some confusion — particularly since it creates a group of people (earning between £14,568 and £18,500) who will be better off under SSP Mark 1 than under SERPS in the short term, but worse off under SSP Mark 2 than under SERPS in the long term. There will also be a larger group of people (all those earning more than £9,000) who will be better off under SSP Mark 1 than under SERPS,

[42]Department of Social Security, 1998a.

[43]Department of Social Security, 1998a.

Figure 5.1. Comparing SSP and SERPS accrual



but worse off under SSP Mark 2 than under SSP Mark 1. This may make the transition from SSP Mark 1 to SSP Mark 2 politically difficult, unless the government has succeeded in getting these people to opt out into Stakeholder Pensions. We return to the issue of Stakeholder Pensions in the next section. In the rest of this section, we assess the impact of SSP on the pensions paid to people earning less than £9,000, who are clear winners from the proposed reforms.

The first effect of the change from SERPS to SSP will be to increase secondary state pensions, particularly for low earners. Some numbers are given in Table 5.1. SSP will have a positive redistributive effect, although, as shown below, this effect is smaller if household incomes are considered rather than individual earnings. It should be noted that the overall redistributive effect is difficult to measure, since earnings are likely to change across an individual's lifetime and may cross the £9,000 threshold. We assume that relative earnings are constant over time.

The main beneficiaries of SSP will be women. Around 20 per cent of workers earn between the lower earnings limit and £9,000, and women comprise 80 per cent of them.[44] Table 5.2 shows the location of people earning between the LEL and £9,000 (who will be the main beneficiaries of SSP) across the earnings distribution (defined separately for men and women). If everyone earned between the LEL and £9,000, each decile would contain exactly 10 per cent of the total. Not surprisingly, those earning between the LEL and £9,000 tend to be towards the bottom of the earnings distribution. Given that women tend to earn less than men, a greater proportion of those earning between the LEL and £9,000 are in higher earnings deciles. In fact, since more than 10

[44]Authors' calculations using data from the 1996–97 Family Expenditure Survey, uprated to 1999 using an index of average earnings growth.

Table 5.1. Comparing SSP and SERPS payments

Annual earnings	Weekly earnings	SSP Mark 1	Total state pension	Replacement rate	SERPS	Total state pension	Replacement rate
£3,500	£67.31	£42.83	£109.58	1.63	£0.26	£67.01	1.00
£5,000	£96.15	£42.83	£109.58	1.14	£6.03	£72.78	0.76
£6,000	£115.38	£42.83	£109.58	0.95	£9.88	£76.63	0.66
£7,000	£134.62	£42.83	£109.58	0.81	£13.72	£80.47	0.60
£8,000	£153.85	£42.83	£109.58	0.71	£17.57	£84.32	0.55
£9,000	£173.08	£42.83	£109.58	0.63	£21.42	£88.17	0.51
£10,000	£192.31	£44.75	£111.50	0.58	£25.26	£92.01	0.48
£11,000	£211.54	£46.68	£113.43	0.54	£29.11	£95.86	0.45
£12,000	£230.77	£48.60	£115.35	0.50	£32.95	£99.70	0.43
£13,000	£250.00	£50.52	£117.27	0.47	£36.80	£103.55	0.41
£14,000	£269.23	£52.45	£119.20	0.44	£40.65	£107.40	0.40
£15,000	£288.46	£54.37	£121.12	0.42	£44.49	£111.24	0.39
£16,000	£307.69	£56.29	£123.04	0.40	£48.34	£115.09	0.37
£17,000	£326.92	£58.22	£124.97	0.38	£52.18	£118.93	0.36
£18,000	£346.15	£60.14	£126.89	0.37	£56.03	£122.78	0.35
£19,000	£365.38	£63.02	£129.77	0.36	£59.88	£126.63	0.35
£20,000	£384.62	£66.87	£133.62	0.35	£63.72	£130.47	0.34

Note: The replacement rate measures the state pension (basic state pension plus the relevant secondary state pension) as a proportion of earnings.

Table 5.2. Distribution of individuals earning between LEL and £9,000 across earnings and income deciles

Decile	Earnings		Income	
	Men	Women	Men	Women
1	5%	0%	20%	12%
2	95%	13%	11%	13%
3	0%	32%	15%	15%
4	0%	32%	11%	13%
5	0%	23%	12%	13%
6	0%	0%	11%	11%
7	0%	0%	8%	7%
8	0%	0%	6%	6%
9	0%	0%	2%	4%
10	0%	0%	5%	5%
Total	*100%*	*100%*	*100%*	*100%*

Note: Incomes are equivalised using a scale of 0.7 for a dependent partner and 0.5 for each child. Income is taken before housing costs and is net of all taxes. Each decile contains 10 per cent of adults.

Source: Authors' calculations using 1996–97 FES data.

per cent of women earn less than the LEL, none of those who benefit from SSP are in the bottom decile of the female earnings distribution. Table 5.2 also shows the distribution of people earning between the LEL and £9,000 across the income distribution, taking the rest of the household's income into account. This shows a smaller positive redistributive effect of the change to SSP, since some people earning between the LEL and £9,000 are in households in the top income decile. It could be argued, however, that individuals' earnings are a more appropriate basis for assessment, since household composition may change before retirement. Indeed, one intended effect of SSP could be to ensure that women have an adequate independent level of income in retirement.

