

WELFARE PROVISION – CORE SERVICES

Pensions and the Coalition: a new way forward?

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Introduction

Since its conception Beveridge's blueprint for pensions has been built upon in piecemeal fashion by successive governments in the context of social and economic change. This has resulted in a complicated pension system with considerable uncertainty about what people will receive in retirement. The long-term decline in the value of the Basic State Pension (BSP), increasing reliance on means-tested benefits, changes to private pensions including tax relief (where there is a £1.25 million lifetime limit on pension saving that qualifies for tax relief), contracting-out mechanisms and further regulation have all featured. Ultimately these changes have failed to halt concerns about the future sustainability of pension systems, their ability to remove the risk of poverty in retirement and incentivise pension saving. The Coalition government faces the same major challenge as its predecessors: ensuring that state pension transfers within the NI scheme remains sustainable while reducing pensioner poverty. Since its election the Coalition government has announced a number of measures designed to transform the pension landscape and reduce its complexity. This has largely involved implementing proposals made by the Pensions Commission and started by the New Labour government, which obtained cross-party and stakeholder consensus.

A changing landscape

Changes have included accelerating the equalisation of the State Pension Age (SPA) between men and women. This will be achieved in 2018 and a rise to 66 years will occur in 2020. In order to halt the decline in the value of the BSP, reform to its indexation has taken place. A 'triple

lock' measure has resulted in the BSP rising in line with CPI, earnings or 2.5%, whichever is the highest. The State Pension system will be substantially reformed, with the BSP and state second pension (S2P) replaced by a new Single-tier State Pension (STP) for those below the State Pension Age in 2016 (see DWP, 2013a). The new STP will be set at approximately £144 per week (in 2012/13 prices), with 35 years of National Insurance (NI) contributions required to qualify for a full entitlement (an increase of 5 years compared to the current BSP). A minimum of 10 years' contributions will be required for any entitlement and all derived benefits will be phased out. The STP will eventually be easier to operate than the two-tier structure and may reduce the need for means-tested Pension Credit (PC), which suffers from poor take-up rates.

The introduction of the STP is intended to complement the expansion of private pensions by providing the foundation for the successful introduction of auto-enrolment. The intention of auto-enrolment, phased in from 2012, is to offer an occupational pension to millions of people without access to good-quality workplace provision, while coexisting with the latter if they have benefits or contributions above the minimal National Employment Savings Trust (NEST) scheme. Employees who are eligible in terms of age and earnings are automatically opted into the scheme chosen by their employer but may withdraw. Minimum contributions are being gradually increased and will be set at 4% for the employee, 3% for the employer and 1% in tax relief by 2018. It is estimated that around 11 million people will be eligible, with six to nine million people newly saving or saving more (DWP, 2013b). The stated logic behind auto-enrolment is that while structured advice and information

may improve understanding, behavioural barriers, including myopia, cynicism and inertia, all inhibit pension saving (Foster, 2012).

Further changes under the Coalition government (announced in the 2014 Budget and due to come into effect from April 2015) allow flexibility in the way a Defined Contribution (DC) pension fund can be used from age 55, removing the requirement to annuitise 75%. Public sector pensions are also changing, including a switch to Career Average Earnings for new joiners and increasing pensionable age to match SPA. These follow previous cuts, such as indexation to the lower Consumer Prices Index (CPI) instead of Retail Price Index (RPI).

What will the changes mean for state pensions?

The accelerated rise in State Pension Age (SPA) means approximately 4.4 million people will have to wait up to a year longer for their state pension. This is on top of the gradual equalisation of women's SPA. These rises will affect eligibility for the winter fuel allowance, concessionary travel and other age-related benefits. This may be particularly problematic for those who have already made work, saving and retirement decisions, and who may struggle to adjust to delay in payment of the state pension. While the 'triple lock' measure is positive, a more realistic RPI which reflects rising costs of essentials, such as food and energy, for pensioners would help the poorest pensioners.

