Centre for Policy Studies

Pointmaker

THE STATE PENSION: NO LONGER FIT FOR PURPOSE

MICHAEL JOHNSON

SUMMARY

- The National Insurance Fund (NIF), which funds the State Pension, is under increasing pressure. In the last reported year it received £84 billion in NICs and paid out £92 billion in benefits (including £86 billion as the State Pension): it required bailing out by a £4.6 billion Treasury grant.

- A universal State Pension age (SPA) is now untenable. The wealthy, who generally live longer, are being subsidised by the poor because they collect a State Pension for longer.

- Tailoring the State Pension age (SPA) to an individual's life expectancy however is not a practical alternative. Such a regime risks spawning immense complexity and cost. Consequently, the State Pension is no longer fit for purpose.

- The State Pension should be put into "run-off", so that, from 2020, no further "entitlements" would be created. Past "entitlements" would be honoured, as the legacy State Pension, which should be means-tested, along with the whole range of other pensioner benefits.

- A residency-based Senior Citizens' Pension (SCP) should be introduced, payable from the age of 80. All non-pensioners in 2020 would be eligible for it, thus the first payments would be made in 2034. Perhaps set at £200 per week, it would be 30% larger than today's full State Pension.

- The SCP should be complemented by a Workplace ISA, to accommodate employer contributions made under automatic enrolment (AE). This would be significantly pre-funded by the State via a 50% bonus, up to a modest annual cap, with no access to assets permitted until 65. The 15 year period until receipt of the SCP invites structured draw down or annuitisation. Thereafter, the SCP would socialise longevity risk across the nation. There is an opportunity to introduce the Workplace ISA in the 2017 review of AE.

- Today's means-tested Income Support should be extended beyond the SPA. Pension Credit could then be scrapped, producing a significant simplification of the benefits arena.

- These proposals could be funded by ending all Income Tax and NICs reliefs on pension contributions, assisted, over time, by the diminishing cost of the legacy State Pension.

- This paper also addresses the plight of those without an employer-sponsor, notably the self-employed. It also posits "Plan B": the ISA Pension, an annuity purchased with Workplace ISA-held assets from the age of 65, with a 25% uplift from the Treasury.

PROPOSALS

Proposal 1: A Royal Commission should be established to review all pensioner benefits. Its remit should include an examination of the scope for means-testing of the State Pension, preferably from an inter-generational fairness perspective.

PLAN A

Proposal 2: In 2020, the State Pension should be put into "run-off", i.e. no additional "entitlement" would be created thereafter, but transitional protection would apply. Simultaneously, a larger Senior Citizens' Pension should be introduced, payable from the age of 80. Everyone under the age of 66 in 2020 (i.e. non-pensioners) would be eligible for it, so the first payments would be made in 2034. Eligibility could be residency-based: for example, a minimum of 40 years between the ages of 30 and 80 for full entitlement, with a 20 year minimum threshold, say, and 5% for every year thereafter.

Proposal 3: The 2017 review of automatic enrolment (AE) should lead to the introduction of a Workplace ISA to accommodate employer contributions, attracting a bonus of 50%, up to a modest annual cap. It should also include a default fund and "auto-protection", a default decumulation framework (with an opt out), perhaps in the form of annuitisation to the age of 80. No access to assets would be permitted until 65. Employee contributions made under AE should be permitted to be paid into a Lifetime ISA.

Proposal 4: The self-employed should be included in automatic enrolment, with the Treasury paying the "employer" contributions, housed in NEST and its competitors. In return, the self-employed should be required to pay full rates of employee NICs (Classes 2 and 4 having been scrapped).

Proposal 5: Today's means-tested Income Support should be extended beyond the SPA, enhanced to reflect the proposed demise of the State Pension. Pension Credit could then be scrapped.

PLAN B

Proposal 6: Consideration should be given to introducing an ISA Pension, an annuity purchased from the age of 65 with Workplace ISA assets, maturing at the age of 80. It should be enhanced by a Treasury-funded 25% uplift on the underlying annuity. Tax treatment should be determined by cost modelling: it could be tax-exempt if, for example, the Workplace ISA bonus were set at 25%, rather than the proposed 50%.

PREAMBLE: A PROJECT INCOMPLETE

In 2014 the then Chancellor announced "Freedom and Choice" which, by ending the requirement to annuitise, gives individuals greater flexibility when accessing their pension savings, i.e. more control. The public response has been very positive. Subsequently, the Lifetime ISA was announced, potentially indicating a change in direction for how long-term savings are taxed. Meanwhile, company DB schemes are withering on the vine, and automatic enrolment into DC schemes has become an integral part of the retirement savings landscape.

The proposals herein, to replace the State Pension, take into account the broader pensions and savings environment. They are consistent with the direction of travel initiated in 2014: their purpose is to complete the journey, set against a pervading ethos of personal responsibility (self-reliance). They explicitly embrace the message that work pays, while providing a robust safety net for those who need it.

OVERVIEW

Life expectancy: increasingly diverse
At the age of 65, the typical Chelsea man can expect to live to 88; he will receive the State Pension for 23 years. Conversely, Tottenham Green man is, on average, expected to die at 71, thereby receiving the State Pension for only five years. Given that entitlement to the State Pension is established on a common basis, through National Insurance contributions (NICs) and NI credits, this is not socially just. The poorest in society are hugely subsidising the wealthiest, who do not even need a State Pension, which is a benefit (i.e. welfare), not a contractual obligation.

This paper considers the hint within John Cridland's recent interim report that he may recommend a more personalised approach to the State Pension Age (SPA). This is to be discouraged: there is a real danger that introducing different SPAs for different people could lead us to immense complexity. It would be expensive to administer and could be highly contentious (potentially litigious). Consequently, the State Pension is no longer fit for purpose.

Retirement income: an integrated approach
This paper proposes an alternative ("Plan A"), which emerged after considering the two main sources of retirement income, the State and the workplace, as an integral package. It also would help address an emerging issue following the end of the annuitisation requirement in 2015: the difficulty in managing life expectancy as an individual, manifest in the risk of running out of money before dying.

Demise of the State Pension
The State Pension should be put into "run-off", so that, from 2020, no further entitlements would be created. Past entitlements, garnered through NICs and NI credits would be honoured, as the "legacy" State Pension. Ideally this should be means-tested, along with the whole gamut of other pensioner benefits. However, if such a decision were deemed too tricky, politically, then a Royal Commission should be appointed to consider it, preferably from an inter-generational fairness perspective.

A Senior Citizens' Pension, from 80
A Senior Citizens' Pension should be introduced, payable from the age of 80. Everyone under the age of 66 in 2020 (i.e. non-pensioners) would be eligible for it, so the first payments would be made in 2034. Perhaps set at £200 per week, it would be 30% larger than today's full State Pension. Eligibility could be

residency-based so that, after 2020, the primary rationale for NICs would evaporate: National Insurance and Income Tax could then be merged as one Earnings Tax. Simplification, and transparency (as to the real tax burden) to the fore.

A Workplace ISA, for income from 65 to 80

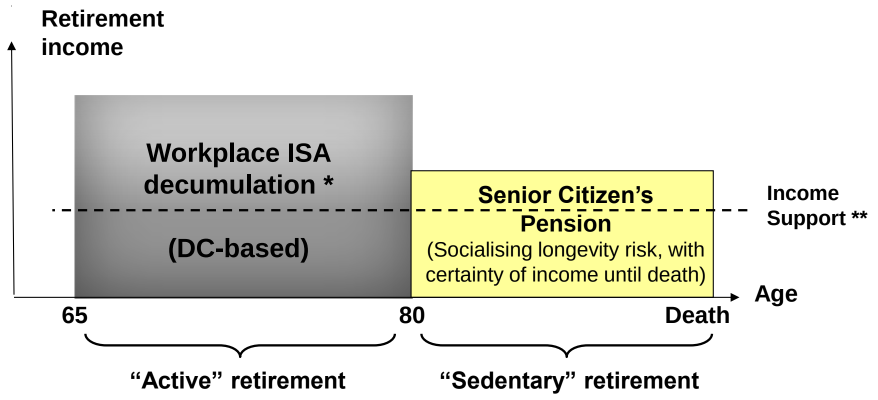
Prior to 2020, a Workplace ISA should be launched, to accommodate employer contributions made under automatic enrolment (AE). These should attract a bonus of 50%, up to a modest annual cap, with no access to assets permitted until 65. Employee contributions made under AE should be permitted to be paid into a Lifetime ISA (attracting the planned 25% bonus), which younger employees, in particular, would appreciate. As such, any risk of AE opt-outs rising as a result of the competing attractions of the Lifetime ISA would be extinguished.

In time, for many, the Workplace ISA would become the primary source of income between 65 and 80, a finite 15 year period which invites structured draw down or annuitisation (at pricing better than that for lifetime annuities), ahead of receipt of the Senior Citizens' Pension (SCP). Through the SCP, tail-end longevity risk (i.e. post-80) would be assumed by the state, the deepest risk-absorbing pool there is, i.e. longevity risk would be socialised across the nation. There is an opportunity to introduce the Workplace ISA in the 2017 review of AE. It would help reinforce AE.

