Pensions Reform after the Election: Can Consensus be Maintained?

Notes based on the ILC-UK and Actuarial Profession joint debate

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Introduction and background

A series of reforms to the UK pensions system are being implemented as we speak. For instance, the female state pension age is rising, the number of NICs qualifying years needed for a full basic state pension has been reduced, and the State Second Pension is becoming more flat-rate. In 2011 the National Employment Savings Trust will spring into life, and tax relief for the highest earners will be restricted. Beyond that, the earnings link will be restored, and state pension age will rise for men and women to 68. Thus far, these reforms, which emerged from the Pensions Commission chaired by Adair Turner, have enjoyed remarkable cross-party consensus. Will any of this change following the election of a new government, and where does pensions reform go from here? The ground also shifted under the pensions reform agenda as the economy experienced the effects of financial crisis - will this impact on pensions reform going forward?

ILC-UK and the Actuarial Profession hosted an event on 15 June to debate these issues, held at the Actuarial Institute in London. The debate was led by the coalition government’s Minister of State for Pensions, Steve Webb MP. The panel consisted of:

- Baroness Patricia Hollis, House of Lords
- Lawrence Churchill, chairman-elect of NEST, speaking in his capacity as a trustee of ILC-UK
- Chris Curry, Research Director, Pensions Policy Institute

Chris Cowling of Pension Capital Strategies introduced the debate on behalf of the Actuarial Profession. The debate was co-chaired by Paul Goodwin, Head of Pensions at Aviva, and Baroness Sally Greengross, Chief-Executive of ILC-UK.

Baroness Greengross’ opening remarks referred to the challenge that a new government and the economic downturn presented to the pensions reform agenda. There are also several unresolved issues within this agenda, such as the appropriate balance between universal and means-tested support, how to introduce flexibility into both pensions saving and annuitisation, the role of pensions in wider asset decumulation options, and most importantly, how to eradicate pensioner poverty.

Baroness Greengross referred also to ILC-UK’s work in the area, which is concerned with all the implications of demographic change, particularly Craig Berry’s paper The Future of Retirement, which was published on 16 June. The paper considered the impact of various forms of pensions and saving on individual retirement decisions, among a variety of wider factors, such as ill-health, job quality and caring responsibilities. The Future of Retirement is available at http://www.ilcuk.org.uk/record.jsp?type=publication&ID=61.
Steve Webb’s speech and the panel’s responses were based on the following questions:

- What is the right balance between universal and means-tested support in pensioner benefits?
- Is the restoration of the earnings link safe?
- Should the state pension age rise further and faster?
- How can the consensus around NEST be maintained?
- Will greater flexibility in pensions schemes incentivise saving?
- Should tax relief on pension contributions be reformed?
- How can the annuities market be shaped to enable more choice for individuals?
Steve Webb MP, Minister of State for Pensions

The Minister began his speech by noting that the average tenure of recent pensions ministers had been only 1 year and 1 month. This is a problem because pensions policy is inherently long-term and future-oriented. For example, state pension age is rising, but over several decades. Also, there are pensions reforms from the 1970s that are still not fully embedded yet.

Therefore, we need stability in policy-making, and we need to be able to look at the bigger picture. The new government intends to be radical in this area. There are several obstacles, however, such as the curse of incrementalism—the need for firefighting by ministers as well as longer-term strategies, and a disjuncture between the Department for Work and Pensions and HM Treasury.

The Minister set out his three main priority areas for the new government. Firstly, state pensions. The restoration of the earnings link and the introduction of the triple guarantee (i.e. the basic state pension will be increased each year by the higher of inflation, earnings growth or 2.5%) will stop the rot in the devaluation of the state pension. State pension age should better reflect increases in longevity, but there needs to be a systematic approach, and we must remember that the benefits of increased longevity have been unevenly spread.

Furthermore, we need simplification in the pensions system, as Craig Berry’s paper recommends. It is not helpful to have two forms of the state pension, as well as Pension Credit, which is extremely complex.

Secondly, the Minister confirmed that the government would phase out the default retirement age, adding that this agenda would be pursued vigorously.

Thirdly, there is a need to reinvigorate private pensions saving. Auto-enrolment is being reviewed, but only in terms of how to implement it in the wake of the credit crunch and the creation of NEST. The principle of automatic enrolment in an occupational pension scheme will be retained. The Minister argued that pensions saving must become more flexible, by allowing early access to capital (in the event, for instance, of financial hardship) and ending compulsory annuitisation. We should also work to ensure that annuities provide better value for money. People retire at different times for a range of reasons, and there needs to be greater choice regarding pensions products.

