# The Pensions Predicament

## Means Testing, the Savings Trap and the Labour Market

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# I
# Introduction*

One of the oldest and most contentious debates in welfare economics and social security provision revolves around means testing.

Today critics such as Frank Field and David Willetts argue that means testing distorts incentives to save and to work, and that it is also complex and awkward to administer. Furthermore, because of the restrictive conditions tied to the payment of benefits, they suggest that means testing encourages dishonesty. It is for such reasons that the move in the UK, under New Labour, from a Beveridgean system which rejected the principle of means testing towards one that depends heavily on means testing, is lamented. The charges laid at the Labour Government's door are that it has opted for means testing as a short-term strategy to reduce the cost of tackling pensioner poverty and that it has irresponsibly ignored the long-term consequences of its actions, creating disincentives for individuals to save. Means testing, the critics argue, is not a sustainable strategy and has a negative impact upon economic incentives.

The supporters of means testing, on the other hand, would remind us that there are some strong economic arguments in its favour. Some of its leading advocates are to be found among prominent free market economists and conservative thinkers. For example, the Nobel laureate and leading monetarist economist, Milton Friedman, advocated the use of means testing due to its positive effect on incentives in that it could lead to lower income tax. For any desired level of benefits (or minimum income level), means testing clearly serves to lower costs and public expenditure relative to a universal benefit, thereby enabling payroll taxes, which are a disincentive to work, to be reduced. Friedman (1972) hence concludes that means-tested systems are superior to universal benefit systems on grounds of economic efficiency.

Another prominent economist, Martin Feldstein, has extended Friedman's (1972) analysis by incorporating such factors as the stigma associated with

* This study develops the themes in Paul Thornton's analysis for Politeia's lecture series *Means Testing From the Cradle to the Grave*. The views expressed are those of the authors who are particularly grateful to Stephen Yeo of Watson Wyatt for comments and suggestions.

means-tested benefits and the consideration that some members of the population may not adequately understand the mechanics of the system – two factors that have been identified as key weaknesses in New Labour's policy. Yet, even taking these factors into account, Feldstein (1987) still finds (for the same reasons as Friedman) that means-tested systems are generally superior to those with universal benefits. Friedman (1972) argued that a lower tax burden improves incentives for those outside the means test and in most cases this is sufficient to offset the negative impact on incentives, and on those brought into a means-tested system. On balance, unless the proportion of workers drawn into (or near) the means test is large, the effect on economic efficiency is positive because of the lower tax rate.

The arguments for and against means testing are less clear-cut than is commonly portrayed and the effect of means testing is not unambiguously negative. Nevertheless, this pamphlet concludes that the way the current means testing system has been implemented in the UK is flawed in the following ways:

- It is unsustainable. The system will increasingly lead to implausible outcomes and greater economic disincentives over time. A high proportion of the population subject to the means test, coupled with population ageing, is likely to lead to heavy political pressure to lower taxes on accumulated pension savings.
- It is confusing. The system has not been explained well by the Government and this is reflected in the lack of understanding amongst the general population of the means-tested benefits that they are to receive.
- It is unimaginative. The system is designed in an old-fashioned and unimaginative way, which relies on static data. It draws on past failures in British welfare history, rather than thinking through what is possible and preferable, in a modern period where dynamic data are available. Implicit within the existing system are unnecessary disincentive effects such as a minimum income guarantee well above the level of the full basic state pension.

We develop our argument as follows. Chapter II presents the historical background in the UK. Chapter III reviews the current means testing system and examines whether or not it is sustainable. Chapter IV discusses what impact recent changes in private pension provision will have upon

Government policy. Chapter V proceeds to examine the pressure which demographic forces will place on the system. Chapter VI presents new survey evidence from Watson Wyatt on the extent to which individuals understand the current system and how it is affecting individual decision-making. Chapter VII sets out our conclusions and proposals for urgent action.

# II
# The System and its Origins

**Pensions Provision before Beveridge**

From the time of the Tudors till the end of the 19th century welfare provision in Britain was dominated by the Poor Law which lasted, in one form or another, for 350 years. British policy was dominated by both central and local government, which set out the conditions for eligibility. By the 19th century, mutual and friendly societies had also began to organise a whole range of benefits, supplementing those services provided by the local parish, which bore responsibility under law for its poor.

The beginning of the 20th century was marked by a concerted movement away from the Poor Law and towards a system of national welfare more recognisable today. Lloyd-George, as Chancellor of the Exchequer in Asquith's Liberal Government (1908-1916), introduced the first major reform of pension provision with the 1908 Old Age Pensions Act. Concern about 'national efficiency' encouraged a national approach to pensions and other social provision in place of the previous variable arrangements. For the first time a state pension was introduced, paying those aged 70[1] or more a non-contributory sum of between 1s and 5s a week (roughly £3-£15 per week in today's currency).[2] Alongside this universal pension was a means test – the pension was only payable to those with incomes of less than 12s a week. These services were deliberately provided outside the Poor Law, thus helping to avoid the stigma associated with pauperism.

In 1911, the Liberal Government, anxious not to raise income tax, followed the route taken by Bismarck in Germany and adopted a contributory system of insurance against illness and unemployment through the National Insurance Act. After the 1914-1918 war the contributory principle was extended by a Conservative Government to the pensions system in 1925 with the Widows', Orphans and Old Age Contributory Pensions Act. This replaced the 1908 measure with an insurance-based system which

1 At this time life expectancy was 48 (source: Government Actuary's Department).
2 http://www.eh.net/hmit/ppowerbp/ was used to convert 1908 purchasing power to today's currency.

established a contributory state scheme, introduced widows benefits and reduced eligibility to the old age pension to the age of 65 for those earning up to £250 a year.

Throughout the 1920s and 1930s occupational pension schemes were also introduced.[3] These followed the growth of the friendly society movement, which had flourished during the 19th century and provided for the sickness or retirement of their members and their widows and orphans.