An Income Support safety net for those in need

Today's means-tested Income Support should be extended beyond the SPA, enhanced to reflect the proposed demise of the State Pension. Pension Credit could then be scrapped, producing a significant simplification of the benefits arena.

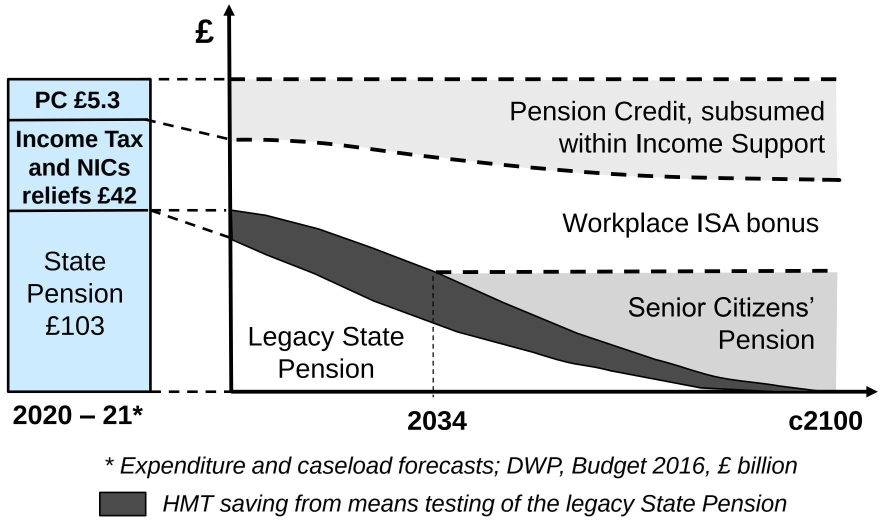
Figure 1: Retirement income from 2034 (legacy State Pension and occupational pensions not shown)



** Incorporating a decumulation default, either a 15 year annuity or automated drawdown*
*** Replacing Pension Credit*

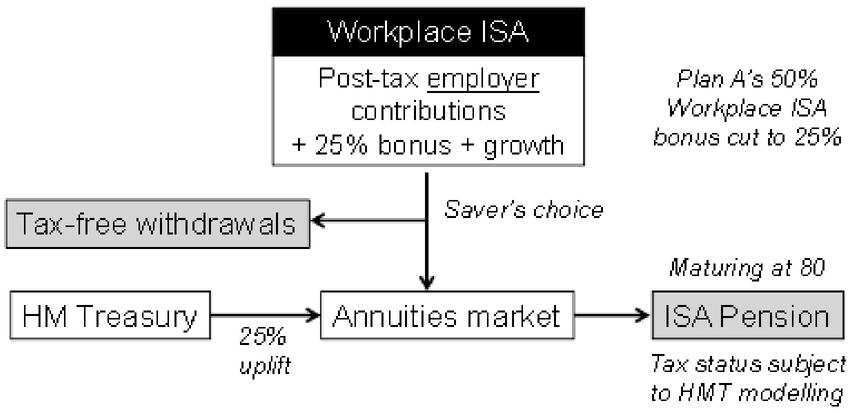
The Senior Citizens' Pension, the Workplace ISA bonus and Income Support could be funded by ending all Income Tax and NICs reliefs on pension contributions, assisted, over time, by a diminishing cost of what would then be the legacy State Pension.

Figure 2: Plan A: HM Treasury cost components (not to scale)



This paper also addresses the plight of those without an employer-sponsor, notably the self-employed. It also posits "Plan B": the ISA Pension, an annuity purchased with Workplace ISA-held assets from the age of 65, with a 25% uplift from the Treasury.

Figure 3: Plan B: the enhanced ISA Pension, available from age 65



INTRODUCTION

John Cridland is currently developing some recommendations for State Pension age (SPA) arrangements beyond 2028, taking into consideration affordability, fairness and the need to encourage fuller working lives. His interim report has recently been published, accompanied by the launch of a consultation on its contents.[1]

Cridland's independent review is essential, not least because politicians, irrespective of political hue, are fundamentally compromised by electoral considerations. It is also overdue: the rate of increase in life expectancy has long outpaced spasmodic retreats in the SPA, magnifying Cridland's task to put the State Pension onto a financially sustainable footing, for the long term.[2] This paper's proposals could be considered as a nudge, ahead of his final report, expected in early 2017.

1. TODAY'S STATE PENSION: UNSUSTAINABLE

(a) Unfunded and unstable

The primary reason for Cridland's work is concern over future affordability: total spending on the State Pension has increased by a quarter since 2010-11. One would like to think that rising intergenerational injustice is also a consideration because, unlike most pension arrangements, the State Pension is unfunded: there are no assets to support it. Instead, it is met by National Insurance contributions (NICs) paid by what is, relative to the pensioner population, a declining number of tax-paying workers.[3] Baby boomers, in particular, have been kicking the fiscal can down the road by making unfunded promises to themselves at a furious pace. And this is at a time when, potentially, Generation Y will become the first generation to have a quality of life below that of their (relatively affluent, home-owning, baby boomer) parents.[4]

Consequently, the National Insurance Fund (NIF), which funds the State Pension, is under increasing pressure. In the last reported year it received £84 billion in NICs and paid out £92 billion in benefits (including £86 billion as the State Pension): it required bailing out by a £4.6 billion Treasury grant.[5] The NIF is a Ponzi scheme in the making, which can only be held in abeyance by periodically reducing the State Pension, in some way.

The recent move to the single-tier State Pension was designed to deliver a long-term (2060) State Pension cost of 8.1% of GDP (assuming that the triple lock remains in place).[6] But, for example, this figure takes no account of Brexit's impact on GDP.[7] The ballooning health- and care-related costs of an ageing population compound the risk of a future fiscal calamity.

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1 *Independent Review of the State Pension age: Interim Report;* 13 October 2016. The allied consultation closes on 31 December 2016.

2 In the 1920s, the SPA was 65 and an individual would receive roughly one year of State Pension for every four years of work: today, it is for every two years of work.

3 Today, those aged 65 and over account for 17.6% of citizens: this is forecast to jump to over 27% in 2064 (OBR, 2014). The underlying causes of our deteriorating dependency ratio are our ageing population (life expectancy at birth is increasing by nearly three years every decade) and low rate of reproduction.

4 Generation Y: broadly, those born between 1980 and 2000 (i.e. aged between 36 and 16 today).

5 *National Insurance Fund Account for the year ended 31 March 2015*; HMRC, October 2015.

6 *The single-tier pension: a simple foundation for saving, Table 5.1*; DWP, 2013.

7 Post-Brexit forecasts for the long-term impact on the UK economy, as % of GDP: LSE -7.9%; HM Treasury -7.5%; OECD -5.2%; CBI / PwC -3.5%; NIESR -3.2%. Financial Times, 27 June 2016.

(b) What of the triple lock?

The State Pension affordability issue is exacerbated by the politically attractive but economically ludicrous triple-lock, whereby the Government has committed to increase the State Pension each year by the higher of inflation (CPI), wage growth and 2.5%, until at least 2020.

A report by the Government Actuary's Department (GAD) estimated that the triple lock already costs roughly £6 billion a year, and that it would eventually consume nearly a quarter of the National Insurance Fund.[8] Martin Clarke, the Government Actuary, wrote: *this analysis highlights the risk that the cost of the triple lock policy could be significantly greater than expected, particularly if earnings and price inflation are low for an extended period*. Intriguingly, his report was quickly removed from the GAD website, replaced with a statement that it had been published in error.[9]

Many, including the Institute for Fiscal Studies, believe that the triple lock should be scrapped, but the politics are tricky (pensioners vote more than the younger generations). Alternatively, it could be watered down, perhaps by removing the 2.5% guarantee. But it is worth noting that this did not play a role in establishing the State Pension from April 2016, earnings having increased by 2.9% over the relevant period.

But whatever becomes of the triple lock and allied affordability concerns, there is an equally important issue to consider: social justice.

2. THE UK: AN INCREASINGLY DIVERSE DEMOGRAPHY

The Government's position is that people should spend, on average, up to one third of their adult life drawing a State Pension. Determining the SPA therefore requires an assumption for each age cohort's average life expectancy, but this ignores socio-economic (and geographic) differences within each age cohort.

(a) Life expectancy

In England, men and women aged 65 years could, on average, expect to live for an additional 19 to 21 years, respectively. This year's crop of babies have a life expectancy of 90.6 years (boys) and 93.5 years (girls). But national "average" data masks substantial diversity in life expectancy at local level, where the difference between the areas of highest and lowest life expectancy, at age 65, is about 5.8 years.[10] In addition, this range is widening. At the level of individual council wards, the range is huge: in one ward in Kensington and Chelsea, a 65 year old man can expect to live to 88 years, while a few miles away in Tottenham Green, it would be 71 years.[11]

Inequality in life expectancy at birth is similarly severe. Baby boys in Kensington and Chelsea can expect to live some 8.6 years longer than those in Blackpool…..and this gap is widening. Over the last 21 years, male life expectancy at birth increased by 10.3 years in Kensington and Chelsea, but by only 3.1 years in Blackpool.[12] The

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8 *Triple lock increases to state pension: background, effects and risks*; Government Actuary's Department, 9 October 2015.

