Notes on Pension Policy and interaction of State and Private Pension Provision
8th November 2001

The current state benefits for pensioners are as follows:

1. **Basic State Pension (BSP)**. This will be £77 from April 2003 for single people with FULL entitlement of 44 years and £124pw for married couples with full entitlement. Set to rise in line with prices.

2. **State Second Pension (S2P or SERPS as it is currently)**. An earnings related top up for the BSP, which is calculated to favour low earners – for example, all those earning under £10,500 will receive full entitlement to S2P as if they were actually earning £10,500.

3. **Minimum Income Guarantee (MIG)** . Proposed at £100pw for single people and £154 for married couples from April 2003. Set to rise in line with earnings. **As the MIG will rise with earnings and the BSP will only rise with prices, the gap between the two will widen over time and, therefore, more and more people will end up on means tested benefits.**

4. **Pension Credit (PC)**, which is designed as a top up over MIG to reward extra savings that would otherwise face a marginal tax rate of 100% and, therefore prove to have been worthless, in the MIG calculations. It is proposed to allow people to keep 60p of every extra £1 of private saving, until entitlement is exhausted at around £135pw. In practice, this means that all single pensioners with pre-means tested income of £77-£135pw will gain. However, pensioners whose income before means testing is less than £77pw – i.e. who have not built up entitlement to the FULL BSP, will still face a marginal tax rate of 100%, as they currently do with the MIG, because the PC calculations are based on a lower income level of £77pw. Therefore, anyone with a BSP of less than £77 per week, will lose the first part of their additional savings which bring their income up to the £77 level. Pension credit is the governments attempt to deal with the concerns that the MIG will penalise all those with private savings between the BSP and MIG level, by taxing them at 100%, so they will be no better off than those who did not save at all.

5. **Other benefits that accompany general means test recipients** (housing, council tax benefits etc). Loss of these benefits, by those whose income is being topped up above the MIG level by PC, would also mean higher than a 40% marginal tax rate. Certainly, the potential loss of these extra benefits means that no-one in rented accommodation should go anywhere near a stakeholder pension!

The disincentive effects of current pension policy:

Stated aims of government pensions policy :

1. spending on pensions should be delivered in a targeted manner

2. people should be rewarded for extra private savings they make for themselves in pre-retirement

The stated aims of the Pension Credit are;

1. it is intended to remove the disincentive to save caused by the MIG
2. to reward people for saving
3. to encourage saving (to save on welfare costs of state support)

Unfortunately, these policy aims are not being met.

If we assume that the government does not want its policies to discourage saving and does actually want people to be encouraged to provide for their own income in retirement, then it needs to be concerned about these disincentive effects of its current policies.

The expansion of means testing will imply that incentives to save will be affected and people's choice between different types of assets will be distorted (with significant disincentives to people holding income-producing investments). The major disincentives are:

1. **High marginal tax rates** on additional saving in the form of pension.

   People who put money into private savings in the form of a pension will be penalised for doing so. There is no other way of looking at this. In fact, they will be penalised, in many cases, by far more than 40%. Steve Bee has produced a great note on the case of 'Ivy', a fictitious lady cited in the pension credit documentation, who is only £7 a week better off for having amassed a SERPS pension of £40pw. This would be the same if she had taken out a stakeholder that provided the £40pw. This would certainly entail an IFA who advised her to take out a stakeholder to be in danger of being sued! I'll attach Steve notes to my email when I send this.

2. **Capital rule changes** mean a problem for income-producing assets – like stakeholder pensions!

   A further disincentive to private pension provision by the stakeholder target group arises with the announced changes to the capital rules: It has been announced that rules for calculating means tested benefits are planned to be income based only, no longer having any capital component (so the amount of capital one owns will be ignored for means tested benefit entitlement). This will be a major disincentive to any additional savings in the form of income-generating assets. (This is, of course, a major discouragement to pensions, including stakeholder pensions, which must be taken in the form of annuities!)

Possible policy responses:

Sales of private pensions have dropped sharply since Labour came to power. Many say this is because of the government's policies aimed at helping the lower paid, in particular the effect of the MIG. The government has started to try to address this issue and many policy statements and consultation papers have been produced on the subject, in an attempt to improve the pensions system. Unfortunately, this has resulted in adding yet another layer of complexity to a pension system that's already too complicated. The complications and uncertainties surrounding current pension provision are definitely providing substantial disincentives to save for people with lowish incomes (i.e. the stakeholder target group). If the government is serious about getting these people to provide for their future, by increasing their pension savings, then the existing regime must be modified. (Of course, the government may not really be serious about this at all, and may be frightened that if too many people suddenly start new saving, consumption will be hit and economic growth will be affected! In this case, the current regime poses no problems!)

People with additional pension income will still face a high marginal tax rates (at least 40% and often significantly more). Again, this means that putting money into a stakeholder pension will not prove to be beneficial to many people in retirement.

Possible policy responses to address these disincentive effects, which are discouraging the target group from taking up stakeholder are:

1. **The MIG (or PC) could be made temporary** (so that people already close to retirement can still benefit from PC and move out of poverty, but those with many years left at work would in future, then, find it had indeed been worthwhile to save because there will be no MIG when they retire and therefore they will be better off having saved.)
2. **The calculation for MIG and PC could ignore any private pension, up to a certain limit** (perhaps tapering higher up), which would then mean it will definitely be worthwhile for people to put money into a stakeholder or other additional pension. Without such measures, the current interaction of pension credit and stakeholder pension rules will mean that stakeholder pensions will not be suitable investments for increasingly large numbers of people.
3. **Introduce a single regime for personal pensions.** The stakeholder pension regime has now been overlaid on top of all the other DC related schemes and I honestly believe the only sensible solution to move personal pensions regulation forward would be to merge all the current personal pension regimes into one new one. Perhaps, politically, this could be called the 'stakeholder regime', in order to build on the introduction of stakeholder as a good model to follow! Essentially, this new regime would need to take the best features of all the existing regimes and establish them as the base. The cost implications of this are not clear and would need to be assessed.
4. **Change the rules governing stakeholder** to sweep away the existing complicated structure. Make the 'non-relevance' tests intelligible (or, preferably, do away with them altogether!)