

Implementing and communicating changes to the state system

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Chapter 6 set out our key recommendations: the creation of a National Pension Savings Scheme (NPSS) into which people are auto-enrolled; and an evolution of the state pension system to focus limited resources on the key objectives of poverty prevention and ensuring that means-testing does not spread as it would if current indexation arrangements were continued indefinitely.

It is important to start implementing these changes as soon as possible. As Chapter 1 stressed, there is no immediate crisis in average pensioner income levels today. But if policies and saving behaviour continue unchanged, pension provision will become increasingly inadequate and unequal over the medium-term (i.e. 10 to 40 years ahead). State pensions paid to individuals in 2030 or 2040 will reflect the accrual rules in place today. Present expectations of future means-testing, reflecting assumptions about state pension indexation, will influence saving behaviour today, which determine private pension incomes several decades from now. And the NPSS will only deliver private pension income equivalent in 2050 to the 0.7% of GDP, illustrated in Figure 6.45, if it starts receiving contributions within the next five or so years.

The feasible pace of implementation will however be determined by two sets of considerations:

- With respect to the NPSS, there are many details of design which need to be determined, and there are significant operational challenges involved in establishing the system. These are described in Chapter 10, which suggests that a target launch date of 2010 may be a reasonable objective. It is essential however that the system works well from the beginning, and further analysis of the implementation challenges is necessary before deciding the precise timetable.
- With respect to state system reforms, and if our recommendation in favour of the gradual two-tier route is accepted, the key considerations relate to the affordability of the proposals, rather than to implementation complexity. For while we have argued explicitly that public expenditure on pensions should not rise significantly as a percentage of GDP before 2020, our recommendations do imply some increase in public expenditure relative to a base case in which pension expenditure as a percentage of GDP would otherwise fall between 2010 and 2020. And there are of course other pressing demands on public expenditure. An open issue, discussed in Chapter 6, is therefore whether state system reform can be delayed beyond 2010 without undermining the objectives we seek to achieve. Our judgement, explained in Chapter 6, is that while a delay of a year or two beyond 2010 might be possible without serious harm to the overall objectives of reform, a delay of say five years would be too long.

Whatever the timing of state system reform, however, our recommendation in favour of the gradual two-tier approach means that implementation complexities are minimised. A major communication exercise will however be needed to help people understand the system towards which we will evolve.

These two issues, implementation and communication, are dealt with in turn below:

1. Implementation

If we had concluded in favour of radical short-term change, there would be a considerable implementation challenge. In particular, as the panel, "Difficulties in offsetting additional pension rights," in Chapter 6 sets out, if a unified Enhanced State Pension (ESP) were introduced immediately, but with "offset" of existing additional pension rights, there would be a major operational and IT systems challenge for HM Revenue and Customs. One of the advantages of our proposed gradual two-tier approach is that it avoids these major operational challenges within the state system.

Figure 9.1 Indexation regimes under present arrangements and Pensions Commission’s preferred long-term option

		Present arrangement	Pensions Commission preferred option for the long-term
BSP indexation		The minimum of 2.5% or the Retail Prices Index (RPI).	Average Earnings Index (AEI).
For S2P accrual	Upper Earnings Limit (UEL)	With RPI	Fixed in cash terms
	Lower Earnings Threshold (LET)	With AEI	With AEI
	Lower Earnings Limit (LEL)	With RPI	With AEI
S2P indexation pre-retirement		With AEI	With AEI
S2P indexation in retirement		With RPI	With RPI
Guarantee Credit indexation		With AEI	With AEI
Savings Credit threshold		With the BSP – minimum of 2.5% or RPI	Faster than earnings to keep the real value of maximum Savings Credit constant

Note: The Primary Threshold is the level at which individuals start paying Income Tax and National Insurance. We have assumed that it is indexed with earnings.

Instead our recommended reforms build on the existing system and on recent changes (e.g. the already planned evolution of the State Second Pension (S2P) to a flat-rate system) but accelerate this evolution. They increase the long-term generosity of the Basic State Pension (BSP) and reverse the spread of means-testing. All of these effects are achieved by changing a variety of indexation regimes [Figure 9.1]. Changing these regimes, and in particular BSP indexation, entails difficult political decisions about affordability and the trade-off with other public expenditure priorities, but does not create any significant implementation complexities.

The greatest operational challenges posed by our recommended evolutionary approach would instead relate to our proposed shift to a universal approach to BSP accrual.

- We recommended that in future, rights to the BSP should be accrued on a universal residency basis, cutting through the complexities of the contributory and credit system. Significant work is now required to identify how precisely such a universal residency test could work, and to decide the number of years of residency required to achieve a full pension, in the light of the complexities spelled out in Chapter 5 Section 6. We believe these complexities can be overcome, and that the universal accrual approach is more desirable than the alternative option of improving the existing contributory system for the BSP along the lines shown in Figure 5.30.
- We have also argued that it is desirable to introduce a BSP which is universal in payment at some age, preferably 75, addressing some of the gaps and inequities which the past contributory system has created for some of today's pensioners. This should be relatively straightforward, since a residence test is already applied in respect to the "Category D" pension payable at 80 years of age but work should start soon on identifying whether there are any non-obvious complexities involved in extending this approach to those aged between 75 and 80.