9 It can still be found on the web: e.g. http://paullewismoney.blogspot.co.uk/2015/10/gad-on-triple-lock.html

10 65 year old men in Kensington and Chelsea could expect to reach their 86th birthday: in Manchester, their 80th birthday (2012-14 cohort). Women in Camden could expect to reach their 89th birthday: in Manchester, their 83rd birthday.

11 The Marmot Review *Fair Society, Healthy Lives; Strategic Review of Health Inequalities in England post-2010*.

12 Comparing 1991 to 1993 and 2012 to 2014.

data for females exhibits similar, but less extreme, characteristics.

The causes of inequality in life expectancy are well known: inequalities in terms of income, education, employment and neighbourhood circumstances.

(b) Healthy life expectancy

If we consider *healthy* life expectancy, and include Scottish data for a more UK-wide perspective, then some of the variations become even more extreme. In Manchester, life expectancy for baby boys is 74.7 years, but *healthy* life expectancy at birth is just 55.8 years (Glasgow: 55.9 years).[13] In Wokingham it is fourteen years longer, at 69.9 years.

A recent TUC report found an enormous drop in labour market participation from well before SPA.[14] One in eight people are too ill or disabled to work by the time they reach SPA (and roughly half of all 60-64 year olds are economically inactive (with considerable regional disparities).[15] Unsurprisingly, they are mostly from manual occupations, having worked in the lowest paid jobs. The TUC rightfully concludes that *seeking to use an increased SPA as a crude tool to encourage longer working is likely both to be ineffective and risk increasing hardship among older people.*

3. ONE SPA DOES NOT FIT ALL

3.1 A later universal SPA? Route blocked

Clearly, such is the extent of the diversity in UK life expectancy, a universal SPA is increasingly iniquitous. *In extremis*, Tottenham Green man's return on his NICs, in the form of his State Pension, is only about a quarter of that of Chelsea man's.[16] This is terrible value for money for those who can least afford it. Worse, the lower deciles of the income distribution are increasingly *subsidising* those with longer life expectancy, who are, generally, relatively wealthy.

Historically, the cost control lever of choice has been to simply send the SPA into retreat: it is currently destined for 66 by 2020 and 67 by 2028 (Cridland is tasked with looking beyond then). Further increases in our universal SPA would, most likely, only exacerbate the injustice. For a just society, this is no longer a route open to Cridland, particularly as his Terms of Reference specify that his recommendations *should be fair to current and future generations of pensioners.*

One alternative approach would be to tailor the SPA to local living standards or specific categories of worker. However, this would be impractical to implement (and open to abuse).

3.2 Flexibility to the fore? Too complicated

Perhaps people should be allowed to choose when to commence their State Pension, from a minimum age of 60, say?

It is currently possible to delay receiving it, in return for a 5.8% uplift for every year of delay: why not apply a 5.8% reduction for every year in which it were taken early (and unreduced for those with more than 45 years of NICs, say)? Perhaps early access should be limited to carers and the disabled (both unreduced), or benefits should be enhanced (Pension Credit in respect of

13 *Health expectancies at birth and at age 65 in the UK, based on 2011 Census health and disability prevalence data: 2010 to 2012*; ONS, 11 October 2016

14 *Postponing the pension: are we all working longer?* TUC, September 2016.

15 Sickness and disability causes 1 in 13 workers in the South West to leave work in the run-up to SPA. The figure is 1 in 4 in Northern Ireland. *Ibid*.

16 With a SPA of 65, Tottenham Green man can expect to receive a State Pension for six years, compared to Chelsea man's 23 years.

pensioners, Universal Credit for those approaching SPA).[17]

Providing flexibility in respect of commencing receipt of the State Pension would be consistent with the ethos behind "Freedom and Choice" (which removed the annuitisation requirement, from April 2015), but fraught with practical difficulties. It would be extremely bureaucratic, and ultimately mere tinkering relative to the scale of the potential financial risks and social injustice. Something more fundamental is required, which would foster a sense of individual responsibility and engagement early in people's working lives. So, what to do?

Outlined below are six alternative approaches to reforming the way in which the state provides retirement income. Four preliminary suggestions are followed by the principal proposal ("Plan A"), plus a derivative of it ("Plan B").

4. RETHINKING THE STATE PENSION: PRELIMINARY IDEAS

4.1 Introduce means-testing?

It is ridiculous that multi-millionaires are eligible for the State Pension, let alone a plethora of other pensioner-specific benefits, including winter fuel and cold weather payments, free TV licences, and a variety of health and travel benefits (together costing some £3 billion per year).

(a) The Australian example

Perhaps the most simple reform to the State Pension would be to means-test it, and leave the rest of the architecture as it is today (including the SPA). This could be done on a basis similar to Australia's, which tests both assets and incomes.[18]

(i) Asset test

The Australian Age Pension is reduced at a rate of \$3 for every \$1,000 of assets above various thresholds, depending upon family, health and home-owning status. Pension assets are included in the test, but the principal home is not.[19] A single, home-owning, pensioner with assets in excess of \$542,500 (£320,000) would receive no Age Pension at all (couples: £480,000), with the threshold for non-home-owners being £118,000 higher.

(ii) Income test

The Age Pension is reduced by 50 cents for each dollar of fortnightly income over \$164 (for singles, equivalent to £2,500 per year), and \$292 for couples. Consequently, single pensioners with income in excess of £29,300 per year receive no Age Pension at all (£44,900 for couples).

(b) Pension Credit: a model for means-testing the State Pension?

Today's Pension Credit benefit is means-tested, topping up weekly incomes to £155.60p for single pensioners and £237.55p for couples. Eligibility criteria include UK residency, being over the SPA, and weekly income below the aforementioned figures. Means-testing considers total income, including any income from private pensions, and any savings over £10,000. Some benefits, such as housing benefit, council tax reduction and attendance allowance, are not included, and nor are personal possessions or the home.

17 *How could the effect of rises in State Pension age be mitigated for the most vulnerable?* Pensions Policy Institute; July 2016.

18 See https://www.humanservices.gov.au for details.

19 Asset test thresholds from 2017: \$250,000 and \$375,000 for home-owning singles and couples, respectively; and \$450,000 and \$575,000 for non-home-owning singles and couples, respectively.

(c) Beveridge's perspective: no longer relevant?

Beveridge was opposed to means-testing, believing it to penalise thrift, and other critics of means-testing also cite moral hazard. This may be so in respect of benefits paid to those of working age, but the idea that a 40 year old today, say, would not save because he thinks that he may lose out on a State Pension more than a quarter of a century hence is not credible.

In addition, at the time that Beveridge's seminal report was published (1942), the national mood was ripe for collective solutions to address, for example, social problems.[20] But the UK is a very different country today; there is a far wider disparity in wealth and life expectancy. A universal SPA no longer fits.

Another fundamental tenet of the Beveridge era was the contributory principle for social insurance and welfare benefits. This has been eroded over time, most recently with the arrival of the universal State Pension (April 2016), which requires ten years of NICs before *any* entitlement is established (previously only one year of NICs was required).

Beveridge was firmly in favour of simplifying the welfare benefits system, and it is acknowledged that introducing pensioner means-testing would add complexity, but the benefits of doing it could outweigh the drawbacks.

(d) Pros and cons of means-testing

Benefits means-testing helps to target resources on the needy, but critics cite non-take-up due to social stigma, the complexity of assessment, and administration costs. However, one by-product of non-take-up is that resources are targeted where they are most needed, because take-up is higher amongst those with larger entitlements.

Indeed, maybe any stigma associated with means-tested benefits could encourage saving to avoid dependence on them? And perhaps a non-means-tested State Pension discourages voluntary saving?

As for criticism of administrative cost, it would help to set the entitlement criteria as simple as possible, but that is hard to achieve. It would be better to streamline the process of claiming and delivering a means-tested State Pension, rather than simplifying the criteria. But if the UK cannot deploy digitalised administration effectively, then perhaps we should no longer enjoy "developed nation" status.

(e) The politics of means-testing the State Pension

There have been repeated calls to means-test the State Pension, as well as other universal benefits for pensioners, particularly from academics and think tanks. But given pensioners' relatively high propensity to vote, it is obviously tricky territory for politicians.

Ahead of the 2010 election, David Cameron promised not to introduce means-testing for benefits such as bus passes, TV licences and the winter fuel allowance. In 2015 he repeated his pledge, adding that *it wasn't a commitment for five years; it was a commitment for as long as I am prime minister.*

Theresa May has yet to comment on the subject, so maybe now would be an opportune time for her to de-politicise the issue and advise the Queen to establish a Royal Commission to consider all pensioner benefits, including the State Pension. Ideally, it would include some members of Generation Y, to ensure that it

[20] *Social Insurance and Allied Services* ("the Beveridge Report"), which served as the basis for the post-World War II welfare state, put in place by the Labour government elected in 1945.

adheres to a principle of inter-generational fairness.