Women will also be the main beneficiaries of a further proposed reform to secondary state pension provision, which is the payment of credits during periods spent out of the labour market caring for others. The government has promised to credit the State Second Pension for recipients of invalid care allowance, carers of people receiving attendance allowance or disability living allowance, and child benefit recipients where the youngest child is five or under. Credits will be paid as if carers had earned £9,000 a year. Under home responsibilities protection (HRP), each year spent out of the labour market due to caring responsibilities reduces the number of years of National Insurance contributions that have to be made to qualify for a basic state pension (to a minimum of 20 years). SSP extends the principle of helping carers build up pension entitlement to secondary state pensions. In principle, SSP promises to be more generous than HRP since it involves the payment of credits for years spent caring, rather than simply reducing the required number of years of contributions. So someone who spends their entire working life caring for others can build up an entitlement to SSP even if they are not entitled to the basic state pension.[45] More problematic is what will happen to women who earn more than £9,000 who will be encouraged to take out Stakeholder Pensions

[45]Although HRP covers all children under 16, rather than up to age five.

and possibly contract out of SSP. They too will need to receive credits for periods spent looking after children and other dependants if they are not to lose out.

A further intended effect of SSP is to reduce the moral hazard problem — the disincentive to work and save for retirement — created by means-tested benefits. Since the combined income provided by the basic state pension and SSP will be higher than the level of the Minimum Income Guarantee (at least in the medium term),[46] individuals will have an incentive to work — and increase their state pension entitlements — rather than relying on means-tested benefits. However, given that the SSP accrual rates will not apply retrospectively, the positive effects of the change to SSP will not be felt immediately. In fact, until the middle of the next century, there will be people retiring

Table 5.3. When would pensioners become eligible for means-tested benefit? Comparing SSP and the Minimum Income Guarantee after retirement (constant 1999 prices)

Year reached age 65	Earnings in 1999	Earnings at age 64	BSP+SSP at age 65 (to nearest £)	MIG at age 65 (to nearest £)	Age eligible for means-tested benefits
2010	£5,000	£5,803	£85	£88	65
	£7,000	£8,124	£92	£88	68
	£9,000	£10,445	£99	£88	73
2020	£5,000	£6,734	£104	£103	66
	£7,000	£9,428	£110	£103	70
	£9,000	£12,122	£115	£103	73
2030	£5,000	£7,815	£129	£119	71
	£7,000	£10,942	£133	£119	73
	£9,000	£14,068	£136	£119	75
2040	£5,000	£9,070	£162	£138	75
	£7,000	£12,698	£163	£138	75
	£9,000	£16,326	£163	£138	75
2050	£5,000	£10,526	£186	£160	75
	£7,000	£14,737	£186	£160	75
	£9,000	£18,947	£186	£160	75

Note: The basic state pension and the lower earnings limit are assumed to be constant in real terms. The Minimum Income Guarantee and the £9,000 threshold are assumed to be uprated in line with earnings each year and real earnings growth is assumed to be 1.5 per cent a year. Minimum Income Guarantee increases at ages 75 and 80. We calculate pension entitlements for people earning £5,000, £7,000 or £9,000 in 1999. We assume that their earnings grow by 1.5 per cent in real terms each year until they reach 65. At 65, each previous year's earnings are revalued to the year of retirement using the economy-wide earnings index (1.5 per cent).

[46]The government has said in the consultation document that the £9,000 threshold will be increased in line with earnings, so SSP will keep broadly in line with earnings. But the rate of increase of the real level of income provided by the basic state pension and SSP will be less than the rate of increase of earnings since the basic state pension will be constant in real terms. If the Minimum Income Guarantee is uprated in line with earnings, the gap between this and the starting level of pension income provided by the basic state pension and SSP will be slowly eroded over time. However, it will not be until 2130 that someone retiring onto the basic state pension and the SSP would also qualify for means-tested benefits at age 65. But indexation after retirement is also important. If the real levels of the basic state pension and SSP payments are held constant in real terms after retirement, it will be a lot sooner than this that pensioners receiving the basic state pension and SSP will become eligible for the Minimum Income Guarantee at some point during their retirement.

with a secondary state pension of which part will have accrued at the SERPS accrual rate and part at the SSP accrual rates.

Some idea of the impact of the long transition period is shown in Table 5.3. This shows the level of state pension received by people with different levels of lifetime earnings who reach 65 during the transition period after 40 years of work. It assumes that someone reaching 65 in 2010 will have contributed to SERPS for 32 years from age 25 to age 56 (inclusive) and to SSP for eight years. Someone retiring in 2020 will have 22 years of contributions to SERPS and 18 years of contributions to SSP, and so on. By 2050, each generation of retirers will have 40 years of contributions under SSP. Until then, however, the greater the number of years of SERPS contributions and the lower the level of an individual's lifetime earnings, the lower the level of their secondary state pension and the more likely they are to be eligible for the Minimum Income Guarantee. People reaching 65 in 2010 who have earned £5,000 a year will be eligible for the Minimum Income Guarantee as soon as they retire. Assuming that state pensions are constant in real terms after retirement[47] and that the Minimum Income Guarantee is uprated in line with real earnings growth, people earning £9,000 will be eligible for means-tested benefits by age 73. This will reduce the incentive to work and save for retirement for people on low incomes. Table 5.3 also shows that this problem is not solved completely when the first generation of people reach retirement with a lifetime of contributions to SSP Mark 2. They will become eligible for the Minimum Income Guarantee at age 75, assuming it continues to be uprated in line with earnings and assuming real earnings growth of 1.5 per cent a year.