2. Communication

While our recommended way forward for the state system (evolving the present two-tier system) is simpler in implementation terms, it leaves considerable complexity in the state system for many years. This is unavoidable. Only an immediate unified ESP worth £109 per week would allow the simple message that the state provides everyone with a minimum of poverty prevention in retirement and that there is no means-testing of private pension provision. But as Chapter 6 showed, this option is either prohibitively expensive, has perverse distributional effects or has substantial complexities of its own.

The challenge therefore is to ensure that people understand as best as possible where the state pension system is heading under our proposals, and the implications for the attractiveness of private savings.

Figure 9.2 State pension income at the point of retirement in the long-term

	Accrual rules	Value at SPA
BSP	Accrued on a residency basis	17% of median earnings (equivalent to £75 in current 2005 terms)
S2P	Accrued on earnings above the LEL and from credits from either caring or long-term disability	For individuals with fairly full contributions a minimum of 12% median earnings (equivalent to £53 in current 2005 earnings terms)*

* Individuals starting work before 2031 with earnings above the LET will have some additional earnings-related pension until the whole of the working life is after the point where the LET overtakes the UEL. Therefore other Figures show the median earner getting 14% of median earnings in SERPS/S2P in 2050.

Source: Pensions Commission analysis

Note: Assuming working life from age 21 to SPA.

The key message should be that state PAYG provision is heading towards a two-tier, flat-rate system: the first tier based on a universal residency basis; the second tier on the contributory system. For a person entering the workforce today this means that [Figure 9.2]:

- They can be sure, on the basis of residency alone, of accruing a BSP whose value will be held steady (if earnings indexation starts in 2010) at about 17% of median earnings.
- If they earn over the Lower Earnings Limit (£4,264) and if they maintain a full contribution record, either via paid work or via credits for caring responsibilities, they can in addition accrue a State Second Pension worth at least 12% of median earnings (equivalent to £53 per week in current 2005 earnings terms) at the point of retirement and price-indexed thereafter. (If they earn more than the Lower Earnings Threshold (LET) they may in addition gain some limited earnings-related S2P rights, but these will disappear from the system eventually.)

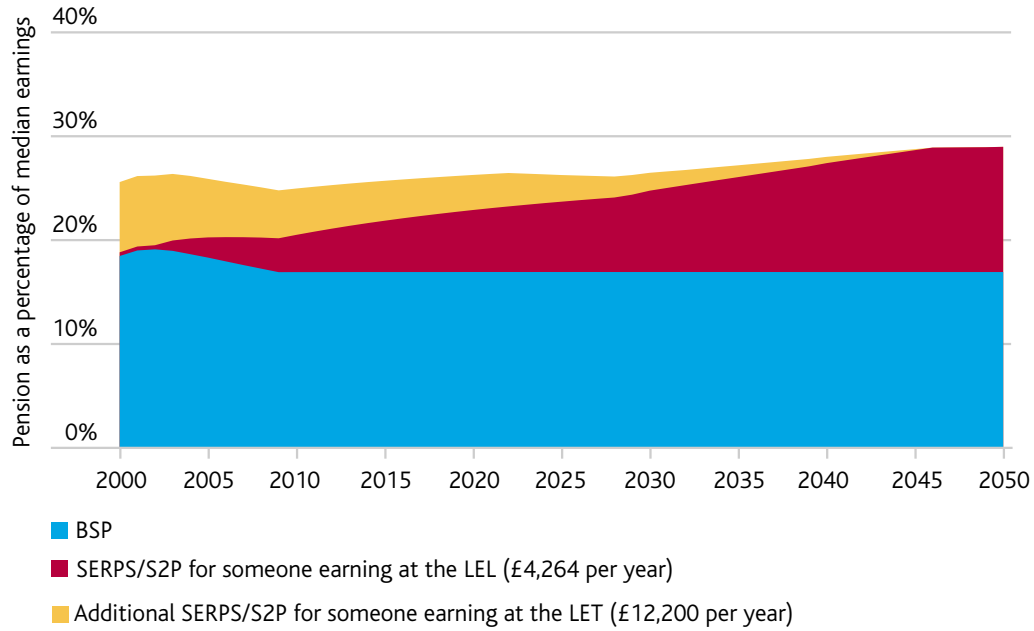
For people already in the workforce and well into their careers, the position is more complex, due to the past evolution of SERPS/S2P accrual rules. These result in the full potential S2P varying by current age [Figure 9.3]. No simple across the board message can therefore be given to people in mid-career. Instead, the challenge is to communicate more clearly, through combined statements of pensions rights, the value of pensions already accrued, and the possible pension at retirement which can be obtained on the basis of full contributions from now on.

For almost all employees, however, it will be possible to provide assurance that saving via the NPSS on top of the state PAYG provision would be beneficial: they will keep the benefit of the savings that they make. This is because:

- The spread and severity of means-testing will tend to fall in future not increase.
- The existence of a compulsory matching employer contribution offsets the effect of the remaining small element of means-testing, ensuring, along with tax relief, that almost all people will be able to enjoy the full benefit of their own individual contributions.

Other issues relating to communication within the NPSS are covered in the next Chapter.

Figure 9.3 State pension income at SPA under the Pensions Commission’s preferred option as a percentage of median earnings: assuming 44 years of accrual



Source: Pensions Commission analysis

Note: Assumes constant earnings in earnings terms and working life from 21 to SPA
 Until the contracted-out rebate system is eliminated the SERPS/S2P element could be partially provided through a contracted-out equivalent.

