A new contract for welfare: partnership in pensions[1]

Deborah Cooper

The government's Green Paper proposes reducing state pension costs whilst encouraging private sector provision. The success of the proposed 'stakeholder pension schemes' depends on regulation. However, regulation can penalise those it is intended to protect. This is a sensitive issue, since stakeholder pension schemes are expected to attract financially vulnerable, lower paid, employees. Whilst the flat rate accrual of the state second pension confers some benefit, certain groups are put in a difficult position by the retention of means-tested benefits.

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Introduction

The Green Paper, *A New Contract for Welfare: Partnership in Pensions*, aims to provide a 'new insurance contract for pensions.' It is important that both parties to a contract understand what is at stake. This paper attempts to evaluate the Green Paper proposals from the point of view of the recipients of government policy.

The minimum income guarantee and the state second pension

State pension provision for employees in the UK comprises a flat rate basic state pension (BSP) and an earnings-related pension. The government proposes that the state earnings-related pension (SERPS) be replaced by the state second pension (SSP). The SSP will provide accrual of up to 40% of earnings between the lower earnings limit (currently £3,224 p.a.) and £9,000, 10% of earnings between £9,000 and £18,500, and 20% of earnings between £18,500 and the upper earnings limit (currently £24,180 p.a.). The maximum accrual will require a 'full working lifetime' of 49 years. SERPS provides a pension of up to 20% of 'relevant earnings,' that is, earnings between the lower earnings limit (LEL) and the upper earnings limit (UEL). The full SERPS can be accrued after 40 years' work.

In addition, there is to be a minimum income guarantee (MIG) for pensioners, set at £3,900 per annum. The MIG will be means tested, and the government hopes to increase it in line with earnings. It will replace the current system of income support: approximately 1.7 million pensioners are dependent on income support,[2] although it is likely that substantially more are eligible.

The poorest pensioners are the oldest and, in particular, elderly widows. The differences in income between young and old pensioners can be partly explained by inadequate pension indexation, but the growth of occupational pension coverage in the 1970s is also significant. This suggests that increased private provision could reduce poverty in retirement. How does the Green Paper set out to achieve this?

Those earning in excess of £9,000 per annum are to be encouraged to contract out of the proposed SSP by increasing the contracted-out rebate.[3] It is envisaged that at some point the SSP will cease to be earnings related, instead accruing to 40% of £9,000 less the LEL. The contracted-out rebate for money purchase pension schemes under the present regime is age related, increasing from 3.1% of relevant earnings to 9% at age 64. At this level of rebate, an individual starting a working life with earnings of £12,000 could accumulate a fund sufficient to provide a pension of about 130% of the SSP (assuming it did not become flat rate). This looks very promising.[4] However, the calculation assumes someone is in employment throughout the full working lifetime of 49 years. Only a small minority of individuals can expect to be in work for this period of time, so it is important to consider more common working lifetimes.

The average time spent unemployed is approximately 17% of a working lifetime.[5] For a working lifetime of 49 years, this equates to 8½ years. Those aged less than 25 and older than 50 have higher rates of economic inactivity than average and, particularly at younger ages, are unlikely to be in categories entitled to 'working credits.'[6] We shall consider the position of employees who complete a 40-year working lifetime, as well as working patterns that do not achieve this 'average.' These illustrate the position of people who start employment late, perhaps due to time spent in higher education; who take breaks from work, perhaps due to family responsibilities; or who are in temporary employment that follows a cyclical pattern, with periods of employment regularly interspersed with unemployment.[7] For comparison, calculations have been performed assuming the earnings-related part of the SSP continues in existence. Eligibility for working credit has been ignored.