[47]SERPS payments are currently uprated only in line with prices after retirement and presumably the same will apply to SSP.

6. Stakeholder Pensions

The third proposed reform in *Partnership in Pensions* is the introduction of Stakeholder Pensions in April 2001. Targeted at full-time workers earning between £9,000 and £18,500 a year who do not already have a private pension, Stakeholder Pensions are intended to increase the level of private pension provision among this group. People who already have occupational and private pension schemes will not be encouraged to switch to Stakeholder Pension schemes. The government wants people to join occupational pension schemes offered by their employers where these are provided, but not all employers run occupational pension schemes. The alternative is a personal pension, but these are seen as unsuitable for many middle earners, largely because of their high up-front charges. Stakeholder Pensions will offer a 'low cost, flexible and secure' alternative.[48] This section discusses some of the key features of Stakeholder Pensions set out in the consultation document. Many of the proposals are sensible — so sensible, in fact, that a lot of them could be applied to all private pensions. What is less clear is that the proposals constitute a genuinely new type of pension. Many of the changes could be made within the existing structure of occupational and personal pensions with the same end result, and probably with less costly confusion. A separate issue, considered in Section 6.3, is who constitutes the target group for Stakeholder Pensions. The government has defined the target group as full-time workers earning between £9,000 and £18,500 who do not have a private pension. We present evidence from the British Household Panel Survey on the earnings and employment patterns of this group, as well as on their level of pension provision and other savings, and ask whether there is any evidence that the government is right in targeting them for increased pension saving.

6.1 What are Stakeholder Pensions?

Like all personal pensions, and some occupational pension schemes, Stakeholder Pensions will be defined contribution schemes. Stakeholder Pensions will differ from personal pensions, however, in having compulsory minimum standards, a different governance structure, guaranteed workplace access and a simpler taxation structure.

Compulsory minimum standards: Standards will govern the maximum level of charges that can be levied (and set these as a proportion of the total funds or contributions, not as a lump sum) and the permitted level for minimum contributions. Standards will also be set to ensure that individuals are allowed to stop and restart contributions without penalty and to transfer funds to and from other schemes without penalty. Finally, Stakeholder Pensions will be required to provide annual information to pension holders about the value of pensions, contributions and charges.

Governance structure: Stakeholder Pensions will be required to have an approved governance structure. Initially this will follow that of occupational pension schemes which are established under trust law and run by a board of trustees. The purpose of the trustees will be to ensure compliance with the minimum standards and to run Stakeholder Pensions in the interests of their members.

[48]Department of Social Security, 1998a.

Table 6.1. The tax-free limits on Stakeholder Pensions and personal pensions

Age at start of tax year	Maximum contribution to personal pension as % of earnings	Implied annual gross earnings if £3,600 is maximum contribution
35 or less	17.5%	£20,571
36–45	20%	£18,000
46–50	25%	£14,400
51–55	30%	£12,000
56–60	35%	£10,286
61–74	40%	£9,000

Guaranteed workplace access: Employers who do not offer occupational pensions will be required to nominate a Stakeholder Pension provider, after consultation with employees, provide employees with information on Stakeholder Pensions and channel employees' contributions to the nominated pension provider.

Simpler taxation structure: The tax treatment of Stakeholder Pensions will be similar to that of personal pensions. Voluntary contributions made into Stakeholder Pensions will be tax-free, while withdrawals will be subject to tax, with the exception of a tax-free lump sum. However, the government is proposing to replace the current earnings- and age-related limits on the size of tax-free voluntary contributions into personal pensions with a single threshold on Stakeholder Pension contributions of £3,600 a year or 100 per cent of earnings, whichever is the lower. The advantage of having a single threshold is that it will reduce the need for schemes to check contributions against earnings for the majority of members. The disadvantage is that the single threshold will be worth a lot less than the current limits on tax-free contributions on personal pensions to high earners and to older workers, as shown in Table 6.1. The £3,600 limit is worth more than the current earnings-related limit on personal pensions for anyone younger than 36 earning less than £20,571 a year. But to someone aged 51–55, say, the level of earnings at which the £3,600 limit is worth as much as the current earnings-related limit is only £12,000. The problem with having two different tax regimes is that differences in the tax treatment of contributions, rather than any underlying differences between Stakeholder Pensions and personal pensions, will affect whether people take out a Stakeholder Pension or not. A further proposed simplification to the tax treatment of contributions to Stakeholder Pensions is to allow scheme members who stop working to continue to contribute, with tax relief, up to the annual limit, for a period of up to five years, instead of the current system of carrying forward and back unused tax relief from one year to the next.

The government envisages that defined contribution occupational schemes can be designated as Stakeholder Pensions if they meet the other requirements. Personal pension schemes will also have the option of meeting the minimum standards and registering as Stakeholder Pensions with the appropriate governance structure. In addition, the government expects Stakeholder Pensions to develop along three lines — those based on representative and membership organisations (such as trade unions), those set up by financial service companies and those set up by employers.