Proposal 1: A Royal Commission should be established to review all pensioner benefits. Its remit should include an examination of the scope for means-testing of the State Pension, preferably from an inter-generational fairness perspective.

Success, however, is not guaranteed. For example, the Royal Commission on Long Term Care for the Elderly (report published in 1999, after four years of work) was eventually followed by the (Dilnot) Commission on Funding of Care and Support. This delivered its recommendation for a lifetime cap on care costs in July 2011, which was then scheduled to be introduced under the Care Act in April 2016. That has now been deferred until (at least) 2020.

4.2 Personalised State Pension ages

Cridland's interim report sheds little light on what he may say, other than to hint at a more personalised approach, i.e. to move away from a universal SPA. This could include accommodating physically demanding jobs that have an early "burn-out" age.

(a) Earlier access, i.e. less, perhaps for longer

Allowing early access to a reduced State Pension, on an actuarially neutral (i.e. cost) basis, would benefit people with relatively short life expectancies (and provide an improved return on their NICs). Such an approach may placate some supporters of the WASPI campaign,[21] but in the short term the cost to the Treasury would increase, because anyone taking their State Pension early, even at a reduced rate, would be an *additional* cost for the years before reaching their SPA.

A recent survey asked people whether they would support giving retirees early access to the State Pension if they began work at a young age.[22] 71% supported the proposal…..but with no discussion as to who would pay for it, this is not surprising. That said, 57% of respondents were in favour of early access at a reduced rate.

Geographic distinctions were less well supported. Early access in areas with lower life expectancy attracted 37% support (41% against), with 50% support for people in jobs with a lower life expectancy (30% opposed).

(b) Later access

The same survey reported 42% support for delaying the SPA for those who entered the workforce later, but 66% opposed later access to State Pensions for people in jobs with a higher life expectancy (16% supported). A proposal to restrict SPA for people living in areas of high life expectancy was "flatly opposed" (69% against, 12% in favour).

(c) Personalised State Pension ages: conclusion

There is a real danger that introducing different SPAs for different people could lead us down a slippery slope into immense complexity. Notwithstanding advances in technology, it would likely lead to high administration costs. In addition, such a regime could prove contentious (ultimately, litigious), and also spawn significant societal tensions, between North and South, for example. These risks would be magnified if other aspects of welfare were included, such as financing needs related to caring responsibilities, ill health and long term care.

21 WASPI (Women Against State Pension Inequality), a campaign group opposed to changes to the SPA of women born on or after 6 April 1951.

22 YouGov survey of 2,092 people, October 2016.

These should be addressed separately, preferably at source.

Two potential exceptions could be to address gender inequality (on average, men enjoy a 25% higher income than women, in their first year of retirement), and to permit early State Pension access for people with lower life expectancy through ill health.[23] This could be in the form of a lump sum to be used to buy an enhanced annuity.

4.3 A later universal State Pension, with interim welfare?

The universal SPA could be set at 80 from 2028, for example, rather than 67 as currently envisaged, accompanied by the introduction of a new needs-based benefit, from the age of 65, say. This arrangement would be a compromise on full means-testing from a lower SPA. But given that much of the saving to the Treasury would have to be redeployed as pre-80 pensioner benefits, it is unlikely that such a structure, in isolation, would achieve very much. It would also remain a wholly unfunded arrangement, which is unfair on younger generations, who would have to foot the bill through taxation.

4.4 End the State Pension?

(a) Incentivised saving plus a safety net

The State Pension could be replaced by a combination of an enhanced Pension Credit safety net (i.e. welfare) for those pensioners who really need it, and personal savings *significantly* enhanced by Treasury bonuses, with access restricted until 65, say. Bonuses paid irrespective of taxpaying status are not unfamiliar territory to the Treasury; the Lifetime ISA, materialising in April 2017, will offer a 25% contributions bonus, and Help-to-Save accounts will include a 50% bonus.[24]

(b) The decumulation problem

One drawback to relying entirely on DC-based personal savings for retirement income is the risk of running out of money before dying, i.e. living too long relative to one's assets, a heightened risk since the advent of "Freedom and Choice". Since then, the industry has been wrestling with designing the optimum approach to asset decumulation, so that the individual minimises his life expectancy risk. Various drawdown structures have been proposed, but it is becoming clear to many that annuities are remarkable in one respect: they have no real competition.

Received wisdom is that many of the newly retired should combine drawdown with the purchase of a deferred annuity (commencing at 75 or 80, say). Unfortunately, that market is very thin, and therefore expensive. This is not a practical solution for the majority of retirees.

5. PLAN A

5.1 An integrated approach is required

In designing a replacement framework for the State Pension, we should take into account automatic enrolment into workplace retirement saving schemes as well as *all* Treasury spending on saving incentives, notably Income Tax and NICs relief.

(a) A Senior Citizens' Pension, from 80

(i) Later, but larger

The state is the deepest risk-absorbing pool there is. It can assume risk more efficiently than any individual or insurer, as it does today through

[23] See *How could the effect of rises in State Pension age be mitigated for the most vulnerable?* PPI Briefing Note 83, July 2016.

[24] Help to Save accounts, to be introduced no later than April 2018, will be available to around 3.5 million workers who receive working tax credits or Universal Credit.

the State Pension, socialising life expectancy risk across the whole population.

The State Pension should be put into "run-off", so that, from 2020, no further entitlements would be created. Past entitlements, garnered through NICs and NI credits would be honoured, as the "legacy" State Pension, albeit on what could be a later (Cridland-inspired?) SPA schedule than today's. Thus, "transitional protection" would apply, albeit that in law there would be no requirement for it (discussed below).

A Senior Citizens' Pension should be payable from the age of 80. Everyone under the age of 66 in 2020 (i.e. non-pensioners) would be eligible for it, so the first payments would be made in 2034. Perhaps set at £200 per week, it would be 30% larger than today's full State Pension.

The Senior Citizens' Pension would provide base retirement income from 80 until death (the "first pillar"). It would socialise the post-retirement longevity risk that few of us are equipped to manage by ourselves. Personal and workplace savings would be required to provide income for the interim period, between the time of retirement and 80, with welfare helping out where necessary.

(ii) Eligibility

The UK already has a pension which provides an income top-up, to £71.50 a week, for anyone aged 80 or over currently in receipt of a State Pension of less than that amount. It is non-contributory, but the qualification criteria include having lived in England, Scotland or Wales for at least half of the period between the ages of 60 and 80, i.e. a minimum of ten years.

This establishes a precedent for residency-based eligibility. Full entitlement to the Senior Citizens' Pension (SCP) could, for example, be set at a minimum of 40 years of residency. There is an inherent assumption that people would probably have been paying taxes for much of that time (VAT at the very least). A minimum threshold could be included, of 20 years, say, so that entitlement to the SCP would increase by 5% for every resident year in excess of 20 years.

Proposal 2: In 2020, the State Pension should be put into "run-off", i.e. no additional "entitlement" would be created thereafter, but transitional protection would apply. Simultaneously, a larger Senior Citizens' Pension should be introduced, payable from the age of 80. Everyone under the age of 66 in 2020 (i.e. non-pensioners) would be eligible for it, so the first payments would be made in 2034. Eligibility could be residency-based: for example, a minimum of 40 years between the ages of 30 and 80 for full entitlement, with a 20 year minimum threshold, say, and 5% for every year thereafter.

The Senior Citizens' Pension would co-exist with what would then be the "legacy" State Pension, the latter attached to a Cridland-reformed SPA.

(b) Work-related pension provision

(i) Automatic enrolment

With the Senior Citizen's Pension not commencing until 80, work-related pension provision would assume heightened significance as a source of pre-80 income. The 2017 statutory review of automatic enrolment (AE) will provide us with an opportunity to consider how AE could be developed, including addressing some of today's gaps in its framework.

Many in the workforce are ineligible for AE, including the 4.7 million self-employed (who lack an employer-sponsor), those on low incomes, and many with part-time jobs (27% of all workers).[25] The AE framework could be simplified by removing both the earnings trigger (£10,000) and the minimum earnings threshold (£5,824), which would deal with today's exclusion from AE of those with several small incomes from multiple part-time jobs.

But these changes would not help tackle widespread disengagement with pensions amongst savers. In 2012-13 some 380,000 auto-enrolled workers were ignoring or unaware of their fund choices, but this figure increased to 1.5 million in 2015-16, 9% and 15%, respectively, of all private sector employees with DC pensions.[26] AE breeds complacency, and lack of awareness is likely to become more significant as the smaller employers enter AE ramp-up, over the next couple of years.

But whatever enhancements are made to AE, they cannot counter the widespread disillusionment with pensions, particularly amongst Generation Y (who are therefore missing out on tax relief).