Using the current levels of contracted-out rebate, the accumulated value of the rebate would, in most cases, be sufficient to purchase a pension in excess of the SSP. However, only those with the equivalent of more than 35 years' full-time paid employment would be able to accumulate a fund sufficient to purchase a pension that, together with the basic state pension (BSP), is greater than the MIG. Indeed, the individual with a 'cyclical' working history, and a starting salary of £12,000, would have to make extra contributions in the order of 8% of salary in order to accumulate assets sufficient to purchase a pension in excess of the MIG. Someone who defers starting work for five years, say, and then starts on a salary of £12,000 would have to save over 2% of his or her salary throughout the working lifetime before the total pension (from BSP, earnings-related SSP and stakeholder pension) exceeded the MIG. If someone contracts out of the SSP, the percentage drops to about 0.5% of salary: however, whilst the amount of contribution required appears to fall, the risk accepted by the individual increases, since a defined benefit (the SSP) is replaced with a money-purchase

benefit (the pension purchased by the accumulated contracted-out rebates). In order to reduce the level of risk, the contribution required must be increased.

The contribution rates that enable certain types of employees to retire with a total pension greater than the MIG are shown in table 1. The disincentive to save increases faster than linearly as the level of starting salary falls.

These calculations are just individual illustrations, of course. However, it has been demonstrated that,[8] if means-tested benefits make up part of state policy towards retirement income, the result is a reduction in overall saving and an increased inequality of wealth amongst those in retirement.

Because the BSP is to continue increasing in line with prices, whilst it is proposed that 'over the longer term' the MIG will increase in line with earnings, with each new cohort of workers the position described in the above paragraphs will deteriorate. The government's intention is that 'People who work all their lives should not have to rely on means tested benefits when they retire.'[9] That might be the case with the first cohorts of workers to retire under the new regime, given favourable investment conditions. However, unless the BSP is uprated in line with earnings, or some other adjustment is made to the pension regime, increasing proportions of workers will again become dependent on means-tested benefits. For example, 'cyclical' employees starting their working life five years after those in table 1 on a salary equivalent in real terms to £12,000, would require a contribution of 7.7% of salary in order to beat the MIG, compared to 7.6%. This is an increase of 1.3%. Uprating the BSP in line with earnings would remove this inter-generational inequality, as well as improving the position of those with broken career paths.

Provision for those earning less than £9,000 a year

Those earning less than £9,000 per annum (in fact, those earning less than £12,000) will be better off under the new system, even when the SSP becomes flat rate. The flat accrual of 40% of £9,000 (in excess of the LEL) marks a step towards a degree of redistribution that SERPS does not provide.[10] However, in contrast with SERPS, which is being dismantled because of its perceived expense just as it matures, the interim SSP might have found itself under review in 40 years' time because it failed to deliver the dramatically improved benefit promised.

Table 1: Percentage of salary required to exceed MIG

	BSP + SSP		BSP + Rebate	
Starting salary	Late starter	Cyclical	Late starter	Cyclical
£9,000	3.5%	12.0%	2.2%	11.7%
£10,000	3.1%	10.7%	0.8%	9.7%
£12,000	2.2%	8.5%	0.2%	7.6%
£14,000	1.5%	7.0%	0.0%	6.1%
£18,000	0.4%	4.8%	0.0%	4.0%

Source: Author's calculations

Those earning (throughout their working lifetimes) between the LEL and £9,000 per annum will receive, on reaching state pension age, the BSP and the SSP. For those retiring in 49 years, these provide a pension just in excess of the MIG. However, because the BSP will only be increased in line with prices, time will erode the real (relative to earnings) value of the total accrued pension. Future generations of workers will be faced by the same problem the government claims it is trying to address today: having worked and paid national insurance throughout their working lifetime, they have to rely on means-tested state benefits in retirement. Figures 1 and 2 show the way in which the MIG encroaches on the value of the total state pension, assuming the proposed regime is now fully mature. Figure 1 considers those on a salary equal to the upper earnings limit (UEL), who accrue the maximum earnings-related SSP and receive the full BSP.