**The Post-War Period**

The crises associated with the depression and the threat of war prevented any substantive changes taking place during the 1930s. By 1942 Sir William Beveridge (who had been an adviser on the 1908 Act) had published his *Social Insurance and Allied Services* report on providing for income lost through sickness, bereavement, retirement etc. His plan was to replace the existing variety of insurance schemes with a comprehensive social insurance linked to flat-rate benefits and contributions, and national assistance for those who were uninsured. During and after the war, those committed to reform pushed for the implementation of Beveridge's report. The war thus accelerated a reform process that had already started and Labour's electoral victory in 1945 led to its enactment (both major coalition parties having promised such a course after the war).

The National Insurance Act of 1946 introduced a universal contributory, flat-rate, state pension, paid from the age of 65 for men and 60 for women. Beveridge had wanted friendly societies to participate in its administration but he was overruled and centralised state agencies were set up to administer the system. Nevertheless, almost from its inception, the basic state pension was set at a relatively low level, leading to increasing dependency on supplementary means-tested benefits and in particular the basic benefit (National Assistance, later renamed Supplementary Benefit and then Income Support).

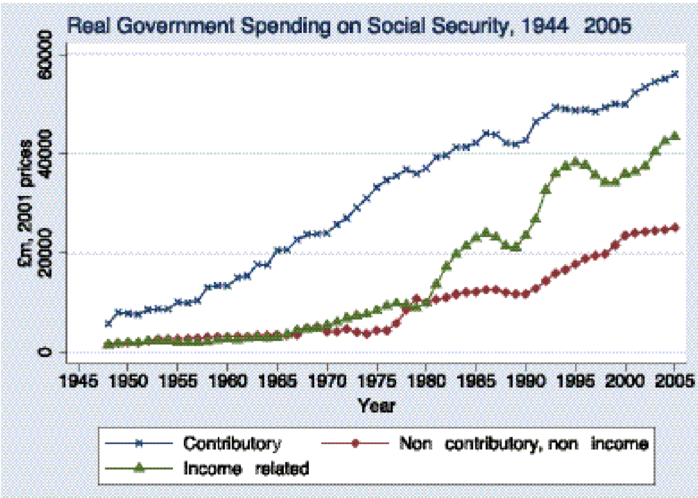
The second major reform of pension provision in the post-war period took place in 1959, with a further National Insurance Act. This introduced a top-up state pension scheme, based on earnings and known as the graduated

3 Leslie Hannah, *Inventing Retirement,* Cambridge University Press, 1986.

pension. This early earnings-related pension was replaced in the Social Security Pensions Act 1975, which introduced the State Earnings-Related Pension Scheme (SERPS). This indexed pensions to the growth in earnings and complemented the basic state pension with an earnings-related pension. Like the first tier, this second tier was also unfunded and compulsory. It guaranteed contributors an additional pension as a percentage of their earnings.

The post-war period was characterised by large increases in social security expenditure. Figure 2.1 shows the growth in real government spending on social security over that period (in 2001 prices). From 1950 to 2000, real government spending on social security grew nine fold from approximately £11,500 million to £105,000 million. From the late-1960s there was an increased reliance on means-tested (or non-contributory income-related) benefits such as income support. The level of spending on means-tested benefits moved sharply upwards during the 1980s, after the link between state pension increases and average earnings was broken by Margaret Thatcher's Government. From 1980 to 1990, expenditure on income support increased from £9,800 million to £23,500 million.

**Figure 2.1: Government Expenditure on Social Security since 1944 (in real terms)**




Source: Watson Wyatt calculation based upon Department of Work and Pension figures (2002).

Traditionally the Labour Party has resisted means testing on philosophical grounds. Yet, when in power, not only has it extended the scope of means testing but it has also increased the level of such benefits at a faster rate than other benefits. As a result, income support has risen substantially for pensioners. Between 1996 and 2002, the rate of income support, for the poorest pensioners, increased by 31 per cent for a single pensioner under 75, and by 25 per cent for a pensioner couple where one is aged over 75.

The major cause of this growth was the introduction of the Minimum Income Guarantee (MIG) in 1999. This was reformed and replaced by the Pension Credit in 2003. There have also been smaller increases in non means-tested benefits, such as the one-off increases in the state pension in 2001 and 2002 and the increases in annual winter fuel allowance. Within private pensions a major change was the introduction of stakeholder pensions in 2001, originally aimed at helping those on low to average earnings to save for retirement. (For a complete discussion see Clark and Emmerson (2003) and Brewer, Clark and Wakefield (2002).)

Broadly, the Government's policies can be seen as an attempt to achieve the dual aims of expenditure control and poverty reduction, via means testing. However, the result has been to diminish the contributory principle. The impact on incentives to save, and estimates of the numbers of pensioners who can expect to receive means-tested benefits in the future, are explored in the next chapter.

# III
## New Labour's Pension Policy

At the beginning of the 21st century the UK pension system exhibits three main characteristics. First, there are a high proportion of pensioner households in receipt of employer pensions, most of which pay benefits based on final salary.[4] Second, expenditure on the state pension is modest and is forecast to remain so due to the linking of pensions to price inflation, the planned increase in retirement age for women and reforms to SERPS, beginning in the 1980s, which substantially cut costs. Third, a large proportion of pensioners are eligible for means-tested benefits and these benefits are an increasingly significant component of pensioner income. We here analyse the likely developments arising from the recent Pension Credit reform and examine whether the Government's policy commitments are credible. In the next chapter, we discuss the likely consequences of recent changes in the provision of occupational pensions and, in this light, revisit the question of the sustainability of the current system.

The key plank of the Government's policy on pensioner benefits has been to increase the generosity of the means-tested element, firstly by introducing the Minimum Income Guarantee and then the Pension Credit. The Government is also committed to link future increases in the Pension Credit to wage inflation during this Parliament. In contrast, the state pension is only guaranteed to rise with prices. As long as the long-established trend for growth in wages to run ahead of the growth in prices continues, so means-tested income support will grow in significance.