Questions for the Minister

To enable people to work part-time as they approach retirement, will state pensions be available in part? The Minister agreed that the cliff-edge between full-time work and retirement was a problem. However, introducing part-pensions may make the system even more complex. He argued that the current deferral options, for instance, were too complicated, and led to many people making the wrong choice.
Will compulsory annuitisation be abolished altogether, or will the age limit simply be increased? The Minister confirmed that the policy would be scrapped entirely. He added later that he agreed annuities are a worthwhile product that work for most people, but the government did not want to be over-prescriptive.

The simplification agenda is dangerous, because ultimately it leads to people’s accrued rights being removed. The Minister confirmed that accrued rights are safe, although he noted that this would slow the pace of reform. While accrued rights will be honoured, this does not mean that people cannot be offered alternatives to their existing entitlements.

Tax relief on pensions savings for high earners should not be abolished. The Minister argued that the tax relief system must be reformed, but agreed that the previous government had handled changes to the system extremely poorly.

Will smaller firms, or those currently without an occupational pension scheme, be exempt from auto-enrolling their staff into NEST schemes? The Minister responded that the review of auto-enrolment will be entirely independent and led by experts. None of the outcomes are pre-determined.

Is the state pension affordable in the long-term? The Minister replied that he is not primarily motivated by questions of affordability. Rather, he is interested in the needs of actual individuals.

The UK private pension system is plagued by bad practice. How can trust be restored? The Minister argued that the pensions system is not as untrustworthy as often reported, especially when compared to, for instance, equity release schemes. Part of the solution is to ensure that the state pension system right, so that it becomes increasingly difficult for private providers to seem bad products.

Should there be a state-run equity release scheme? The Minister disagreed that the state should organise an equity release scheme. He also questioned the utility of equity release, stating that often the people that hold equity are not the people most in need, so equity release is only part of the solution to under-saving for retirement.

Not all pension pots are used to provide a retirement income – the end of compulsory annuitisation means more will be passed on to heirs. The Minister responded that it is right that people can pass on their pension pots to their children; it is your money. But this means we must ensure that pensions savings and inheritance are taxed fairly.

A wider array of risk-sharing models (shared risk between employers and individuals) should be available. The Minister said that he is happy to encourage employers and providers to offer different model of saving and risk-sharing. He added that he is concerned by the current defined contributions model.
Panel Speakers

Baroness Patricia Hollis, House of Lords

Baroness Hollis began by saying that there must be a cross-party consensus on pensions reform, or future change will be impossible.

The main point made by Baroness Hollis was that we must reduce the reliance of many people on means-tested benefits. We should therefore move towards a Citizens’ Pension, a residency-based universal benefit set at the same level as Pension Credit. By amalgamating the basic state pension, second state pension and Pension Credit, this can be implemented at broadly the same cost to the state.

Baroness Hollis went on to argue that that while automatic enrolment in an occupational pension is a good thing, people need a solid platform on which to save. Currently, means-testing acts a disincentive. For some low earners, saving through NEST will simply lead to reductions in the amount of Pension Credit received. Replacing means-tested benefits with a Citizens’ Pension would mean that people could keep every penny they save.

Baroness Hollis is in favour of introducing greater flexibility into pensions saving. For instance, she would welcome the end of compulsory annuitisation, but added that if people are to pass on pension pots to their children, it must be inherited as pensions saving rather than capital. Also, early access to lump sums would be a good thing, particularly for women. She pointed out that more money is invested into ISAs than pensions, precisely because ISAs are more flexible, even though less attractive financially. In fact, pensions and ISAs should be better integrated.

Lawrence Churchill, Trustee of ILC-UK

Lawrence began by stating that while there is consensus on the broad shape of pensions reform, there is a lack of consensus on the detail.

He then outlined five key issues and questions. Firstly, is the incentive to defer consumption for several decades (in other words, save for a pension) sufficient to make the decision economically rational? Lawrence argued that currently it is not, mainly because the tax relief system is uncompelling for low earners. A system of matching contributions would provide a greater incentive.

Secondly, is the UK model comprised of relatively low state provision alongside a vibrant private pensions system working effectively? Lawrence argued that it is not working, for various reasons. The basic state pension is too low, the state second pension too complex, and the issue of the relationship between the state pension and the poverty line has not yet been resolved. Furthermore, while private provision is adequate for high earners, there is market failure regarding low earners.
Thirdly, the need for structural reform. In terms of the state, the state pension age must rise in order to fund a higher state pension. State pension age would be much higher today had it increased in line with longevity since the Beveridge reforms. However, increasing state pension age requires attention to the capacity of people to work for longer. In terms of the private sector, Lawrence said that a compulsory saving system should be considered. Furthermore, the risks taken by providers in providing defined contribution pensions are low, so this should be reflected in higher returns on investment for individuals.