Figure 2 shows the position for those earning between the LEL and £9,000. The value of the pension is eroded less than the pension of the higher earner, relative to the MIG. This is because the £9,000 limit is assumed to increase in line with earnings, and so the value of the pension also increases partly in line with earnings, whereas the LEL and the UEL only increase in line with prices.

Had the earnings-related SSP been implemented 50 years ago, those retiring now, having earned at less than the equivalent of £9,000 throughout their 49-year working lifetime, would receive a pension of 145% of the MIG; those retiring in 50 years' time would receive only 124% of the MIG. A reduction of 15% over 50 years is perhaps not too significant when one considers that no recent state pension regime has survived a decade without adjustment. However, it seems obtuse to structure a pension system with built in, long-term, obsolescence.

Perhaps in recognition of this, the government proposes to close the earnings-related part of the SSP and, for those earning more than £9,000, replace it with saving in money-purchase pension schemes. It thus replaces a price-related rate of return with one linked to investment markets. If investment trends

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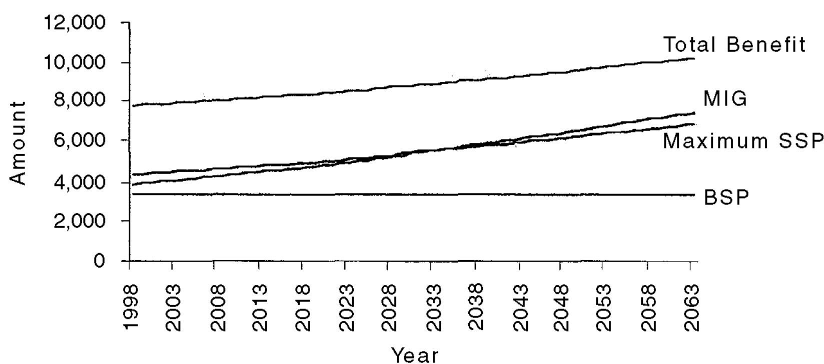

Figure 1: Interaction between different parts of proposed pension regime, for someone earning at or above the UEL

Source: Author's calculations

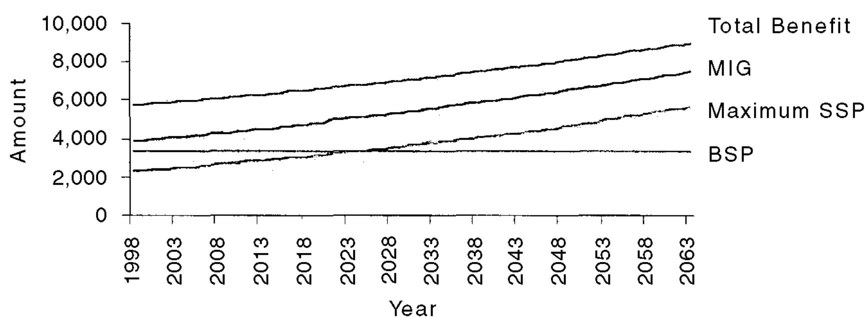

Figure 2: Interaction between different parts of proposed pension regime, for someone earning the equivalent of £9,000 or less

Source: Author's calculations

over the past 40 years continue, this should redress the erosion observed above. However, it also increases the risk involved in pension planning, particularly for those on lower earnings. The earnings distribution is highly skewed, with more than 50% of the workforce earning less than £18,500, so many people will be subject to this extra risk. How desirable the shift in responsibility for investment risk is, will depend on each individual's risk-reward trade off and the state of future investment markets.

Removal of the earnings-related SSP

The removal of the earnings-related SSP marks a significant reduction in the state's involvement in pension provision.

By 2050, when the proposed new scheme first matures, the BSP will be worth about 10% of average earnings (depending on growth in earnings and prices). Most of those earning over £9,000 will have been encouraged to contract out of the flat rate SSP, leaving a rump of the low paid in receipt of state pension. In the long run the real value of the BSP will become nugatory, and the significant benefit will be the 40% of earnings up to the equivalent of £9,000, provided by the SSP. Remarkably, 40% of £9,000 is £3,600 which is close to the present level of the BSP (£3,364). The result will be a flat rate pension, uprated in line with earnings, from which most of the working population will have contracted out.