Neither employees nor employers will be compelled to contribute to a Stakeholder Pension. The government has promised a small 'carrot' in the form of additional National Insurance rebates, although these may simply reflect the higher level of benefits

forgone by middle earners contracting out of SSP in the short term (compared with current SERPS pensions). To avoid encouraging anyone to switch out of existing occupational and personal pension schemes, these additional NI rebates will also be offered to people earning less than £18,500 who are already in private schemes. In the longer term, should SSP become a flat-rate pension, the 'carrot' will be supplemented with a 'stick'. People earning above £9,000 will continue to receive earnings-related rebates if they contract out of SSP, but if they remain in SSP, they will only qualify for the same rate of SSP as someone earning £9,000, despite the fact that they will have to make higher NI contributions.

In addition to this 'carrot' and 'stick' approach, the government is aiming to increase the level of private pension provision among middle earners both by a process of education and by creating, in Stakeholder Pensions, a savings vehicle that will be more attractive than personal pensions. Among the key problems that make personal pensions unsuitable for some middle earners, the government has focused on the costs and charging structures of personal pension schemes.

In theory, competition between pension providers for customers should keep costs down. But people may not have enough information (because obtaining information may be costly, for example) to make comparisons between complex pension products — and charging structures — offered by different pension providers. This would allow uncompetitive pension providers to stay in business and tend to reduce the downward pressure on costs and charges. Also, individuals may not be able to monitor pension providers effectively because the level of noise created by genuine fluctuation in asset prices may disguise pension providers' underlying performance. In addition, once individuals have taken out a personal pension, they may have little power relative to pension providers, since high up-front charges make changing pension provider costly and may tie individuals to underperforming pension providers. In the long term, poor performers will lose a flow of new customers and may go out of business, but for the medium term they will retain their stock of existing customers which will tend to reduce cost-cutting pressure.

The government's proposals go some way in addressing these possible market failures. Compulsory minimum standards will mean a greater degree of uniformity between Stakeholder Pensions offered by different pension providers. This will create a greater degree of transparency in the charging structures offered by different pension providers and make it easier for consumers to shop around, increasing the downward pressure on costs. Benchmarking will have a second effect on costs. By making all pension providers offer a relatively uniform product, there will be less need for individuals to have independent financial advice before taking out a Stakeholder Pension. Of course, a benchmarked product may not be suited to everyone — but, as with the new Individual Savings Account, it could exist alongside a range of non-benchmarked products.

The government argues that guaranteed workplace access should also reduce costs in a number of ways. First, it should cut down on costly advertising and marketing activity. Second, employers should have greater bargaining power than individuals in setting up pensions and should be able to secure a better deal for their employees — assuming they have the best interests of their employees at heart. Third, the fact that employers can

channel the contributions from a number of employees to a single pension provider will cut down on administration costs. But in the longer term, job turnover will mean that a single employer has employees with Stakeholder Pensions with different providers (as well as employees with personal pension plans). This makes the task of employers in passing on pension contributions more complex unless the government succeeds in its long-term aim of establishing a clearing-house for all Stakeholder Pension contributions. Finally, there is evidence from the US that workplace access to private pensions and, in particular, the provision of information on pensions by employers can have an additional positive effect on individual contribution levels (see Bernheim and Garrett (1996)).

One argument for each Stakeholder Pension having a board of trustees has to do with effective monitoring. Measuring the underlying investment performance of pension providers is relatively complex and time-consuming, and may be made harder by the 'noise' generated by genuine fluctuations in asset prices. A board of trustees, it may be argued, will have more time and more information to be able to monitor pension providers more effectively and to ensure that pensions are run in the best interests of their members. However, this relies on finding enough good, qualified trustees who will genuinely have the interests of individual members of pension schemes at heart. If not, the establishment of a board of trustees simply shifts the location of the monitoring problem from the pension providers to the trustees themselves. If the problem is one of a lack of adequate information, then requiring pension providers to provide clear annual statements of performance may go some way to rectifying the problem. In addition, ensuring that pension holders can transfer their funds between different pension plans without penalty means that individuals are no longer tied to a single provider and this will increase the competitive pressure on performance as well as charging structures.

What this discussion is intended to highlight is that many aspects of the government's proposals are sensible. Benchmarking simple defined contribution schemes should facilitate comparability between different pension providers and increase the downward competitive pressure on charges. Greater workplace access could reduce the administration costs. More information should help people make better choices about their pension provision. What is less clear is that these changes constitute a genuinely new type of pension. The same end results could be achieved by reforms to existing defined contribution schemes — particularly since, with the increase in competition, especially from direct sales of personal pensions, 'best-practice' rates of charges have already fallen sharply. It would be straightforward for the Department of Social Security to benchmark personal pension charges and, as with the Individual Savings Account, a benchmarked defined contribution pension scheme could exist alongside a range of non-benchmarked products.[49] Stakeholder Pensions will be clearly distinguishable from existing personal pension schemes if they are required to have a different governance structure. But, as we have argued, the case for requiring Stakeholder Pensions to have a board of trustees is not a particularly strong one. Moreover, the launch of Stakeholder Pensions as a new type of pension scheme is likely to have costs. It adds an additional layer of complexity to an already complicated system of pension provision while, in the

[49] There may have been a feeling at the time of the introduction of personal pensions after the 1986 legislation that excessive regulation would hinder the development of the market. With the benefit of hindsight, this view was probably mistaken.

short term, pension providers are likely to engage in costly marketing and advertising activity. There is a danger that increased variety of fairly similar retirement saving vehicles will lead to 'fads' and unnecessary and suboptimal switching between pension types. In this context, the apparent ambiguity over whether Stakeholder Pensions are designed to complement, or substitute for, personal pensions is a cause of some concern.