(ii) A Workplace ISA and 50% bonus

A Workplace ISA should be introduced within the AE framework, specifically to accommodate employers' contributions, perhaps accompanied by a bonus of 50%, up to a modest annual cap.[27] Employee contributions made through automatic enrolment should be permitted to be paid into a Lifetime ISA (attracting the planned 25% bonus), which younger employees, in particular, would appreciate. As such, any risk of opt-outs arising as a result of the competing attractions of the Lifetime ISA would be extinguished. Indeed, this would help reinforce AE. Workplace ISA contributions and bonuses should only be accessible from the age of 65: the Appendix provides more detail.

The Workplace ISA would, ideally, incorporate a default fund and some form of default decumulation framework: "auto-protection".[28] This could be in the form of either a fixed-term annuity maturing at 80 (joint life for couples), purchased through an open-market auction, or automated drawdown (perhaps initially set at 5% of assets each year, rising as the age of 80 is approached).

Proposal 3: The 2017 review of automatic enrolment (AE) should lead to the introduction of a Workplace ISA to accommodate employer contributions, attracting a bonus of 50%, up to a modest annual cap. It should also include a default fund and "auto-protection", a default decumulation framework (with an opt out), perhaps in the form of annuitisation to the age of 80. No access to assets would be permitted until 65. Employee contributions made under AE should be permitted to be paid into a Lifetime ISA.

One consequence of introducing a Workplace ISA (ultimately to become the primary source of pre-80 retirement income) would be that any doubts as to the primary purpose of the Lifetime ISA would disappear. Unambiguously, the Lifetime ISA would become the principal vehicle to help Generation Y attain home ownership.

25 There are 8.5 million part-time workers, out of 31.8 million in work; *UK labour market: September 2016*; ONS.

26 *Working Lives reports Q1 2013 and Q1 2016*; Aviva, and ONS data for private sector employees with DC pensions (4,250,000 in 2012-13 and 9,787,000 in 2015-16).

27 Detailed in *The Workplace ISA*; Michael Johnson, CPS, April 2016.

28 See *Auto-protection at 55*; Michael Johnson, CPS, February 2015.

(iii) No 25% tax-free lump sum

The end of the 25% tax-free lump sum (implicit in an ISA-centric TEE world)[29] would lead to post-retirement annuity incomes being 33% larger than otherwise; particularly useful in today's world of low interest rates. In addition, the lump sum is not seen as a significant advantage by the next generation of savers. Only accessible from the age of 55, it is too time-remote to change Generation Y's savings behaviour. Consequently, from the Treasury's perspective, it is an ineffective incentive: the opportunity cost of not scrapping it is some £4.5 billion a year.

Meanwhile, the availability of the lump sum risks encouraging some people to take what subsequently proves to be a short-sighted decision.

(iv) The self-employed

The self-employed, lacking an employer-sponsor, miss out on AE's employer contributions. One approach to rectifying this would be to accommodate the self-employed within an AE framework provided by NEST (and its competitors), with the Treasury making "employer" contributions to complement the individual's own contributions.

The self-employed pay lower rates of NICs than those paid by employees, and they do not, of course, pay employer NICs, but they enjoy the same "entitlement" to the State Pensions.[30] A reasonable *quid pro quo* for state contributions under AE would be to require the self-employed to pay full rates of employee NICs, the increase being roughly equivalent to the minimum employer contribution under AE (once fully ramped-up, by 2019): 3% of AE's qualifying earnings band.[31] NICs classes 2 and 4 could then be scrapped, a welcome simplification.

Detractors of such a proposal may say that this would represent the introduction of compulsory saving. Yes, but in terms of helping the self-employed provide for their retirement, it could be the least-worst option.

Proposal 4: The self-employed should be included in automatic enrolment, with the Treasury paying the "employer" contributions, housed in NEST and its competitors. In return, the self-employed should be required to pay full rates of employee NICs (Classes 2 and 4 having been scrapped).

This approach is consistent with the mood music emerging elsewhere. The Danish government, for example, has recently proposed mandatory pension savings for nearly everyone of working age.[32] The proposal is that everyone aged over 25 who is saving less than 6% of their income into a pension will be eventually required to save 2% of their income. The scheme would cover benefits recipients and employees as well as self-employed people, with mandatory contributions being paid into ATP, Denmark's supplementary, statutory, funded (income-related) pension plan.

29 TEE: Taxed, Exempt, Exempt. The first letter refers to contributions (of capital), the second to investment income and capital gains, the last letter to post-SPA income. Conversely, the pensions framework is EET.

30 2016-17: Employees' Class 1 NICs 12% (£155 to £827 a week) and 2% (over £827 a week). Self-employed Class 2 NICs £2.80 a week (on annual profits between £5,965 and £8,060), or Class 4 NICs at 9% on profits between £8,060 and £43,000, and 2% thereafter.

31 2016-17 band earnings: between £5,824 and £43,000 a year (£112 and £827 per week).

32 *Danish Government 2025 Plan,* August 2016. Under the proposal, the mandatory pension contributions will start at a level of just 0.25% in two years' time, rising gradually to 2.0% by 2025.

(c) Income Support for retirees

There would still be a need for a welfare-based (means-tested) retirement income supplement. Today, this is provided by Pension Credit, at a cost of £6.1 billion last year (about 7% of the cost of the State Pension).[33] Many of those who receive it were previous recipients of Income Support, a means-tested benefit available to people under Pension Credit qualifying age (the SPA) who do not have enough to live on.[34]

As a simplification measure, we could extend eligibility for Income Support beyond the SPA, increasing it as appropriate (the additional cost being offset by what would then be a diminishing legacy State Pension cost). Indeed, there is already an Income Support "premium": additional money for those with a partner who is a pensioner. Pension Credit could then be scrapped: one less benefit to administer would be a welcome simplification measure.

Proposal 5: Today's means-tested Income Support should be extended beyond the SPA, enhanced to reflect the proposed demise of the State Pension. Pension Credit could then be scrapped.

Figure 1 illustrates how the Senior Citizen's Pension and Workplace ISA in decumulation would fit together, supplemented by Income Support (replacing Pension Credit).

6. PLAN A: MANY ADVANTAGES

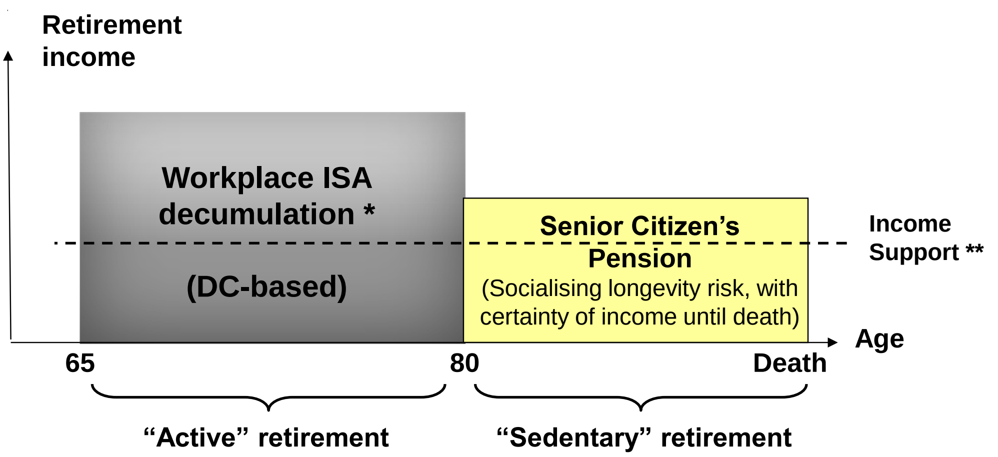
The Workplace ISA / Senior Citizens' Pension combination would bring a number of significant benefits to the retirement funding landscape.

6.1 Drawdown / decumulation

(a) Planning

Introducing a Senior Citizens' Pension (SCP) would make it much easier to plan the drawdown of Workplace ISA assets (and other private

Figure 1: Retirement income from 2034 (legacy State Pension and occupational pensions not shown)



** Incorporating a decumulation default, either a 15 year annuity or automated drawdown*
*** Replacing Pension Credit*

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[33] *Benefit expenditure and caseload tables 2016*; DWP, September 2016.

[34] Income Support is only available to people who do not get Jobseeker's Allowance or Employment and Support Allowance, and are not in full time employment. Claimants of Universal Credit are ineligible.

pension pots). With the SCP in place, there would then be a finite 15 year period between the first opportunity to draw down from the Workplace ISA, and receipt of the SCP, at 80. (Today's minimum age of 55 for accessing private pension pots should be moved rapidly to 65.)[35]

(b) Annuity market impact

With the SCP in place then, beyond the age of 80, longevity risk would be socialised across the whole population, housed within the Senior Citizen's Pension and Pension Credit. We could expect demand for fixed term annuities to increase substantially (maturing at 80), with demand for lifetime annuities much diminished.[36] Annuity incomes would be higher, and not just because of the shorter term: annuitants would no longer have to pay insurers' regulatory capital costs associated with tail-end longevity risk. This could set in train a virtuous circle: annuities could be written more efficiently (from a regulatory capital perspective), and demand would further increase.