In principle the introduction of the STP is a welcome development for many low earners and for the self-employed, although the amount is barely above the threshold for means testing. In the short term it may provide a stronger foundation than the current system for some individuals (although long-term prospects are less positive). Those with a 35 year NI record will have a full state pension in their own right in retirement. However, women will be less likely than men to receive the full amount given their breaks in employment, if these do not all qualify for NI credits. The STP alone is insufficient for a decent standard of living, replacing about 25% of national average wages. There are large

numbers of men and women who are already retired or due to retire in the near future who are excluded from the STP and will continue to receive the state pension in its current form. The change to STP is expected to reduce pensioner poverty from 11% now to 10% by 2025; but if the STP were available to all, including existing pensioners, this would reduce pensioner poverty to 7% (Carrera et al., 2012). Approximately 430,000 women born between 6 April 1952 and 16 June 1953 will miss eligibility for STP by a few months and will also suffer a particularly long wait for their pension due to the rise in their SPA (Ginn, 2013). The ending of derived rights for married and widowed women will adversely impact those who have been unable to build an adequate state pension in their own right.

What will the changes mean? Private pensions

The recent decline in return on investments together with increasing longevity has jeopardised the viability of private pension schemes. These are switching from Defined Benefit (DB) to Defined Contribution (DC), particularly in the private sector, transferring financial risk to employees. Guidance around pensions will also become more necessary due to changes in the way DC pension pots can be used from 2015. However, only £20 million has been allocated for a free independent guidance service in future. While choice may enable some people to use their pension pot more effectively, individuals will have increasingly complex decisions to make, both among different types of annuities and providers and among numerous other options for their money. Advice will be particularly important for those with small pensions. In the public sector, changes to pension scheme design and increasing pensionable age could reduce the average value of the pension by more than a third (PPI, 2013).

The introduction of auto-enrolment may increase the numbers of lower earners saving into private pensions with the bribe of an employer contribution and tax relief. However the distribution of tax relief (currently at £45 billion per annum) will benefit higher rate taxpayers, mainly men, more than basic-rate taxpayers. All DC schemes,

including the government-sponsored NEST, individualise risk and there are barriers to portability of auto-enrolled funds (NEST cannot currently be transferred and is locked in until retirement and charges apply elsewhere). Contributing to such schemes may be inadvisable due to potential interaction with means-testing in retirement. Deciding whether to contribute to NEST or other schemes chosen by employers – which could be poorly managed or fraudulent – are difficult and free advice will be only generic. Many low to middle earners will lose where employers reduce their pension contributions to minimum levels: about half the average made by employers who now operate a scheme. Employees earning below £10,000 pa are not auto-enrolled although those earning between £5,772 pa and £10,000 pa may choose to opt in. Those earning below £5,772 pa may opt into NESTs but they will not attract an employer's contribution (figures are reviewed annually). This may incentivise employers to keep wages low and restrict hours of work. As in other private pensions, no credits are provided for periods of family care for children or parents. Thus the abolition of the S2P removes the only carer-friendly second-tier pension scheme. Alternatively a fully portable voluntary pay-as-you-go scheme, including carer credits as in state pensions could be operated (with cross-subsidy or an Exchequer grant in lieu of tax relief), thus avoiding the penalty for caring years which is incurred in private pensions.

Conclusions

The impact of the Coalition's pension changes is mixed. In the short term many women, others with low lifetime earnings and the self-employed are 'winners' in relation to the new STP. But its level and inclusiveness need to be improved if low earners are to benefit fully, especially given their continuing disadvantage in accumulating private pensions. The STP is meagre by international standards. Setting it at a higher level would reduce pensioner inequality. In the longer-term there will be many 'losers', with the new system less generous than the current one for most men and women as a consequence of a lower accrual rate than the combined accrual rate of the BSP and S2P. The introduction of auto-enrolment and NEST will offer new possibilities for those who

otherwise lacked access to an employer's contribution. However, caring commitments are not taken into account and the lowest earners are excluded. Time will tell if it pays to save in a DC pension and for whom. Promotion of individual retirement provision through private pensions is likely to result in greater income inequality between older women and men, and between those with intermittent or low-paid employment and those with an advantaged labour market history. Therefore, while the new pension regime may eventually reduce complexity and encourage retirement saving, it will not reduce the gap between the poorest and most affluent pensioners.

References

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