6.2 Lifetime Individual Savings Accounts

Some indication of a more integrated approach to Stakeholder Pensions and existing defined contribution schemes came with the recent publication of a consultation document on pension investment.[50] This proposed a new financial instrument for pension investment — a tax-privileged container into which to place units in pooled investment schemes, including authorised unit trusts (AUTs), open-ended investment companies (OEICs) and investment trust companies (ITCs). It is proposed that this new instrument — unofficially dubbed the Lifetime Individual Savings Account (LISA) — could be used for any defined contribution scheme, including both personal pensions and Stakeholder Pensions.

Currently, most personal pensions (with the exception of Self-Invested Personal Pensions) take the form of life insurance policies which pool funds from different scheme members. A move to LISAs would mean individuals having their own personal fund invested in pooled investment products. This is seen as having two main advantages. First, there would be greater transparency in the funds' performance since the prices of such products are published usually daily. Second, the charging structure on managing pooled investment products typically involves a fee that is a proportion of the total managed funds, rather than the up-front charges of insurance-based products. Finally, having a single instrument that can encompass occupational, personal and Stakeholder Pensions creates greater flexibility in the pension provision.

One problem is that it is difficult to see why many basic-rate taxpayers would prefer to make additional voluntary contributions into a Stakeholder Pension that was invested in this way rather than saving money through an Individual Savings Account (ISA).[51] People can invest in similar products through the ISA, and the annual contribution limits are higher for an ISA than they are for the Stakeholder Pension — £5,000 for an ISA compared with £3,600 for a Stakeholder Pension. The main advantage of an ISA is that the money can be taken out in the short term if needed, whereas money invested in a LISA cannot be accessed before retirement. With this in mind, the government has proposed that people can use an ISA as a feeder account for a LISA, then, when they are ready to tie up the money for their retirement, simply 'replace the ISA wrapper with a pension wrapper'.[52] However, since the tax treatments of ISAs and LISAs are different, this may not be at all straightforward in practice. Money invested in an ISA comes out of taxed income; if it is subsequently transferred into a Stakeholder Pension, it could be

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[50]HM Treasury, 1999.

[51]Higher-rate taxpayers may prefer to opt for saving through a pension since the fact that contributions are tax-free gives them the opportunity to engage in tax-rate smoothing and reduce their overall tax burden.

[52]HM Treasury, 1999.

problematic for a taxpayer to claim back tax relief on the money that they originally paid into an ISA.

6.3 Who are Stakeholder Pensions targeted at?

The government is targeting Stakeholder Pensions at full-time workers earning between £9,000 and £18,500 a year who do not currently have a private pension.[53] Here we present some evidence on the characteristics of this target group. How many people in this earnings band do not have a private pension? Among those who do not have a private pension, do they typically have stable employment and earnings? Do they typically have any additional savings? If there are individuals with stable employment who earn between £9,000 and £18,500 each year and who have some other savings but no private pension, it may be reasonable to assume that one of the reasons that they do not currently have a pension is that there is not an appropriate pension vehicle. In this case, the reforms proposed by the government, if they can overcome some of the current problems associated with personal pensions, will be meeting a genuine need. But if members of the government's target group do not typically have stable employment and if they do not have significant other savings, it is not at all clear that they could — or indeed should — be saving more in a pension.

To address these issues, we use data from four waves of the British Household Panel Survey from 1992 to 1995. This allows us to look at the dynamics of employment and earnings over time — albeit a relatively short period of time. Table 6.2 compares levels of private pension coverage among those who are employed full-time in at least one of the four waves, by their earnings when they are working. We split the sample according to the earnings thresholds set out by the government for SSP and Stakeholder Pensions. For the time being, we define the target group for Stakeholder Pensions as those who earned between £9,000 and £18,500 at least once during the period. The level of private

Table 6.2. Second-tier pension coverage, by earnings: full-time employees

	< £9,000 throughout[a]	Stakeholder Pension target group: £9,000–£18,500 at least once	> £18,500 throughout	Other
% of sample	20%	42%	19%	18%
No private pension	64%	16%	3%	40%
Occupational pension	17%	41%	55%	20%
Personal pen., no extra contribs	6%	7%	4%	12%
Personal pen., extra contribs	8%	14%	6%	13%
OP + PP	6%	22%	32%	16%
Total	*100%*	*100%*	*100%*	*100%*
No. of observations	766	1,622	742	707

[a]Including periods spent unemployed.

Source: British Household Panel Survey, 1992–95.

[53]Department of Social Security, 1998a.