Subsequent generations of those remaining in the scheme will see a gradual reduction in their standard of living in retirement, relative to previous generations. There is nothing new here for the low paid, having been most affected by the reduction in value of the BSP relative to average earnings. As a consequence, since the MIG is to be linked to earnings, over time increasing proportions of those reaching retirement will be forced to rely on means-tested benefits.

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Similarly, since the SSP (and BSP) will only increase in line with prices once in payment, as lower paid pensioners age they are likely to become increasingly dependent on means-tested benefits.

This leads one to question the nature of the 'contract' the government is proposing. It is apparently not a social contract, as it could lead to increased disparity of income and wealth amongst retired people and, for the first time since Beveridge, it appears to take a step back from universal coverage.

Stakeholder pension schemes

The government assumes that five years is sufficient time for a mechanism for providing pensions to 'establish itself.' The market for personal pension products has grown substantially since the 1988 Pensions Act, having absorbed a premium increase of 200%. However, it is still struggling for respectability. The government's hope must be that, because of restrictions placed on the flexibility of stakeholder pension schemes, they will become acceptable more quickly.

The proposals relevant to this discussion are that there will be:

1. a maximum level of charge;
2. a low minimum contribution;
3. freedom to stop and start contributions without penalty;
4. freedom to transfer the fund to another company without penalty; and
5. annual information.

Since the introduction of personal pension schemes, the level of expenses charged and the standard of administration has improved.[11] Even so, Mark Boleat, when Director General of the ABI, did not seem to feel his industry could justify charging expenses at a fixed percentage of the fund,[12] as recommended in the Green Paper (Chapter 7, paragraph 32). He believed this would involve cross-subsidies from higher to lower contributors, in which case insurance companies would target their marketing efforts at high earning consumers. These consumers are those most likely to use alternative pension provision to the stakeholder pension, thus gearing the coverage of the stakeholder pension to those on low earnings and raising administrative costs as a percentage of the fund.

Price control has not generally been an effective way of promoting the supply of a product. However, there are already personal pension schemes that meet most of the stakeholder criteria, with low minimum contributions, and no fixed charges. It is interesting to compare the present value of deductions under this regime with the alternative. A provider meeting the stakeholder criteria charges 4% of each contribution, with a management charge of 1%. An alternative provider charges 5% of each contribution, together with a fixed fee of £1.50 per month and a management charge of 0.5% of the fund per annum. Someone contributing the minimum £300 per annum would be worse off under the former arrangement after 23 years' contributions. After a 'full working lifetime' of 49 years, the former provider would have deducted over £600 (in present value terms) more than the latter. The larger the contribution, the sooner the former provider profits relative to the latter.

Points 2 to 5 above, whilst on the face of it desirable, are all likely to increase the costs of running a stakeholder scheme. In particular, individuals could choose to remain loyal to their stakeholder provider, and thus benefit from lower charges, if providers were allowed to impose withdrawal penalties. By removing this option, there is no incentive for investor loyalty, and all investors could be penalised because a few choose to change providers with gay abandon.

One can also argue that a charging structure that penalises withdrawal makes it expensive to move provider, reducing the incentive to provide a good service for existing investors. Each charging structure has positive and negative incentives for the provider, as well as the consumer: it seems inappropriate for the government to impose one over the other.

Turning to investment advice, Section 78 of Chapter 7 states 'We would … expect stakeholder pension schemes … to take steps to protect the value of members' funds as they approach retirement.' However, the purpose of money-purchase pension schemes is to provide an income stream in retirement, not a lump sum at a particular age. The problem of protecting the value of an income stream in retirement is different from and more complex than providing a lump sum. There is no empirical evidence to show that 'lifestyle' investment strategies, for example, provide a 'better' route to pension financing. Indeed, research has demonstrated that in the majority of cases investors would receive higher pensions, with lower downside risk, by investing solely in equities.[13] Thus, again, a restriction attempting to minimise cost by apparently reducing

the need for investment advice might result in penalising those it attempts to protect.