What are the implications for incentives to save? The increased generosity of means-tested benefits has a negative effect on the incentive to save for those likely to receive them – as their expected retirement income increases they have less need to save. For those households brought into the scope of means-tested income support (where previously they would not have expected the receipt of such benefits), in addition to that negative effect, there is a further negative effect from being exposed to the benefit withdrawal rate for the first time. Not only is the incentive to save

4 According to DWP figures (2003) some 60 per cent of pensioner households are in receipt of an occupational pension.

diminished by the prospect of greater income in retirement but also by the withdrawal of benefits as their private savings increase. Brewer and Clark (2003) show that MIG increased the number of pensioners facing very high marginal tax rates. They estimate the number (aged over 65) facing marginal rates of 100 per cent increased from 1.5m.in 1996/7 to 2.5m. in 2002/3, whilst the number facing rates above 80 per cent increased from 2.4m to 3.1m and the number facing rates above 50 per cent increased from 2.5m. to 3.2m.

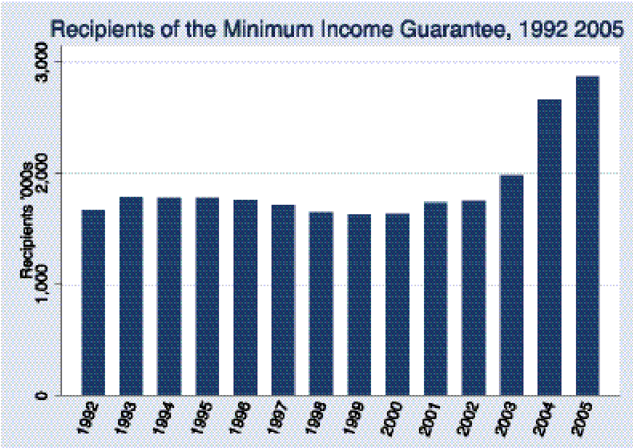
Perhaps in the light of these figures, the Government acted to reform the system, introducing a savings credit into the MIG and from 2003 the Pension Credit. This is essentially a reduction of the (MIG) withdrawal rate from 100 per cent to 40 per cent, for incomes in excess of the basic state pension. This brings down the number of pensioners estimated to be facing rates of 100 per cent to 400,000 in 2003, the number facing rates above 80 per cent to 1.4m. and the number facing rates above 50 per cent to 2.9m.

The Pension Credit has thus reduced the high marginal tax rates faced by those in receipt of means-tested benefits, as compared to the previous system. But, the effect on the incentive to save is only positive for some people. First, for those expecting to retire on the (contributory) basic state pension the effect is clearly positive, as their state benefit income is unchanged but they can now keep more of every pound saved. Second, for those who were previously expecting to be in receipt of the MIG, but had some private savings, the effect is less clear. The reduced benefit withdrawal rate encourages private saving, but the fact that their retirement income has implicitly increased (since they can keep more of their existing savings) reduces the incentive to save. For those retired people who used to be outside the scope of the MIG but who will now benefit from the Pension Credit - the reduced withdrawal rate allows those with greater savings to receive the credit - the incentive to save is reduced. Finally, those on high incomes, who are outside the scope of the Pension Credit, are not affected directly.

In general, the replacement of Income Support with the more generous MIG would be expected to tended to reduce private saving for retirement. Reducing the benefit withdrawal rate, as the Pension Credit has subsequently done, will improve incentives to save for some, but reduce the incentive for private saving for others.

It is not yet possible to establish whether the MIG and Pension Credit have *actually* crowded out private saving.[5] However, the increased incidence of means testing is clear. Figure 3.1 plots the number of recipients of means-tested income support, amongst the retired, from 1992 to 2005.

**Figure 3.1: The number of recipients of the Minimum Income Guarantee/Pension Credit (previously Income Support)**




Source: Department of Work and Pension figures (2002). Figures for 2002-2005 are DWP estimates.

Brewer, Clark and Wakefield (2002) estimated that the increased generosity of the MIG should have increased the numbers eligible for income support by 40 per cent, other things being equal. Nonetheless, whilst the system became more generous in the late 1990s there was virtually no increase by 2000. The authors attribute this to the fact that newly retired people had larger private pension incomes than previously - taking them outside the means test. However, after 2000 the trend in the number of recipients is expected to be positive.[6]

5 In order for the Pension Credit to crowd out private saving, people (or financial advisors, friends, etc.) have to foresee the benefits of the policy. If people do not understand the system, or do not believe it to be credible, its impact on private savings will be marginal.

6 A related issue is that take-up rates are lower for means-tested benefits, possibly due to people being unaware of that availability, the stigma associated with the benefits, or the delays caused by the application process. By November 2003 only half of those eligible were claiming the Pension Credit (DWP figures). The Government plans to streamline the process and to have longer periods between assessments. Yet, in doing so exploitation of the system becomes easier – one-off wealth increases may be taken outside the assessment period, with individuals remaining eligible.

The policy of indexing the state pension to prices while the Pension Credit is indexed to wages (and grows at a higher rate) suggests that we will see an increasing number of people relying on means-tested benefits in the future. Over time, the gap between the state pension and the Pension Credit will grow, with an increasing number of people caught in the band of income where disincentives to save start to have effect. Clark and Emmerson (2003) estimate that currently 52 per cent of adults over 65 are living in households eligible to receive the Pension Credit. Given current plans, they forecast that the proportion will rise to 73 per cent by 2025 and 82 per cent by 2050, principally as a result of the different indexing rules. The numbers affected by the Pension Credit are particularly large at the older ages. Put differently, the proportion of average earnings that a person retiring must receive from a private pension to avoid being on the Pension Credit rises from 12.3 per cent in 2003 to 26.9 per cent in 2025. As explained in the next chapter, it is likely that an increasing proportion of the population will not have savings on this scale.

With our ageing population and an increasingly large retired population, the increased generosity of the Pension Credit is likely to lead to a large increase in the numbers receiving means-tested income support and to greater public expenditure. This might be avoided if the introduction of the state second pension were to encourage private saving (and take people out of means testing) or if, for other reasons, we see a substantial growth in private retirement income. In the short term this may occur, as workers are still retiring with relatively generous defined benefit occupational pensions but since future generations are likely to receive less generous private pensions, this seems unlikely in the longer term.