Table 6.3. Second-tier pension coverage among Stakeholder Pension target group (all those earning £9,000–£18,500 at least once)

	Earned £9,000–£18,500 throughout	Earned less than £9,000 at least once	Earned more than £18,500 at least once	Unemployed at least once
% of sample	38%	16%	26%	20%
No private pension	11%	23%	5%	35%
Occupational pension	39%	34%	50%	38%
Personal pen., no extra contribs	7%	8%	7%	6%
Personal pen., extra contribs	18%	16%	12%	11%
OP + PP	25%	20%	27%	10%
Total	*100%*	*100%*	*100%*	*100%*
No. of observations	623	253	421	322

Note: We exclude three individuals who moved into self-employment.
Source: British Household Panel Survey, 1992–95.

pension coverage among those earning less than £9,000 throughout the period — those who will benefit most from SSP — is low. Also, as the consultation document correctly asserts, those who are earning more than £18,500 already have a high level of private pension provision: only 3 per cent of this group have no private pension.

What may be more surprising is that, among full-time employees with the target level of earnings for Stakeholder Pensions at least once over the period, the level of coverage of private pensions is already fairly high. Only 16 per cent have no private pensions, although a further 7 per cent have a personal pension but are making no additional contributions. As Table 6.3 shows, if we focus only on the group of full-time employees with earnings between £9,000 and £18,500 with stable earnings and employment (i.e. on those who were employed and earned between £9,000 and £18,500 across the entire period), the level of private pension coverage increases. Of this group, 11 per cent have no private pension, while a further 7 per cent have a personal pension but are making no additional contributions. Among those who fall into the Stakeholder Pension target range of earnings at least once over the period, but also earned below £9,000 at least once or were also unemployed at least once, the proportion without a private pension is higher. But it is harder to argue that these individuals belong in a genuine target group for Stakeholder Pensions. If they face greater employment and earnings instability then, if they do save, they are more likely to want to save in a relatively liquid form and not tie up their savings in a pension.

Table 6.4 summarises the characteristics of the government's proposed targets for the new Stakeholder Pension. First, we consider a broadly defined target group comprised of those who earn £9,000–£18,500 at least once during the four-year period and either have no private pension or have a personal pension into which they make no additional contributions. Compared with the group of all full-time employees who earn £9,000–£18,500 at least once, those with no additional private pension coverage are more likely to be aged less than 30. They are also more likely to have a less stable earnings profile across the four-year period and to be unemployed at least once during the period. Also,

Table 6.4. Characteristics of Stakeholder Pension target group

	Earned £9,000–£18,500 at least once — and no private pension or no additional contributions	Earned £9,000–£18,500 throughout — and no private pension or no additional contributions	All who earned £9,000–£18,500 at least once
% who are men	48%	54%	49%
% aged 20–29	39%	31%	35%
% aged 30–39	27%	25%	28%
% aged 40–49	20%	27%	24%
% aged 50–59	14%	17%	13%
% earning £9,000–£18,500 throughout	30%	100%	38%
% earning <£9,000 at least once	20%		16%
% earning >£18,500 at least once	13%		26%
% unemployed at least once	36%		20%
% with no savings	34%	27%	24%
% with interest-bearing account (IBA) only	36%	33%	36%
% with IBA plus investments	24%	31%	32%
% with investments only	6%	9%	8%
No. of observations	369	110	1,622

Source: British Household Panel Survey, 1992–95.

they are less likely to have any other savings, defined as an interest-bearing account or investments.[54]

In fact, given these characteristics, it is not clear that these people are genuine targets for more pension saving. People with less stable earnings and employment profiles are more likely to want to hold some liquid assets as precautionary balances against periods when their income is low. The fact that many of these people have no other savings at all may make it more sensible for them to begin to save in a liquid form, such as an Individual Savings Account, rather than tying up money in a pension. More genuine targets for increased pension saving are those who earn between £9,000 and £18,500 who have stable employment and earnings over the four-year period but have no additional private pension coverage. The characteristics of members of this group are also summarised in Table 6.4. The first point to make is that this group is relatively small – only around 7 per cent of all those who earned between £9,000 and £18,500 at any point. Moreover, on average, the members of this group tend to be slightly older and may have less time to build up adequate secondary pension coverage.

[54]Investments include any one of the following: National Savings Certificate, Premium Bonds, unit trust, PEP, stocks and shares, Investment Bond.

7. Conclusions

The government has described the proposed measures in *Partnership in Pensions* as a 'radical reform of the whole pension system'.[55] There are three key elements:

- a means-tested Minimum Income Guarantee (MIG) for poorer pensioners;
- a State Second Pension (SSP), to replace SERPS, targeted at people earning between the lower earnings limit (£3,432 from April 1999) and £9,000; and
- Stakeholder Pensions, a 'low cost, secure and flexible'[56] alternative to personal pensions for people earning between £9,000 and £18,500.

Broadly, the changes fit with the common thrust of the majority of reforms to the pension system over the past 20 years, which has been to widen coverage of secondary private pension provision. But there are some important new departures:

- The Minimum Income Guarantee commits the government (albeit loosely) to real increases in the future level of income provided by the state to poorer pensioners.
- The State Second Pension represents the first proposed real increase in the generosity of state secondary pensions for more than 20 years. In the shorter term, all earners will be better off. In the longer term, only lower earners will benefit. There will, however, be a long transition period from SERPS to SSP and the full benefits of SSP to lower earners will not be felt until the middle of the next century. This will mean that many lower earners will continue to receive means-tested benefits in retirement.
- In the longer term, should SSP become a flat-rate pension, it will mean the end of any relation between state pensions and earnings.
- The proposed framework for Stakeholder Pensions has many sensible features, including benchmarking, increased workplace access and greater information. But the same end result could fairly easily have been achieved by simple changes to existing defined contribution schemes. Moreover, there is a danger that launching Stakeholder Pensions as a new type of pension will cause costly confusion as well as possibly resulting in individuals suboptimally switching from occupational and personal pension schemes.