In addition, the state itself should be free to sell annuities, perhaps via the Post Office and National Savings (acting as agents for the Treasury), not least to add some market pricing tension.

6.2 The 50% bonus

(a) Helping to tackle inequality

A redistributive, flat rate 50% bonus (replacing regressive Income Tax relief, and NICs relief) would be an important step in tackling inequality, which is increasingly being considered an economic, as well as a social, issue. IMF research shows that countries with bigger wealth gaps tend to have shorter periods of high growth, and more volatile economies.[37] This is partly because (ever expanding) consumer credit masks inequality, which leads to debt bubbles and financial crises. Indeed, the IMF now believes that reducing inequality is as important as free trade in terms of fostering economic growth.

(b) A politically appealing policy

A 50% bonus would *double* the rate of incentive to save for basic rate taxpayers, compared to today's 20% tax relief. From a political perspective, being able to tell 84% of the workforce that the Government had doubled their rate of incentive to save should be an attractive message to disseminate.

(c) Communication: "bonus" better than "Income Tax relief"

It is not intuitive that a 50% bonus is twice as big as tax relief at 20%.[38] But communicating it as "two for one" (not "matching" which misleadingly implies "one for one") would be simpler than trying to explain tax relief, which many people do not understand. (The Lifetime ISA is the first example of the language of tax relief being reframed as a "bonus".)

In addition, the Government could emphasise that, for basic rate taxpayers, the Workplace ISA's 50% bonuses would reward work far more generously than tax relief. "Work pays" is a message that the Government is keen to propagate.

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35 Currently, the minimum pension age is set to rise to 57 in 2028, when the SPA will rise to 67 (maintaining the 10 year differential).

36 Today, the term structure of annuity pricing discourages people from annuitising early (perhaps not until they reached 70).

37 *Causes and consequences of income inequality: a global perspective;* IMF Strategy, Policy, and Review Department, June 2015.

38 Today, basic rate taxpayers receive tax relief of 25p per post-tax £1 saved (which is £1.25 pre-tax, less 25p, being 20% Income Tax). A 50% Workplace ISA bonus added to a post-tax £1 saved would be 50p, i.e. double tax relief's 25p.

(d) Towards a fully funded framework

Bonuses could be considered as the Treasury's contribution towards the pre-funding of some of the retirement income which is today derived from the unfunded (pay-as-you-go) State Pension. As such, this would represent a step towards a fully funded framework for all retirement income, and a reining back on the older generations' talent for perpetrating inter-generational injustice by making unfunded promises to themselves, to be met by later generations.

6.3 Reduced pressure to raise AE contributions

A 50% Workplace ISA bonus would lessen the pressure to increase AE's minimum contribution of 8% of band earnings (currently 4% (employee) + 3% (employer) + 1% (tax relief at 20%) = 8%, once fully ramped up). Instead, today's contributions framework would become 4% + 3% + 3.5% = 10.5% (for basic rate taxpayers). An additional 2% each, from employees and employers, would produce 6% + 5% + 5.5% = 16.5%, thereby exceeding Lord Turner's 16% target contribution rate for median earners.

6.4 Improved engagement

The Workplace ISA would be a highly personalised account, with the individual's name on it. Younger employees' AE contributions could go into their Lifetime ISAs, and would benefit from the additional flexibility relative to corporate DC schemes.

In addition, today NICs relief on employer contributions goes to shareholders: employees are oblivious of it. Consequently, as an incentive to encourage individuals to engage with saving, it is ineffective. By redeploying NICs relief to help fund Workplace ISA bonuses, the Treasury's contribution would be made highly visible to the individual: it would be more appreciated and therefore more engaging.

6.5 Simplification and transparency

(a) Tax simplification

One advantage of introducing a residency-based eligibility assessment for the Senior Citizens' Pension is that it could lead to a significant simplification of the tax framework. NICs would become largely redundant, so National Insurance could be integrated with Income Tax to become a single Earnings Tax. For decades, NICs have been a politically convenient mechanism to obfuscate the true tax burden.[39]

The value of tax simplification and transparency should not be under-estimated. Harvard economists, in particular, have long argued that it is the convoluted nature of tax codes, not tax rates, that drives businesses abroad.[40]

(b) Savings simplification: the defenestration of pensions' EET

Ending Income Tax and NICs relief on pensions contributions would mean that the pensions savings framework of EET would fall away, to leave a purely TEE-based savings arena. Note, however, that more than half of today's pensioners pay no Income Tax: for them, pensions are EEE.[41]

The (long-term) simplification benefits could not be over-stated. Subsequent generations, for example, would not have to wrestle with a dictionary of impenetrable pensions jargon,

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[39] See *NICs: the end should be nigh*; Michael Johnson, CPS, October 2014.

[40] Notably Professors Ken Rogoff and Carmen Reinhart.

[41] Many pensioners have been taken out of Income Tax by the rapid rise in the Personal Allowance (from £6,475 in 2010-11 to £11,000 in 2016-17), the £5,000 nil-rate Starting Rate on income from savings and the Personal Savings Allowance of £1,000 in tax-free interest.

currently requiring the translation services of an army of costly advisers and consultants. Uncrystallised funds pension lump sum (also called a FLUMP)? Trivial commutation? And, with a modest annual cap on bonus-eligible employer and employee contributions (£10,000, say, shared with the Lifetime ISA), there would be no need for a Lifetime Allowance in respect of Treasury-incentivised savings.

6.6 Fairness

Replacing tax relief on pensions contributions with a bonus paid irrespective of taxpaying status would address today's fundamental conundrum that because Income Tax is progressive, then tax relief is regressive. Tax relief undoes society's buy-in to a progressive tax regime. The end of tax relief would also put an end to injustices brought about by arrangements such as "net pay", which can result in low earners missing out on tax relief on employer contributions.

6.7 Treasury spending: more effective with bonuses

Income Tax relief primarily benefits the wealthy, who save anyway, whereas a 50% flat rate Workplace ISA bonus, being more redistributive, would focus Treasury resources more onto those most in need. This would help catalyse a much more broad based savings culture, which the UK desperately needs.

Thus, bonuses would be a far more effective use of Treasury resource, while also leaving scope for the Treasury to find a net saving of perhaps £10 billion per year (having scrapped Income Tax and NICs relief).

7. IMPLEMENTATION OF PLAN A

7.1 State Pension entitlement: misunderstood

Contrary to widespread belief, the State Pension is *not* a contractual obligation arising from the payment of NICs: it is technically and legally a contributory social security benefit.[42] But this is not widely appreciated, because its true status has long being shrouded behind politically convenient ambiguity.

A judgement delivered by Lord Hoffman makes it clear that the State Pension is not a "property right": *National Insurance contributions has no exclusive link to retirement pensions….in fact the link was a rather tenuous one.*[43] Essentially, National Insurance is to "insure" people against the risk of not being able to work, by providing an income until either they are able to work, or they die. Old age is just one of a number of insured risks, which include unemployment, sickness, maternity and bereavement. NICs also partially fund the NHS. In short, National Insurance is not a pension scheme.[44] It is really a work-related tax, akin to Income Tax, albeit loosely hypothecated (via the National Insurance Fund) to pay the State Pension, i.e. an inter-generational transfer of cash from workers to pensioners.

State Pension payments are dependent upon certain conditions being satisfied. These include past NICs and NI credits, but they do not give rise to a specific value of State Pension: witness how

42 The word 'benefit' is used as a general term to encompass all State-issued payments, and from the time of the 1946 National Insurance Act, which applied from the inception of the National Insurance scheme, retirement pension (now known as State Pension) has always been classified in law as a "benefit", defined in section 122(1) of the Social Security Contributions and Benefits Act 1992.

43 House of Lords judgment, May 2005, dismissing a discrimination claim made by a pensioner living in South Africa who was not receiving the same pension increments as those paid to pensioners living in the UK. For more detail, see Frances Coppola's *Coppola Comment, State pensions: property right or benefit?* 20 October 2016.

44 *Ibid*.

indexation rules have changed over the years (and the new single-tier State Pension is different from its predecessor). The age of eligibility as defined in legislation, but this could, *in extremis*, be changed at any time.[45] Consequently, the State Pension does not appear in the National Accounts, nor even the (more transparent) Whole of Government Accounts' balance sheet.[46]

7.2 Transition: HM Treasury's perpsective

For illustrative purposes, let us assume that the Senior Citizens' Pension is announced in 2020, coinciding with the State Pension being put into "run-off", i.e. no additional "entitlement" would be created thereafter.

The cost of the legacy State Pension would diminish from 2020, as a consequence of (i) pensioners dying (both those who were pensioners in 2020 and the beneficiaries of transitional protection); and (ii) the onset of means-testing. Current tax revenues would become increasingly available, through time, to help fund the Workplace ISA bonuses, which would be helping to fuel workers' subsequent retirement incomes, as well as the enhanced Income Support commencing in 2020.