Compared to its counterparts on the continent, the UK spends considerably less on public pensions so there is no fundamental economic reason why the UK cannot spend more on means-tested benefits. Given the likely increase in expenditure on means-tested benefits in the long run and the fact that means testing will affect a wide section of the voting population, it is not surprising that the Government is increasingly reviewing the appropriateness of its policies. In a means-tested regime, individuals' saving decisions will be determined by the extent to which they regard the promise of Pension Credit as credible in the long run. The political risks associated with a potentially unsustainable scheme may therefore mean that workers simply ignore the Pension Credit in their retirement planning.

One of the more fundamental issues is whether the means-tested system is politically sustainable in an environment where large numbers of voters have high implicit tax rates on their accumulated pension savings. High marginal tax rates on private savings may then fuel pressure to change the system.

# IV
# The Role of Private Pensions

If the Pension Credit does survive in its current form, it seems likely that the level of retirement income provided by private sources will fall and the role of the state will increase. Whereas occupational defined benefit pensions are indexed to prices and the majority of those with money purchase pensions lead to fixed annuities, the Pension Credit is indexed to wages. For those currently retired and in receipt of a private pension, the monetary significance of Pension Credit and the numbers affected by it will thus increase to the extent that wage growth exceeds price inflation. Those with defined contribution pensions have incentives to take out nominal annuities or lump sums if they are near eligibility, as the provision of a means-tested safety net reduces the incentive to apply their savings to index-linked annuities which would otherwise be better used in preventing the erosion of the real value of retirement income in later years.

Reductions in private pension income and/or coverage also increase the number of individuals eligible for the Pension Credit and so increase expenditure. Conversely, increases in private pension income would lead to less expenditure on means-tested benefits. Watson Wyatt conducts an annual pension plan design survey, which includes very large private sector employers. Its 2004 survey found that under half of employers had final salary pension plans that were open to new entrants. This marks a significant decline relative to our 2000 survey where nearly two-thirds of employers offered final salary pension to new employees.

In the last three years we have observed an unambiguous trend towards pension provision through less generous defined contribution schemes. Amongst small firms provision of defined benefit pensions is even less common. The 2003 survey of trends in occupational pensions amongst smaller firms (those with fewer than 250 employees) by the Association of Consulting Actuaries found that 74 per cent of defined benefit schemes had been closed to new entrants. In addition, the total contributions to defined contribution schemes averaged 9.9 per cent, less than half the level in defined benefit schemes (21 per cent).

To summarise, we are observing the following trends in the market:

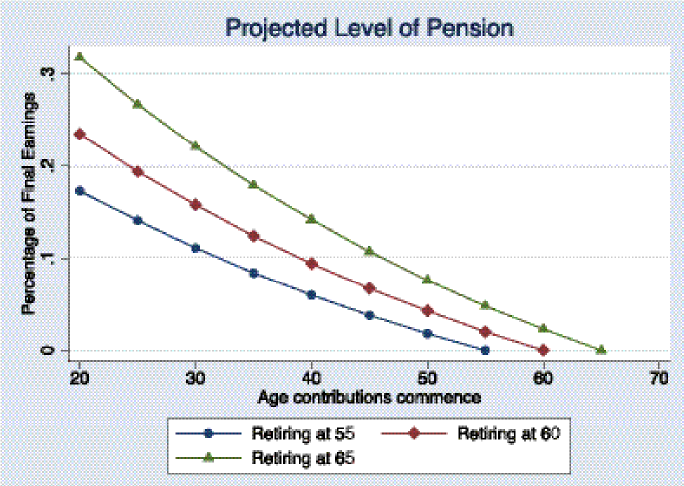
- Less generous benefits (a lower proportion of salary is pensionable, with lower rate of accruals and lower contribution rates)
- Defined Contribution schemes increasingly contracted in
- Greater use of eligibility restrictions (which may particularly affect lower income workers).

Taken together, these changes will mean less pension saving in the future than would have been anticipated several years ago. Figure 4.1 shows the projected level of pension relative to final earnings for an individual in a typical defined contribution arrangement. For example, an individual starting contributions at the age of 25 at the average level in the 2003 Watson Wyatt plan design survey and retiring at the age of 65 will achieve a replacement rate of about 25 per cent. By contrast, a similar individual in a typical final salary scheme will achieve much higher benefits. A typical final salary scheme in the plan design survey with an accrual rate of 1/60th of final pay for each year of service would achieve a replacement rate of double this after allowing for what are now small portability losses from job changes.

These changes in occupational pension benefits are due to the desire of companies to rein in rising costs from increased and increasing longevity as well as from lower investment returns and lower interest rates. The result of these changes in benefits is that those retiring with occupational pensions are destined to be less affluent than they would have been before the changes in provision over the past five years. There is hence a danger that even more individuals than anticipated will rely on means-tested benefits because of the failure to maintain previous levels of occupational pension provision.

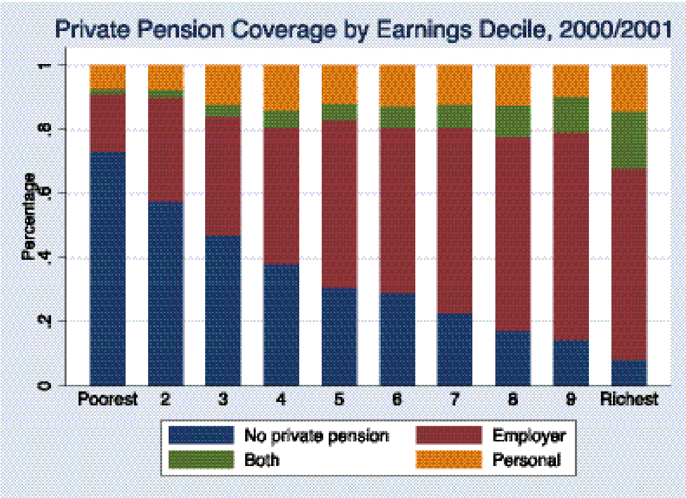
Figure 4.2 shows coverage of private pensions by earnings decile. Our figures indicate that even at the second lowest decile coverage by employer pensions is around 30 per cent. Because poorer and medium income people are covered in significant numbers by employer pensions, changes in their private pension income will potentially affect the extent to which they draw on means-tested benefits.