The expenditure of those employees in the lower half of the earnings distribution (those earning less than £17,000) is already at, or close to, its maximum. Each decile in the lower half of the earnings distribution has an average spend greater than 100% of the median pay for the decile.[14] Thus, encouraging those earning between £9,000 and £18,500 to contract out is likely to produce a proliferation of stakeholder pension schemes with only the contracted-out rebate invested. Individuals in this group are most vulnerable to the proposals in the Green Paper, since they lose the protection of a state earnings-related scheme and are least likely to have alternative provision.[15] Those at the lower end of this group have the most difficult decisions to make regarding contracting out, and the additional risks it entails (even when the choice of an earnings-related scheme is removed), and the difficulties in optimising lifetime earnings when some benefits are means tested. Even so, the government considers they are not in need of financial advice.

Assuming members of stakeholder pension schemes are allowed to take a lump sum, the optimum strategy at retirement could well be to take the maximum lump sum permitted. The level of retirement income provided by the member's own contributions would be reduced, but it could be supplemented with the means-tested MIG. This is common practice in Australia,[16] for example, where the state operates a means-tested old age pension, and employees are permitted to take 100% of their superannuation guarantee fund as a lump sum. The existence of the means test is therefore likely to create a disincentive to save for those with an intermittent working history, as well as distorting decisions about how to spend pension savings at retirement.

Similarly, those retiring with a stakeholder fund sufficient to purchase a pension just greater than the MIG will have a disincentive to purchase pensions that protect from inflation, since the increase will keep them just above the MIG net. If they purchase level pensions, they will have a higher income to start with. The extent to which its value would fall due to inflation will be mitigated by the MIG, which is expected to increase in line with salaries.

Because of the proposed maximum contribution (a fixed sum of £3,600 a year, or 100% of earnings, whichever is lower), stakeholder pension schemes are likely to be of most interest to those earning less than the UEL. This is the group least likely to be able to afford financial advice, which is why the government considers stakeholder pension schemes should be constructed in such a way as to limit its need. However, as we have seen, it is not necessarily the group least in need of advice, both at the point when contributions are made as well as when they approach retirement.

Simplicity

One of the criticisms of the present regime made in the Green Paper is that its beneficiaries lack trust in it, and its level of complication made it unacceptable.

The Green Paper proposes to introduce a more transparent regime of pension provision. In this respect the suggestion that annual benefit statements be provided, summarising both state and private pension provision is admirable. The more information investors have, the better able they should be to plan appropriately. However, because of the uncertainties of the investment and annuity markets, it will not be straightforward to devise an acceptable statement.

There are several other points at which the proposed system introduces additional complexity, which we just mention briefly here:

- the phased implementation of the Green Paper proposals;
- the introduction of an earnings-related SSP, and its subsequent replacement by a flat rate scheme;
- replacing defined benefits with money-purchase benefits;
- the criteria for determining that stakeholder schemes are successful;
- the different tax regime for stakeholder pension schemes;
- different rules for calculating working credits for the BSP and the SSP; and
- the interaction between different benefits, each increasing at different rates.

The complexity of the proposed system could be substantially reduced if there were no phased introduction.[17] Also, whilst the government feels that reintroducing earnings-related increases to the BSP would be too expensive, the proposed SSP is effectively a flat rate benefit that will be uprated in line with earnings. However, a large proportion of the working population is expected to contract out of the SSP. Individual decision-making would become much simpler if:

1. the same rate of indexation were used for all increases;

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2. there were no means test; and
3. individuals retained the choice of an earnings-related SSP.