Fourthly, the contribution of increased savings flows to economic stability and growth. Pension funds should be supported because they are natural funders for government debt through the purchase of gilts and because they provide capital for investment in the private sector.

Finally, the need to disaggregate customer needs. Lawrence pointed out that individuals do not have a single risk appetite. Abraham Maslow’s theory of human motives (which listed a hierarchy of needs, from physiological needs, up to safety, belonging, esteem, and self-actualisation at the top) should be adapted for pensions saving.

Chris Curry, Research Director, Pensions Policy Institute

Chris’s presentation examined the basis of consensus on the pensions reform agenda.

He said that there was a significant and growing consensus around a single-tier state pension. Baroness Hollis’s Citizens’ Pension is one possible model, although there is less consensus of the universality and qualification criteria for a single-tier pension.

Chris described this as the logic of Turner that is, the implication of subscribing in full to the Pension Commission’s recommendations. More generally, there is consensus that the Turner reforms should be implemented faster than currently planned, including state pension age increases. However, there is disagreement on how far and how fast state pension age should rise. The key to consensus in this regard is the muddy issue of extending working lives. This is one of the Pension Commission’s most important objectives, but we do not yet have a detailed plan of action on how to enable people to work for longer.

According to Chris, there is consensus around the principle of auto-enrolment, but less so regarding NEST as the appropriate vehicle. There is also consensus that the basket of income and assets people utilise in retirement will become broader, and must include housing.

He agreed that there is a consensus on early access to pensions saving, but noted that Baroness Hollis and Steve Webb supported the policy for different reasons. Baroness Hollis to enable flexibility, and Steve Webb to help address periods of hardship. This reflects a lack of consensus on the details of early access arrangements. Chris argued that there is no consensus on the other main way of introducing flexibility into pensions saving, that is, compulsory annuitisation.
Similarly, there is no consensus on pensions tax relief. According to Chris, this is because we have not yet determined who and what tax relief is for. Is it to incentivise saving, or to mitigate the unfairness of double-taxation?

The key to consensus may be, for Chris, policy stability. If the message on what the government is doing is simple and consistent, and there is certainty over what the state pension gives (and doesn’t give you), consensus will be easier to achieve.

Audience discussion with panel

Role of employers

One contributor asked about what the appropriate role of employers is in pensions provision. Lawrence argued that, ideally, employers would have no role, but they are very important in practice. Chris added that employers are important as they help to aggregate and mediate individual preferences, which helps the pensions industry. Paul Goodwin of Aviva said that employers are particularly important for enabling young people to think about pensions.

Another contributor argued that employers were vital to pensions provision, and that too many employers had stepped back from their responsibility in this regard. Chris replied, however, that we cannot expect all employers to continue making large contributions to employee pensions anymore. Lawrence suggested that risk-sharing models are crucial, but said that nobody had yet come up with a sustainable model for risk-sharing. Baroness Hollis agreed on the importance of risk-sharing, and suggested that this could be a solution for public sector pensions.

Equity release

One contributor stated that we need to know more about equity release, and whether it could be a part of retirement incomes in the future. Baroness Hollis said that people need equity release for different reasons at different life-stages. If equity release was used to fix pension problems when people are in their 60s, it means it cannot be used to pay for care in their 80s.

Means-tested benefits

One contributor said that although there is consensus on removing Pension Credit, there are questions over the implications for other means-tested benefits, such as Housing Benefit and Council Tax Benefit. Another contributor was worried that the new government would actually increase means-testing in the pension, by means-testing some benefits currently available universally.

Baroness Hollis restated her strong opposition to means-testing — the poor would never be able to save their way off means-tested benefits. She pointed out that the
need for tapers made means-tested benefits expensive and difficult to administer. Regarding Housing Benefit, she hoped that the emphasis of public spending would return to building homes rather than subsidising rent. Chris added that different means-tested benefits serve different purposes – he argued that it was justifiable to retain Council Tax Benefit, for instance, even if Pension Credit was removed. Lawrence said it would be impossible to entirely eradicate means-testing, but added that we needed to find the ‘sweet-spot’ between helping the poorest and incentivising saving – we have not yet achieved this.

Tax relief

One contributor asked about the role of tax relief, given that costs were likely to increase. Chris replied that pensions tax relief is extremely complicated. For instance, it has knock-on effects not just for individual savers, but the entire industry. By removing tax relief for high earners, this could harm the low earners in the same schemes. Baroness Hollis and Lawrence both argued that the current distribution of tax relief was unjustifiable. Baroness Hollis said we should move towards a TEE model whereby pension contributions are taxed, but pension funds’ investment gains and pensions in payment are exempt. Another contributor said making annuities tax-free would be a key part of this system.
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