Means-testing could be expected to produce an immediate saving to the Treasury, which would grow quite quickly as the tail end of the relatively affluent baby boomer generation reaches SPA, in around 2031.[47]

Given that the Senior Citizen's Pension (SCP) would only be payable to those under SPA in 2020 (i.e. under 66), the first year of payments would be fourteen years later, in 2034 (i.e. from the age of 80). The cost of the SCP could then be expected to grow quickly thereafter; see Figure 2.

7.3 Funding and cost control

(a) Funding

Funding of the ISA bonuses (the 50% Workplace ISA bonus, along with Lifetime ISA's 25% bonus on employee contributions made under AE), pensioners' Income Support and, from 2034, the Senior Citizens' Pension, could be met by scrapping all Income Tax and NICs relief on pensions contributions; totalling over £40 billion per year.[48] That said, some Income Tax relief may have to be retained for ongoing contributions to address DB scheme deficits.[49] However, there are other potential cost savings available elsewhere, such as the annual opportunity costs of the 25% tax-free lump sum (about £4.5 billion) and salary sacrifice schemes (roughly £2 billion). The latter is a tax arbitrage at the Treasury's expense, unfairly unavailable to those without an employer-sponsor.[50]

(b) Cost control

Figure 2 assumes that the Treasury would aim to keep overall pensions-related spending at the 2020-21 level (less the saving from introducing means-testing of the legacy State Pension). In practice there would be many variables at large

45 The SPA can be amended at any time through primary legislation, as per the Pension Acts 1995, 2007, 2011 and 2014.

46 If the State Pension were to be included in the WGA, the UK's net liability would leap from £70,000 to £221,000 per household.

47 Baby boomers: born c.1946 to c.1964. The youngest would reach the SPA of 67 in 2031.

48 *Table Pen 6*; HMRC, February 2016.

49 Detailed in *What of DB in a TEE world?*; Michael Johnson; CPS, April 2016.

50 Unlike employer contributions, employee contributions do not attract NICs relief. Consequently, employees accept a salary cut in return for a larger pension contribution from the employer, so that both parties save on NICs (which can be recycled into the additional contribution).

that could produce a larger, or smaller, total expenditure, but most of them would be within the Treasury's control. Detailed modelling would be required, and the variables include:

- the maximum size of the Senior Citizens' Pension and its indexation and eligibility criteria;
- the limit on Workplace ISA bonuses payable to any individual in a single year;
- the parameters for means-testing of the legacy State Pension, from 2020;
- the structure of the enhanced, post-2020, Income Support; and
- the ongoing need to reduce the Budget deficit.

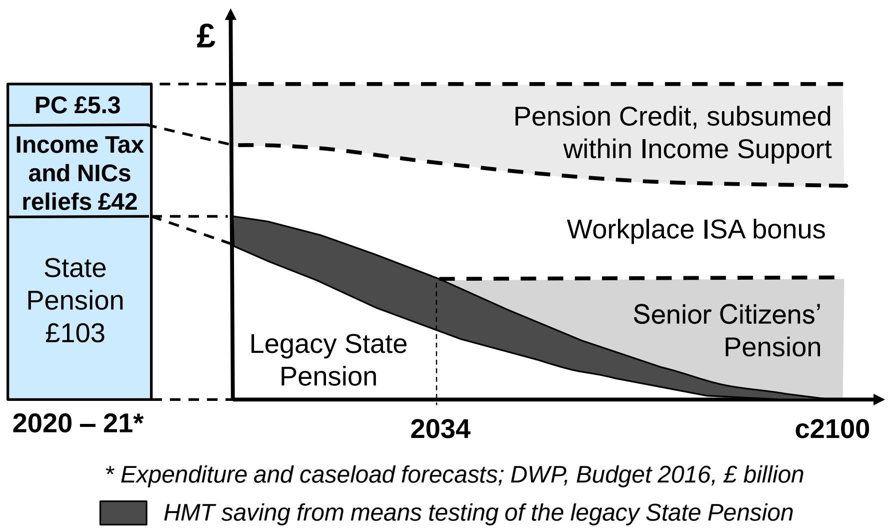
There is considerable scope for slippage in the timetable envisaged in Figure 2. Politicians are naturally inclined to place considerable time between announcing a potentially unpopular measure, such as the introduction of means-testing of the legacy State Pension, and its implementation. For example, rather than in 2020, this could be timed to coincide with the arrival of the Senior Citizens' Pension in 2034, with attendant adverse budgetary implications.

The primary cost control lever could be a combined annual limit on bonus-eligible contributions of perhaps £10,000, shared between the Lifetime and Workplace ISAs, to which the bonuses would be added. This would provide a more than adequate savings capacity, particularly if saving were commenced early. Unused annual limits could perhaps be rolled up, over ten years, say, to accommodate people who reinvest in their businesses ahead of saving for retirement.

7.4 Cross party support: achievable

It is acknowledged that some may find this paper's proposals challenging, and cross party support for them should be a pre-requisite for them to progress. But it would be disingenuous of the Labour Party not to support the broad thrust of these proposals, to attune state-funded retirement income provision to contemporary times. The iniquity of today's universal State Pension age is hardest felt in inner city constituencies and the formerly industrial North: Labour Party heartlands. In addition, the

Figure 2: Plan A: HM Treasury cost components (not to scale)



proposal for a 50% Workplace ISA bonus is highly redistributive.

7.5 Clear and precise communication required
Coinciding with the publication of his interim report, John Cridland commented that *whatever recommendations I decide to make in my final report, they will be underpinned by the importance of effective communications about the State Pension age. People need to be able to plan effectively for their own retirement.* This is crucial: witness the WASPI campaign.

In time, the pension dashboard, currently in development, should play an important role in communicating the status of individuals' potential retirement incomes.[51] It should certainly include the legacy State Pension, the Workplace ISA and the Senior Citizens' Pension.

8. PLAN B: THE ISA PENSION

8.1 What is a "pension ISA"?

In the run up to the 2016 Budget, the term "pension ISA", or PISA, entered media common parlance, but it is without any formal definition. The author regularly asks journalists who write about it to explain what a pension ISA is.[52] To-date, no one has offered a clear description. Unfortunately, pre-Budget, the lack of a formal definition of a "pension ISA" helped pensions industry lobbyists sow confusion, culminating in the Chancellor ducking any (immediate) reform of today's regressive tax relief on pension contributions.

The author uses "ISA Pension" (*not* "pension ISA") to refer to a regular income stream derived, from the age of 65, say, from assets accumulated within a Workplace or Lifetime ISA: yes, an annuity. 15 year ISA Pension annuities would then provide an income bridge until receipt of the Senior Citizens' Pension from 80. The annuity providers would then assume the inflation, investment and longevity risks (until 80) that few of us are equipped to manage by ourselves.

8.2 People like annuities: they just do not know it

Several surveys have asked people about their intentions for their DC retirement savings. One found that nearly 70% of respondents expressed a desire for a "steady, secure income" in retirement, without the risk of outliving their savings, i.e. a lifetime annuity, although few people describe it as such.[53] Another survey reported that the majority of DC pot holders aged over 55 want a guaranteed income for life, particularly an income protected against inflation.[54] It also found that only 50% of people understand how to obtain this from their pots: the word "annuity" does not resonate. It would appear that most people do not appreciate that an annuity *is* a pension.

8.3 Distinguish between noise and signals

Notwithstanding the prevailing anti-annuity mood, we should be careful to distinguish between background "noise", such as today's exceptionally low interest rate environment, and

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[51] See *The pensions dashboard: vital for UK plc;* Michael Johnson, CPS, July 2016.

[52] Notwithstanding that the broad concept has been in circulation for at least a decade. The author has a copy of an industry presentation given to the DWP outlining a Pensions ISA, dated July 2005.

[53] *In a brave new pensions world, what will DC members really want?* Aon DC Member Survey, Aon Hewitt and Cass Business School, December 2014.

[54] *Making the system fit for purpose: How consumer appetite for secure retirement income could be supported by the pension reforms.* International Longevity Centre-UK, January 2015.

more permanent “signals”. A recent paper from two eminent authors observes that:[55]

> *the current negative real rate of interest is not the new normal; it is an extreme artefact of a series of trends, several of which are coming to an end. Where might real interest rates reach? By 2025, they should have returned to the historical equilibrium value of around 2.5% to 3%, with nominal rates therefore at 4.5% to 5%.*

In time, we should expect higher real interest rates to feed through to better annuity pricing, and this could significantly change sentiment towards annuities.