**FIGURE 4.1: Projected levels of pension**




Source: Watson Wyatt Pension Plan Design Survey 2002

**FIGURE 4.2: Private Pension Coverage by Earnings Decile**




Source: Watson Wyatt calculations using British Household Panel Survey

# V
# The Demographic Background

The reforms of the current Labour Government have, as seen in Chapter III explained, expanded the amounts, and extended the scope, of means-tested income support for retired people. Given the current policy of indexing the basic state pension to prices but the Pension Credit to wages, it seems that an increasing number will be drawn into means-tested benefits and that the monetary significance of these payments will grow. This seems more certain when we consider the recent shift from defined benefit occupational pensions to defined contribution pensions, which are generally on less generous terms.

Against this backdrop of increased eligibility the population is ageing: the number of elderly people is predicted to grow dramatically in the next 50 years. The costs associated with the current pensions system are likely to be large.

At the same time the number of retired people is increasing, declining birth rates will reduce the working age population that supports them. As a result (Table 5.1), across the developed world there is forecast to be a large increase in the elderly dependency ratio (the population aged 65 or above relative to those of working age, 20 to 64).

**TABLE 5.1: The Elderly Dependency Ratio**
**The ratio of the population aged 65 or more to the population aged 20 to 64**

| Country | 1975 | 2000 | 2025 | 2050 |
|---|---|---|---|---|
| France | 0.25 | 0.27 | 0.40 | 0.52 |
| Germany | 0.26 | 0.26 | 0.42 | 0.59 |
| Italy | 0.21 | 0.29 | 0.44 | 0.74 |
| Japan | 0.13 | 0.28 | 0.53 | 0.78 |
| Netherlands | 0.20 | 0.22 | 0.37 | 0.49 |
| Spain | 0.19 | 0.27 | 0.39 | 0.80 |
| Sweden | 0.26 | 0.30 | 0.45 | 0.60 |
| UK | 0.25 | 0.27 | 0.38 | 0.52 |
| USA | 0.19 | 0.21 | 0.32 | 0.39 |

Source: United Nations (2002).

In France, Germany, the Netherlands, Sweden, the UK and the USA there has been only a limited increase in the elderly dependency ratio over the last 25 years (1975 to 2000), but in the next 50 years a significant rise is expected. In the UK, it is predicted that the elderly dependency ratio will increase from 0.27 in 2000 to 0.38 in 2025 to 0.52 in 2050. Similar figures are forecast for France and the Netherlands, with slightly worse positions forecast for Sweden and Germany.[7] In the US, a large increase in the absolute numbers of the elderly is somewhat offset by a relatively high birth rate and immigration. The growth in the elderly dependency ratio is then less pronounced, increasing from 0.21 in 2000 to 0.39 in 2050. In Japan, Italy and Spain the effects are far more pronounced, increasing from approximately 0.3 to 0.8 between 2000 and 2050.

Declining birth rates, whilst reducing the working age population, will also reduce the number of child dependants. As a result the increased costs associated with a larger retired population will be somewhat offset by a smaller pool of children. Table 5.2 shows how the total dependency ratio is forecast to change over time for developed countries.

**Table 5.2: The Total Dependency Ratio**
**The ratio of the population aged 0 to 19 or 65 plus to the population aged 20 to 64**

| Country | 1975 | 2000 | 2025 | 2050 |
|---|---|---|---|---|
| France | 0.83 | 0.70 | 0.80 | 0.93 |
| Germany | 0.78 | 0.60 | 0.70 | 0.92 |
| Italy | 0.77 | 0.60 | 0.69 | 1.06 |
| Japan | 0.65 | 0.61 | 0.84 | 1.14 |
| Netherlands | 0.81 | 0.61 | 0.70 | 0.87 |
| Spain | 0.85 | 0.62 | 0.64 | 1.13 |
| Sweden | 0.73 | 0.70 | 0.76 | 0.96 |
| UK | 0.81 | 0.69 | 0.72 | 0.90 |
| USA | 0.83 | 0.69 | 0.75 | 0.84 |

Source: United Nations (2002).

7 It should be noted that these figures are based upon the population sizes of age groups and do not take account of differing retirement ages (discussed later). For example, the figures for France are substantially higher if we allow for the younger standard retirement age of 60 (0.38 in 2000, 0.58 in 2025 and 0.71 in 2050).

As regards the total dependency ratio, the impact over time appears less severe, though still marked. For the US, the total dependency ratio will be essentially the same in 2050 as in 1975, though there will be an increase from 0.69 to 0.84 between 2000 and 2050. In the UK, the figures are similar to those for the US: as the total dependency ratio will increase from 0.69 in 2000 to 0.90 in 2050. Similar trends will occur in France, Germany, the Netherlands and Sweden. In Italy, Japan and Spain, however, change will be more dramatic, with total dependency ratios of approximately 0.60 in 2000 rising to about 1.1 by 2050 – more than one dependant per worker.[8]

This expanding elderly population is predicted to lead to very large increases in expenditure on public pensions in certain countries (see Table 5.3, below).

**Table 5.3: Comparing Public Pensions Costs**
**Expenditure on Public Pensions as a Percentage of GDP**

| Country | 2000 | 2025 | 2050 |
|---|---|---|---|
| France | 12.1 | 15.6 | 15.8 |
| Germany | 11.8 | 14.0 | 16.9 |
| Italy | 14.2 | 15.4 | 13.9 |
| Japan | 7.9 | 7.9 | 8.5 |
| Netherlands | 5.2 | 8.3 | 10.0 |
| Spain | 9.4 | 11.2 | 17.4 |
| Sweden | 9.2 | 10.8 | 10.8 |
| UK | 4.3 | 4.1 | 3.6 |
| USA | 4.4 | 5.9 | 6.2 |

Source: Dang et al (2001). These figures covers expenditure on public pensions, both contributory and non-contributory and just old age benefits.

