The Pensions Quagmire

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The Quagmire

- Every aspect of pensions provision is surrounded by government-imposed complexity
- Includes: state pensions, taxation of funds, tax qualification for funds, contracting out, regulation, social security benefits, taxation of personal income in retirement
- State tries to “micro-manage” personal incomes in retirement to achieve social objectives
- An individual can have ten income sources when on an income of <£10,000 per year

Structure

- Take *some* aspects of the quagmire and examine them in greater detail
- Look at the consequences of these problems
- Examine possible solutions

State Pension System

- Basic state pensions (BSP)
  - Contributory principle
  - Full pension £82.05 a week
  - Link between national insurance contribution record and pension received
  - 44 years contributions needed for a full pension

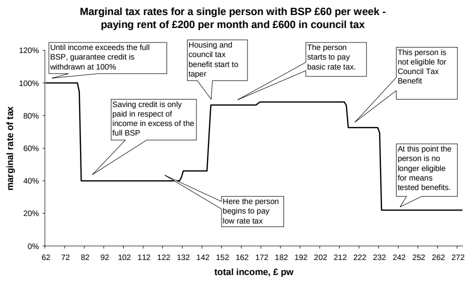
State Second Pension (S2P)

- Replaced state earnings related pension (SERPS) and made much more complex
- Contributory
- Based on average revalued earnings between lower and upper national insurance contribution (NIC) limits (earnings related)
- Full record can earn pension of 20% of revalued earnings between lower and upper NIC limits
- Pension accrued revalued in line with national average earnings; rises in line with prices in payment
- Actual rate of accrual (amount of pension received relative to earnings) varies with earnings: now horrendously complex
- Individuals and schemes can "contract out" if they make appropriate alternative provision but rebates of national insurance contributions given for contracting out now inadequate

Social Security

- Massive increase in means-tested benefits since 1997; 50% of pensioners now entitled to them
- Complex taper provisions: minimum income guarantee, pension credit and savings credit
- In addition to basic benefit there is: housing benefit, council tax benefit, "winter-fuel" allowance, television licence…
- No time to explain all these but best illustrated by chart showing marginal rates of benefit withdrawal by income

Marginal Tax and Benefit Withdrawal Rates



Tax System for Pensioners

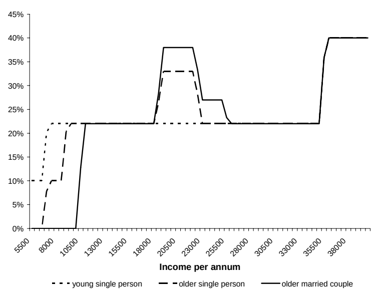


Illustration of Disincentives to Save

Return on saving for individual saving £20 per month

	Actual return, net of the Pension Credit Number of years of work and saving			
Real investment return	**10**	**20**	**30**	**40**
2%	-10%	-3%	-1%	-1%
4%	-7%	-1%	1%	2%
6%	-5%	1%	3%	5%

Tax Treatment of Pensions

- Two coherent types of tax system
  - Taxes on expenditure only
  - Taxes on all income (including returns from saving)
- Pensions saving is supposed to follow expenditure tax
  - Income put into pension schemes not supposed to be taxed until an annuity is taken
- Two major exceptions
  - Returns from equity investment are taxed
  - Tax free lump sum

Fundamental Problem

- Much of the problem is a manifestation of "public choice" economics.
- Governments have provided special benefits for interest groups that have significant electoral power.
  - Dispersed costs versus concentrated benefits
- Any answer to the problems of UK pensions must address this problem at its root.

How Not to Solve the UK Pensions Problem

- The citizen's pension
  - Proposed by NAPF, supported by PPI and, it seems, many in government
- Abolish the contributory principle and the accrual principle
- Pay a much higher basic pension to all citizens
- Abolish earnings related pensions
- Abolish contracting out
- Pension would be paid at a level determined by the Parliament of the day (say £135 a week at first)

Why Not a Citizen's Pension?

- A citizen's pension has neat simplicity but…
- Ignores public choice economics
  - As the population ages, pensioners make up a larger proportion of voters
  - Continual pressure for higher pensions
  - Those who benefit do not pay
    - Lose link between contributions and benefits
  - Contracting out creates pressure for fair accrual processes – transparent link between contributions, benefits and rebates: like vouchers
- Why treat the old poor differently from the young poor?
- Who is a citizen?

Alternative Proposals

- Single contributory pension benefit, payable from age 70
- Single means-tested benefit that is not age related
- Individuals and schemes should be allowed to contract out of the state pension
- No special income tax allowances for the elderly
- The pension tax-free lump sum should be abolished but pension funds should not be taxed on equity investments
- Significantly reduced regulation of pension schemes
- Regulations surrounding the purchase of annuities should be relaxed significantly
- Independent Pensions Commission