8.4 International perspective

There is growing international evidence that more focus needs to be placed on decumulation. New Zealand, for example, has no annuitisation market, not least because of the lack of any state incentives to annuitise. Some are now suggesting that this should change, to facilitate the emergence of annuitisation’s social gains (including fewer retirees falling back on the state, having exhausted their assets).[56]

Australia’s “Murray Inquiry”, charged with examining how the financial system could be positioned to best meet Australia’s evolving needs and support economic growth, was unequivocal.[57] It recommended a shift of focus away from tax-incentivised wealth accumulation (and estate planning) towards the provision of retirement income, including an increase in risk-pooling in decumulation, i.e. annuitisation. It also recommended placing an increased emphasis on setting clear retirement income objectives (such as an income replacement rate, mirroring a recommendation from Lord Turner’s Pensions Commission).

8.5 A 25% enhancement when securing an ISA Pension

If we accept that annuitisation does offer societal benefits (including protecting both the state and the individual), then perhaps we should incentivise it? This could take the form of a 25% uplift, say, on the annuity rates inherent in an ISA Pension, which could be particularly attractive given today’s very low interest rate environment. This would not be without precedent. Swiss insurers, for example, are required to subsidise annuities, which perhaps explains why Switzerland has the highest level of voluntary annuitisation in the world (some 80% of pension pot assets).[58]

8.6 ISA Pension: tax treatment

Given that ISA Pensions would be acquired with assets formerly held within the Workplace ISA, then perhaps they should be tax-exempt. The Workplace ISA’s tax treatment could then be characterised as TEEN (Taxed, Exempt, ENhanced). But the Treasury is likely to view the combination of bonuses on contributions and a subsequent 25% uplift upon annuitisation as being too generous.

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55 *New world faces challenges from an age-old problem;* Charles Goodhart, Emeritus Professor, London School of Economics and Philipp Erfurth, Financial World magazine, February 2015.

56 Notably Prof. Susan St. John, Co-Director, Retirement Policy and Research Centre, University of Auckland. She has also suggested that cost-effective insurance for long-term care could be incorporated within annuities.

57 Financial System Inquiry, Final Report to the Treasurer, November 2014.

58 Swiss insurers are currently required to provide a minimum annuity conversion rate of 6.8%, which is clearly incompatible with life expectancy at retirement and expected investment returns. It is planned to lower this rate to 6% in connection with reform “Pension 2020”, and increase social contributions per employee.

Substantial cost modelling is required, which could examine the consequences of taxing the ISA Pension at the recipient's marginal rate, or reducing the Workplace ISA's bonus to 25% rather than the proposed 50%.

> **Proposal 6:** Consideration should be given to introducing an ISA Pension, an annuity purchased from the age of 65 with Workplace ISA assets, maturing at the age of 80. It should be enhanced by a Treasury-funded 25% uplift on the underlying annuity. Tax treatment should be determined by cost modelling: it could be tax-exempt if, for example, the Workplace ISA bonus were set at 25%, rather than the proposed 50%.

8.7 Broadening eligibility for an ISA Pension

We could make *today's* stock of ISA assets eligible for a tax-exempt ISA Pension, at any time after the age of 65, say.[59] The 25% annuitisation uplift would most likely encourage some ISA savers to delay accessing their ISA-held assets until 65. Once the initial swathe of annuitants had past, the "steady state" annual cost would settle down at a few £ billion per year, as successive cohorts of 65 year olds secured enhanced, ISA Pensions with their ISA capital.[60] This could be a far more effective use of Treasury funds than Income Tax and NICs relief.

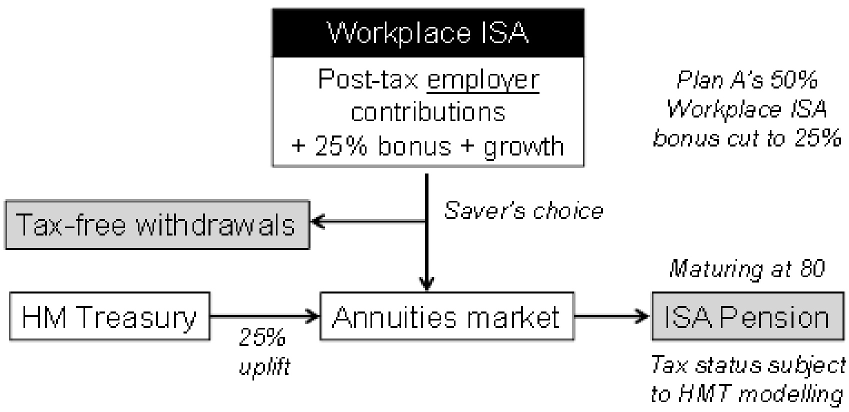
8.8 ISA Pension as a default at 65?

In time, demand for auto-protection at retirement could emerge (i.e. a default), which could take the form of an ISA Pension.[61] But, to be clear, there is no desire to row back on "Freedom and Choice"; savers should be free to choose what they do with their savings in retirement.

9. WHAT OF PUBLIC SERVICE PENSIONS?

John Cridland's review of the SPA is implicitly a review of public service pensions because the Public Service Pensions Act 2013 raised normal pension age to the greater of 65 or the SPA. Cridland's interim report flags the issue of the SPA being used as a reference point elsewhere, and invites suggestions as to how far his review should take into account impacts on

Figure 3: Plan B: the enhanced ISA Pension, available from age 65



[59] In April 2016, £518 billion was held in adult ISAs, with people aged at least 65 holding roughly £238 billion (46%), split 48:52 between cash and stocks and shares ISAs. *Individual savings accounts statistics, Tables 9.6 and 9.11;* HMRC, August 2016.

[60] Today, annuities purchased with ISA assets are partially taxable at the beneficiary's marginal rate. Part of the income is treated as a return of capital, and is tax-free. The rest is paid with tax of 20% already deducted.

[61] See *Auto-protection at 55,* Michael Johnson, CPS, February 2015.

occupational scheme rules. He should anticipate a contribution from the public service unions, which is likely to shed light on the growing schism between the quality in pension provision between the public and private sectors.

CONCLUSION

Today's State Pension structure has had its time. The world is very different to that in which Beveridge formulated his plans for social welfare. In addition, the cost control lever of choice, that of sending a universal SPA into retreat, is unwittingly propagating social injustice, partly because of the big differences in life expectancy across the nation. A radical rethink is required: hopefully this paper will help catalyse the debate.

APPENDIX

The Workplace ISA: reinforcing auto-enrolment[62]

Key features

- A Workplace ISA should be included in the auto-enrolment (AE) legislation. This is fundamental: employers are integral to auto-enrolment's success. It should be open to all auto-enrolled employees under the age of 50.

- Employer contributions, taxed at the employee's marginal rate, may be paid into a Workplace ISA until the age of 50 (as per the Lifetime ISA). They should be accompanied by a Treasury bonus of at least 25%, and perhaps 50%.

- Withdrawals from the Workplace ISA should not be permitted until the age of 65; thereafter, they would be tax-free.

- Auto-enrolled employee contributions, made with post-tax income, may be paid directly into the employee's Lifetime ISA. They would be subject to the same tax, withdrawal and penalty rules as other Lifetime ISA savings. They should also be eligible for the Treasury's bonus.

- Employer and employee contributions should share an annual cap on bonus-eligible contributions of £10,000, subject to Treasury cost modelling.

- The Workplace ISA could be housed within the Lifetime ISA, leaving the individual with a single retirement savings vehicle (all other ISAs having been folded into the Lifetime ISA, with their individual characteristics retained).

- Workplace ISA assets should enjoy the same Inheritance Tax treatment as today's pension pots, and should be excluded for means-testing purposes, as per today's pension assets.

ISAs as part of auto-enrolment: to discourage opt-outs

Including the Lifetime and Workplace ISAs within the auto-enrolment framework would enable employees to choose where AE contributions would be accumulated. The choice would be between a Lifetime ISA (employee contributions), a Workplace ISA (employer contributions) and the employer's own occupational pension scheme (all contributions). Auto-enrolled Lifetime ISA contributions would provide employees with the benefit of flexible access, which would likely *discourage* them from opting out of auto-enrolment. This is important given that within the next three years, employees' statutory minimum contributions are set to quintuple. Being in control is closely allied to being motived (perhaps, in this case, to save more), and therefore engaged.

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62 Based upon *The Workplace ISA*; Michael Johnson, CPS, April 2016.

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Jenny Nicholson
Deputy Director, Events and Fundraising
Centre for Policy Studies
57 Tufton Street
London SW1P 3QL
020 7222 4488
jenny@cps.org.uk

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THE AUTHOR

Michael Johnson is a Research Fellow of the Centre for Policy Studies and a highly regarded pensions analyst. He originally trained with JP Morgan in New York and, after 21 years in investment banking, joined Towers Watson, the actuarial consultants. More recently he was Secretary to the Conservative Party's Economic Competitiveness Policy Group.

He is the author of more than 35 influential pensions-related papers for the Centre for Policy Studies (all of which can be freely downloaded from www.cps.org.uk). He is consulted on pension reform by serving Ministers and shadow Ministers, the DWP Select Committee and the House of Lords Select Committee on Public Service and Demographic Change.

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57 TUFTON STREET, LONDON SW1P 3QL TEL:+44(0) 20 7222 4488 FAX:+44(0) 20 7222 4388 WWW.CPS.ORG.UK