The Minimum Income Guarantee

- The government's long-term commitment to indexing the Minimum Income Guarantee in line with earnings ensures that poorer pensioners will benefit from economic growth. It is less clear that this will happen in the short term, however, when uprating will only occur as 'resources allow'.[57]

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[55]Department of Social Security, 1998a.

[56]Department of Social Security, 1998a.

[57]Department of Social Security, 1998a.

- As successive cohorts retire with higher levels of private pension income and SSP, the number of pensioners eligible for means-tested benefits is likely to fall. Within each generation of pensioners, however, the number eligible for means-tested benefits is likely to increase over time if their pensions remain constant in real terms while the real level of MIG increases.

- The government is using the MIG as a way of targeting resources at the neediest pensioners. However, it is right to look at ways of addressing the problem of low take-up of means-tested benefits directly. Increasing their generosity and renaming income support may help but is unlikely to solve the problem completely.

- The government is consulting on the treatment of wealth in means-testing benefits. It does not make sense to eliminate the wealth test altogether since this would act as a disincentive for people to annuitise their wealth. But it does make sense to raise the current capital thresholds as the generosity of the Minimum Income Guarantee increases. The government could also consider varying the wealth thresholds with age.

The State Second Pension

- The initial effect of the State Second Pension will be to increase the generosity of secondary state pensions for the first time since 1978, particularly for low earners. Women will be the main beneficiaries: around one-fifth of workers earn between the lower earnings limit and £9,000, and women comprise 80 per cent of them. Predominantly women will also benefit from the introduction of credits to SSP for periods spent out of the labour market caring for others.

- The design of SSP is an attempt to deal with the disincentive effects of more-generous means-tested benefits by increasing the pension entitlements of low earners who work and save for retirement. The problem is that giving adequate pension entitlements to low earners is costly. The government has sought to reduce the cost by not applying SSP accrual rates retrospectively. This results in a lengthy transition period from SERPS to SSP and means the full benefits of SSP will not be felt until the middle of the next century.

- Once Stakeholder Pensions have been established, the government expects that everyone earning more than £9,000 a year will contract out of SSP into a private pension. At this stage, the government proposes that SSP will become a flat-rate pension paid only to lower earners. Once this happens, there will no longer be any link between state pensions and earnings. Whether the transition occurs depends crucially on how successful Stakeholder Pensions are at increasing the level of private pension provision among middle earners.

Stakeholder Pensions

- Many of the ideas behind stakeholder pensions are welcome. These include regulating the maximum level of charges and the minimum level of contributions, allowing individuals to switch between different schemes without penalty, increasing available information and having workplace access.

- A single £3,600-a-year limit for contributions to Stakeholder Pensions may reduce administration costs since pension funds will not have to check people's contributions against their earnings. But the existing limits on the amount of tax-free additional contributions to personal pension schemes are more generous than £3,600 for many older workers.

- The relationship between Stakeholder Pensions and existing defined contribution schemes is unclear. Stakeholder Pensions are similar to many existing defined contribution schemes, particularly given recent changes in personal pension provision and increased direct sales of personal pensions. Given this, simple reforms to existing defined contribution schemes could have achieved the same results. For example, as with the new Individual Savings Account, a benchmarked defined contribution scheme could have existed alongside other defined contribution schemes.

- Moreover, launching Stakeholder Pensions as a new type of pension may have real costs. It will add further complexity to the current system, there is likely to be a lot of expensive marketing and advertising, and there is a danger of suboptimal switching from existing pension schemes.

- The target group for Stakeholder Pensions is not as clearly defined in practice as it is in the government's consultation document. Evidence from the British Household Panel Survey shows that the majority of full-time employees earning between £9,000 and £18,500 already have a private pension. For many of those who have already taken out a personal pension, it may be unwise to switch to a Stakeholder Pension if they have paid up-front charges, even if a Stakeholder Pension would have been a better choice in the first place.

- We show that those earning between £9,000 and £18,500 who do not have a private pension are more likely to have unstable employment and earnings. If they do take out a private pension, they will certainly benefit from greater flexibility in private pension provision. However, there are some people whose earnings fluctuate a lot, particularly those who take time out of the labour market because of caring responsibilities, who may be better off under SSP than with a private pension unless the government continues to make a contribution into their pension fund as an alternative to credits for SSP.

- We also show that those earning between £9,000 and £18,500 who do not have a private pension are less likely to have any other savings than those who do have a private pension. Given that they also have less stable employment patterns, it is likely that they will want to hold any savings in a more liquid form than a pension. This means that they may be more appropriate targets for the Individual Savings Account rather than Stakeholder Pensions.

- A more integrated approach to Stakeholder Pensions, existing defined contribution schemes and Individual Savings Accounts (ISAs) can be found in recent proposals for what have unofficially been dubbed Lifetime Individual Savings Accounts (LISAs).[58]

[58]HM Treasury, 1999.