For example, costs in France are forecast to grow from 12.1 per cent of GDP in 2000 to 15.8 per cent in 2050. For Germany, the figures are 11.8 per cent to 16.9 per cent respectively, whilst in Spain the increase is from 9.4 per cent to 17.4 per cent. By contrast, despite the growing elderly population, public

8 We underestimate the number of dependants by not counting those retired pre-65, or those in education, unemployed, or out of the labour force. On the other hand, we omit those in work after the age of 65.

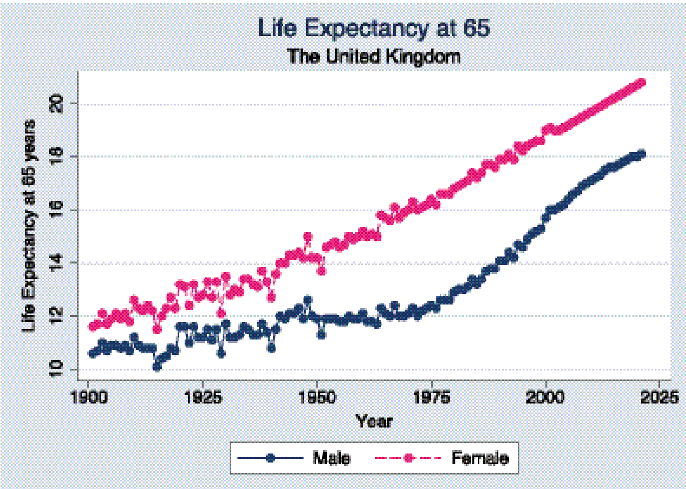
pension costs in the UK are actually forecast to fall from 4.3 per cent in 2000 to 3.6 per cent in 2050. This is largely due to the fact that, in the UK, the state pension is set at a relatively low level and is indexed to prices, so its value will fall in real terms over time relative to economic growth. However, the UK figures do not incorporate Pension Credit expenditure (and lack other elements of future pension expenditure such as significant civil service and other government pension costs). Under this Government's own worse case scenario (an increase in the percentage of those receiving the Pension Credit from 50 per cent in 2000 to 65 per cent in 2050, with stable retirement income), this would cost 1 per cent of GDP by 2050 (Department of Work and Pensions, 2002b). Would a lower share of GDP going to the elderly in the UK be sustainable in the light of income and consumption expectations?

In response to ageing populations and increasing public expenditure, we have begun to see a movement towards raising the age at which state pensions can be drawn. The pension age or age at which pensions can be drawn without reduction, needs to be carefully distinguished from the retirement age. Currently in the developed economies the standard age of eligibility for a public pension is, in the vast majority of cases, 65. However, there are notable exceptions. In France the pension age is set at 60. Italy recently introduced reforms to allow the possibility of retirement between the ages of 57 and 65, with reduced pensions being calculated to keep the cost to the state the same. Japan is also currently phasing in an increase in the pension age, to 65, for both men and women. The UK still has an earlier state pension age for women than men, though this is being phased out between 2010 and 2020 with 65 becoming the common pension age, and an enhanced pension is paid on retirement deferred by up to 5 years. Other countries have gone further. Both the US and Germany are increasing the pension age from 65 to 67, for both men and women. The US will phase the reform in by 2022, Germany between 2025 and 2040.

We now examine whether the route taken by Germany and the US – raising the retirement-age – offers a solution to the problems we foresee regarding funding the current system in the long term and would allow more generous pension provision. Raising the pension age would tend to expand the tax base and reduce the dependency ratio and, given reasonable participation levels, reduce expenditure. Quite apart from the question of controlling public pension expenditure, this analysis is of more general interest, as a means of raising retirement income in the face of increased longevity. For individuals, it provides a way of increasing their retirement wealth and, given the shift –to private pensions on less generous terms - we may expect to see a trend towards remaining in work until a later age regardless of any formal change.

Figure 5.1 shows that from 1900 to 1950 the average life expectancy at the age of 65, in the UK, increased by approximately one year for men and two years for women. Between 1950 and 2000 the improvement was four years for men and five years for women. By 2020 a further improvement of around two years is forecast for both males and females.

**Figure 5.1: Improved life Expectancy at Age 65 in the UK**

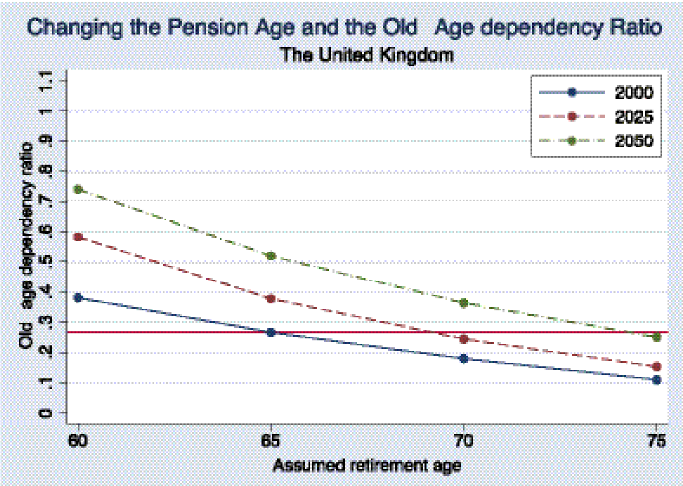



Source: Office for National Statistics (2003).

Given the large improvements in life expectancy, it does not seem clear why the retirement age should remain fixed at a level first set in 1946, especially as health during later years has rapidly improved and work conditions are now, arguably, less physical and onerous. Figure 5.2 simulates the impact of varying the assumed retirement age on the old age dependency ratio. We do not here give model participation rates at older ages, which we discuss later. Rather we examine how varying the assumed age of retirement alters the demographic backdrop.

In Figure 5.2, the x-axis measures the assumed age of retirement at which the elderly population is measured and the resulting figures on the y-axis are the implied old age dependency ratios (e.g. ratio of the retired age to that of working age population age 20-64). It will be seen that the curves shift outwards in accordance with the trend in longevity. For comparison, the figures at the age of 65 exactly match those in Table 5.1.

**Figure 5.2: The Impact of changing the pension age on the elderly dependency ratio in the UK**




Source: United Nations (2002).