Conclusion

The previous government made changes to the state pension that left the UK with a system that is widely regarded as manageable, in financial terms, despite the increase in the dependency ratio projected for the next 40 years. The present government proposes reducing pension costs further, whilst recognising that the state must provide some security for the low paid and those with intermittent working histories, since the private sector is not well placed to meet their needs. By introducing a flat rate of accrual for those earning between the LEL and £9,000, the government attempts to address this weakness. However, its solution is not without problems. By making the cut off for the SSP as low as £9,000, and by maintaining the prices link for the BSP, the government will not fully succeed in what it sets out to do.

The difficulties of encouraging private provision by those earning above £9,000 will be exacerbated by the means-tested MIG. A rational decision about whether or not to save, and at what level, must take into account all sources of income, including those that are means tested. Many working people can only expect to save enough to provide a pension at about the level of the MIG. They might be best advised not to save at all, which is hardly the government's intention.

The Green Paper recognises that the success of the government's proposals depends crucially on the success of stakeholder pension schemes and the value they offer to the lower paid. It proposes imposing certain restrictions, such as a particular charging structure and a limited need for investment advice, which it expects will help their development. However, whilst some regulation might be necessary to protect members of personal pension schemes, if it is too prescriptive the net effect might be to penalise those it is intended to protect. This is a particularly sensitive issue with the proposed stakeholder pension schemes, which will mostly attract lower paid employees, who are the most financially vulnerable group.

1. DSS (1998) *A New Contract for Welfare: Partnership in Pensions*, CM 4179, London: The Stationery Office.
2. Department of Social Security, *Social Security Statistics* (1997) London: The Stationery Office.
3. Green Paper, Chapter 6, para. 11.
4. The calculations throughout the paper assume 2% real investment growth per annum, net of expenses, and 1% real earnings growth. Different assumptions will, of course, give rise to different conclusions.
5. This estimate is based on data in *Labour Market Trends*, 1998, Vol. 106, No. 9, and *Labour Market Trends*, 1999, Vol. 107, No. 1. It is likely to be conservative as the data refer to those making an unemployment claim, and not all those out of work necessarily make such a claim.
6. Certain people, who are not in paid work, will be credited with accrual in the SSP.
7. For explanation, see D. R. Cooper (1997) 'Providing Pensions for UK Employees with Varied Working Histories', *Journal of Actuarial Practice*, Vol. 5.
8. J. Sefton, J. Dutta and M. Weale (1998) 'Pension Finance in a Calibrated Model of a Saving and Income Distribution for the UK', *National Institute Economic Review*, No. 166.
9. Green Paper, Chapter 4, para. 1.
10. Note that redistribution brings with it some disadvantages. As with any flat rate benefit, the rate of accrual for low earners might introduce distortions into individuals', and their employers', decisions. In particular, viewed from the bottom up, the marginal tax rate of those paid less than £9,000 will increase by 4.6% (the national insurance contribution), since no additional benefit is being accrued for each additional £1 earned, up to £9,000. This could affect the work/leisure decisions of those on low incomes, particularly bearing in mind that it would not affect their retirement income.
11. *Money Management* (1996 and 1997) London: Financial Times Magazines.
12. M. Boleat (1998) *Insurability and Welfare Risks*, presented at the Insurance and Welfare State Conference, IBC.
13. P. Booth and Y. Yakoubov (1998) *Investment Policy for Defined Contribution Pension Scheme Members Close to Retirement*, Actuarial Research Paper No. 110, City University.
14. ONS (1998) *Family Spending, a Report on the 1997–1998 Family Expenditure Survey*, London: The Stationery Office.
15. ONS (1998) *Living in Britain, Results from the 1996 General Household Survey*, London: The Stationery Office.
16. H. Bateman and J. Piggot (1999) 'Mandating Retirement Provision: The Australian Experience', *The Geneva Papers on Risk and Insurance*, Vol. 24.
17. See the Pension Provision Group's *Response to the Green Paper*, 1999, DSS.