The proposed LISA is a tax-privileged container for units in pooled investment schemes, which could be used for any defined contribution scheme, including both personal pensions and Stakeholder Pensions. Furthermore, the government has proposed that people can use an ISA as a feeder account for a LISA. This sounds a sensible direction for reform, but it will have to be thought through very carefully since the differential tax treatment of ISAs and pension saving could make transfers between ISAs and LISAs very complex. Any money transferred from an ISA will have been invested out of taxed income and hence should not be taxed on withdrawal from a Stakeholder Pension. Either that, or a way will have to be found for people to claim tax relief on money transferred into a LISA from an ISA.

Appendix A. The reform process from Beveridge to the present day

The original Beveridge scheme, 1948–60

The original Beveridge scheme was based on a system of flat-rate contributions being paid in order to qualify for a flat-rate level of benefit. The basic state pension was originally set at £1.30 a week — equivalent to about 14 per cent of average earnings. As long as sufficient contributions had been paid, this could be received from the age of 65 for men and 60 for women. The scheme was designed to be financed on a pay-as-you-go basis from the contributions being made by the working population. Additional revenue from general taxation was used to pay pensions to older generations who had not made sufficient contributions. This contributory social security system operated alongside a system of benefits to ensure that the incomes of those with insufficient National Insurance contributions were not below a minimum standard of living. This universal means-tested benefit, originally known as national assistance, was set below the flat-rate pension, at £1.20 a week in 1948.[59]

In practice, however, the generosity of the basic state pension and national assistance was increased on a rather *ad-hoc* basis. For example, between 1951 and 1954, the level of national assistance was actually higher than that of the pension. Since national assistance was not claimed by all those who were eligible, some pensioners were reliant on just the basic state pension — below the subsistence level of income.

Increased state and private second-tier provision, 1960–80

Since the state was providing a relatively low level of retirement income, with the basic state pension in 1960 at around 15 per cent of average earnings, it is not surprising that it did not fully 'crowd out' the private provision that existed pre-1946. This was mainly in the form of employer-provided occupational pension schemes which were typically linked to final earnings. Those who were not members of an occupational scheme and were unable to save for retirement in other forms, mainly due to low incomes during their working lives, were left reliant on the state. During the 1970s, growing numbers were in this situation as a result of both rising unemployment and reluctance by employers to increase coverage of occupational schemes. In an attempt to address these factors, the following reforms were introduced in 1975:

- The basic state pension was to be increased in line with the greater of the growth in prices or earnings. In addition, those who were not working due to sickness, unemployment or looking after a dependant were 'credited' with contributions. These had the impact of substantially increasing not only the future generosity of the benefit but also the levels of eligibility, particularly amongst women.

- A compulsory second tier of pension provision was introduced. All those with earnings above a certain floor had to contribute to the State Earnings-Related Pension Scheme (SERPS) unless they were a member of an occupational scheme that

[59]Source: *Social Security Statistics 1983.*

guaranteed at least the same pension as SERPS.[60] In return for 'opting out' of their SERPS entitlement, those with occupational pensions paid a reduced rate of National Insurance.

The increase in coverage and generosity of the basic state pension coupled with the introduction of a substantial compulsory second tier would have certainly, if left unchanged, ensured that the vast majority of pensioners were not left on subsistence levels of income. However, at least partly in response to the future expected cost of these pension commitments, the next two decades saw reforms that substantially reduced the future costs and hence generosity of state pension provision. These were coupled with further encouragement for individuals to make increased private provision.

Reduction in the level of state provision, 1980 to the present day

The indexation of the basic state pension to earnings only lasted until 1982, when it was formally indexed to prices. While it was worth around 20 per cent of average earnings at the start of the 1980s, this has fallen to around 15 per cent today, due to the high level of real earnings growth experienced by the UK over this period. In addition, both the floor and the ceiling that were used to calculate SERPS entitlements were indexed to prices, which also had the effect of reducing the generosity of future payments.

Further substantial reforms followed. Three reforms to SERPS contained in the Social Security Act of 1986 halved its future generosity. First, entitlements are now based on earnings averaged over an individual's entire lifetime rather than from the best 20 years. Second, SERPS now pays 20 per cent, not 25 per cent, of this average earnings level. Third, the amount that was inherited by a surviving widow was reduced from 100 per cent to 50 per cent of the deceased partner's entitlement. Perhaps even more important than the cost-saving changes to the SERPS calculation was extending the right to 'opt out' to those with a defined contribution scheme. In return for this, the government paid a National Insurance rebate direct into the fund. Individuals could then make additional contributions which were encouraged by the state by allowing them to be made tax-free, up to a certain proportion of earnings.

Yet more reforms followed soon after, again with a major impact on the future costs of the state pension scheme. The most obvious of these is the equalisation of the retirement age for both men and women at 65, which will have a phased introduction between 2010 and 2020. In addition, another, more complex, change was made to the SERPS formula.[61] The combination of these two reforms has again halved the future expected costs of SERPS when it matures in 2040.

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[60]This is known as the Guaranteed Minimum Pension (GMP).

[61]Instead of the LEL in the year prior to retirement being subtracted from the individual's entitlement, the LEL in each year is subtracted. This reduces future expenditures because the value of the LEL relative to average earnings will fall over time since it is indexed to prices. For a more complete description, see Disney (1996).

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