For example, if the retirement age were 60 for both males and females, the old age dependency ratio would rise from 38 per cent in 2000, to 58 per cent in 2025 and 74 per cent in 2050. This case is instructive as it shows the impact of early retirement on the numbers. By contrast, with a retirement age of 65, the relevant figures are 27 per cent, 38 per cent and 52 per cent respectively. If we were to postpone the retirement age to 70, the old age dependency ratio would fall to 18 per cent in 2000, 24 per cent in 2025 and 36 per cent in 2050. Put another way, in order to maintain the old age dependency ratio at 27 per cent as in 2003, the retirement age would need to move to around 74 in the year 2050.

Altering the retirement age then has a significant impact on the size of the dependent population, yet the impact on the size of the working population may be relatively small, if labour force participation rates amongst the elderly remain low. Table 5.4 indeed shows that the proportion of men not in the labour force at age of 59 is currently high. In France and Italy some 53 per cent of men are no longer economically active at 59, in Germany and the UK the figures are 34 and 38 per cent respectively, whilst in Japan and the US they are 26 per cent and 13 per cent.

Hence an increase in the retirement age may have a more limited effect without other changes that encourage working to older ages. Such changes are likely to be necessary in themselves, as the ageing population will imply a shrinking pool of employees and, unless there is increased participation in the workforce or far greater productivity growth levels than seen in the post-war period, there will be reduced national income levels. (For a comprehensive discussion of these issues see Nyce and Schieber (2002)).

**Table 5.4: Current Participation Rates amongst Older Men**
**Percentage of men out of the labour force at age 59**

| Country | Percentage of men out of the labour force at age 59 |
|---|---|
| France | 53 |
| Germany | 34 |
| Italy | 53 |
| Japan | 13 |
| Netherlands | 47 |
| Spain | 36 |
| Sweden | 26 |
| UK | 38 |
| USA | 26 |

Source: Gruber and Wise (1998).

Increasing the participation of older workers is likely to require different pay and benefit structures and different ways of working. Williamson and McNamara (2001) argue that the most effective way to increase the number of older workers will be through changes in employment practices that promote flexibility, whilst, in the US context, Mulvey (2003) discusses the changes necessary to health insurance plans and defined benefit pensions to facilitate later retirement. For the UK, an immediate challenge is to modify the incentives within both the state and occupational defined benefit pensions systems towards early retirement. In the longer term, the movement towards defined contribution occupational pensions largely removes the incentive towards early retirement and government incentives to encourage working to older ages may also have an impact.

Nevertheless, incentives by themselves may not be effective without changing the way work is organised and managed, to make it more favourable to older workers. Other steps to increase the pool of workers in the UK are also possible though they seem to offer only limited answers to the problem. Increasing female participation with more working full-time has been a core plank of Government policy. However, female labour market participation rates are already reasonably high so that scope for an increase in this area is somewhat limited. Immigration, on the other hand, is feasible, though politically very sensitive, especially in view of the numbers required.[9] The most fruitful option would appear to be raising participation among more elderly people.

Concerns about a declining birth rate and ageing population are not new (see Thane, 2000). In the immediate post-war period there was a fear that: 'The combination of the ageing of the labour force with the continuation of the trend to towards retirement at earlier ages threatened to exacerbate the labour shortage and to reduce production levels.'[10]

In 1947 the Government's *Economic Survey* emphasised the problem of labour shortage and appealed to older workers to 'contribute to the national task by staying on instead of retiring'. In the first of a series of reports, the Nuffield Foundation (1947) argued more optimistically that, due to their improved health, older workers would be more flexible and productive than was widely assumed. The Royal Commission on Population (1949) recognised that improvements in mortality and declines in fertility would reshape the population and that an ageing population might lessen the flexibility of the workforce. Against this background it argued that older workers were a reservoir of skills, that the trend towards earlier retirement

9 There is also a question of whether siphoning off developing countries' young and productive employees is ethical.

10 See Thane (2000) pp 345.

(before 65) should be discouraged and that a flexible retirement age was desirable.

Yet, contrary to these objectives, the 1946 Pensions Act required almost total retirement as a condition for receiving the state pension and many public and private sector occupational pension schemes (e.g. NHS) encouraged retirement at 60. This was in part seen as a way to open up jobs to younger workers who were viewed as more flexible and productive. In 1951, the Government slightly modified the earnings rules of the state pension scheme in order to encourage more older people to remain in part-time employment, though this was as much a response to an increase in numbers receiving means-tested income support as to a concern about retirement patterns. By the mid-1950s, as concerns regarding the ageing population receded, the trend to earlier retirement accelerated, with the entry of baby boomers into the labour force, greater participation by women and an influx of immigrant workers to offset the loss of older employees.

Yet, given the much sharper demographic shift expected in the next 50 years and with baby boomers, increased female participation and immigration unlikely to come to the rescue, it is likely we will have to return to the conclusion reached by the Royal Commission in 1949 – that greater retirement flexibility and working for longer will have to be encouraged to return the UK pension system to sustainability.

# VI
## A State of Confusion

Even before 1997 the UK pension system was by any measure quite complex. Since then, the introduction of means testing, stakeholder pensions and the second state ension, along with the Pension Credit, have made the system yet more complex. If the justification for means testing is the targeting of benefits, it is necessary to assess the extent to which the target audience understands the benefits from which they will receive help.

To answer these questions, as part of the YouGov Work Retirement and Pensions Index (WRaPI) survey, Watson Wyatt asked 2983 individuals in April 2003 and 3061 individuals in August 2003 questions about to their understanding of current Government policy. The WRAPI survey is a web-based questionnaire of pensions and retirement issues conducted quarterly on a sample drawn from the general population, though there is some degree of over-sampling of higher income individuals with only limited coverage of those over 65.

The survey indicates that most individuals do have a basic understanding of non means-tested benefits. For instance, summary answers in Table 6.1 demonstrate how well individuals understand the basic state pension. Results are shown both for the percentage of the population as a whole and also for the subset of those surveyed who expect to receive at least 50 per cent of their income from the state (672 cases). Over 60 per cent of individuals were able to identify correctly the value of the full basic state pension for single individuals and the proportion was close to 70 per cent among individuals expecting to receive a majority of benefits from the state.

At the same time, individuals were asked about how well they understood the Pension Credit. Table 6.2 shows the results in August 2003. Only 3.1 per cent of the population said they had a very clear understanding of the Pension Credit, whereas over 60 per cent were very unclear. Among those who expect to receive at least 50 per cent of their income from the state, the results were quite similar.

**Table 6.1: What do you think the current value of the basic state pension is for a single person?**

| Amount | % of Population* | % of Population † |
|---|---|---|
| £0 to £29 per week | 1.7% | 0.7% |
| £30 to £59 | 16.2% | 12.4% |
| £60 to £99 | 60.3% | 69.2% |
| £100 to £129 | 7.9% | 9.5% |
| £130 to £159 | 1.1% | 1.8% |
| £160 to £199 | 0.1% | 0.5% |
| More than £200 p.w. | 0.2% | 0% |
| Don't know | 12.4% | 6.0% |

Source: Watson Wyatt/YouGov Work Retirement and Pension Index Survey, April 2003.

* denotes all individuals.

† Individuals who expect to receive at least 50 per cent of their retirement income from the state.

**Table 6.2: Do you have a clear idea of what the 'Pension Credit' is? (August, 2003)**

| | Number of Observations | Percentage |
|---|---|---|
| Very clear | 94 | 3.1 |
| Fairly clear | 370 | 12.1 |
| Fairly unclear | 721 | 23.6 |
| Very unclear | 1,875 | 61.3 |
| **Total** | **3,060** | |

Source: Watson Wyatt/YouGov Work Retirement and Pension Index Survey, August 2003.

This is consistent with research recently released by the Department for Work and Pensions (2003), which found that, before the introduction of the Pension Credit, 88 per cent of people questioned had not heard of it. Nearly a quarter of all pensioners expressed uncertainty about claiming the Pension Credit or said that they definitely would not make a claim for the benefit. Half said they did not like asking for extra money and 44 per cent said claiming income-related benefits would affect their pride. If this current state of confusion remains, it is doubtful whether the Pension Credit will fulfil the Government's objectives.

# VII
## Tackling the Problems

**The problems to be tackled**

This pamphlet has shown that since 1997 the UK Government has put in place a costly system of means testing, which is likely to become more costly over time.

Historically, pensions policy – from the 1920s to Beveridge and the 1959 Act – was based on the contributory insurance principle. One aim was to avoid the burden of increased income taxes, while means testing was then seen to create significant problems. From the late 1960s, however, there was an increased reliance on means-tested benefits such as income support. During the 1980s, the level of spending on means-tested benefits moved sharply upwards after the link between state pension increases and average earnings was broken by Margaret Thatcher's Government. Indeed, from 1980 to 1990, expenditure on income support increased from £9,800 million to £23,500 million pounds.

Means testing increased yet further under the Labour Government which came to power in 1997. The policy of indexing the state pension to prices while the Pension Credit is linked to wages (which typically grow at a higher rate) will result in an increasing number of people relying on means-tested benefits in the future. Over time, the gap between the state pension and the Pension Credit will grow, with an increasing number of people earning incomes where disincentives to save start to have an impact.

The trends in occupational pensions will also exacerbate the problems caused by means testing. Already the changes in the provision of occupational pensions are reducing significantly the level of income retired people can expect from their occupational pensions. There is therefore a danger that even more individuals than anticipated will rely on means-tested benefits due to a failure to maintain pre-existing levels of occupational pension provision.

Furthermore, demographic factors will increase the costs of means-tested benefits. Given the much sharper demographic shift expected in the next 50 years it is likely we will have to return to the conclusion reached by the Royal Commission in 1949 – that greater retirement flexibility and working into older age will have to be encouraged to return the UK pension system to a sustainable position.

Indeed, in addition to the likely increasing pensions bill because of the growth of means testing, there is another worrying development. The latest survey evidence suggests that the means-tested system is so complex that few people understand it. Even before 1997 the UK pension system was, by any measure, quite complex. Since then, the introduction of means testing, stakeholder pensions and the Second State Pension, as well as the Pension Credit, have made the system yet more complex. If the justification for means testing is the targeting of benefits, it is necessary to assess the extent to which the target audience understands the benefits they are to receive.

The Pension Credit, as currently envisaged, will, in future, cover an increasingly large proportion of the population, especially now that future private pension income is likely to be lower than previously anticipated. It is also evident that the new policies have been poorly explained, or at least poorly understood, with well under one-fifth of the population having a clear idea about the Pension Credit system which lies at the heart of the government's agenda to encourage people to save more.

The extent of wide spread confusion and lack of strong incentives to save, means that we are unlikely to witness increases in private pension saving among the less well off unless the Government radically rethinks its approach. The Government has appointed a Pensions Commission to look into issues such as compulsion, as a potential remedy for the failure of individuals to save adequately for retirement – though whether compulsion is likely to lead to more problems than it will resolve, is a moot point. The real difficulty is that the entire system is so flawed that that policy must, as a matter of urgency tackle the fundamental problems.

The message from this study is clear. The Government must take urgent action to tackle the fundamental problems discussed here. In particular:

- *The present pension system will result in a large proportion of the retired population receiving means-tested benefits.* The policy which leads to more and more retired people dependent on means-tested benefits should be reversed.

- *Unless the state pension age rises, economic costs will rise significantly and this is likely to be politically unsustainable.* The state pension age must therefore be raised.

- *The contribution of occupational pensions to retirement income will decline, exacerbating these features.* The decline in occupational pensions must be arrested.

- *The latest research suggests that the population is confused by the complexity of the system and does not have a clear enough incentive to save.* The framework must be reformed so that the system for savings becomes transparent and encourages, rather than penalizes savings.

All of these problems owe much to the increasing role of means testing in the pensions and benefits system and the damaging consequences, discussed in this pamphlet, will be further exacerbated by the changing demographic pattern and increase in the elderly dependency ration. Major reform is therefore urgently needed to tackle all of these interdependent issues, at the heart of which is a flawed over reliance on means testing as a basis for policy.

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