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British Pension Policy in the Twenty-first Century: a Partnership in Pensions or a Marriage to the Means Test?

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Abstract

This paper analyses how well the latest in a long line of reforms to the British pension system will serve the low-income population and protect against a means-tested old age. We argue that New Labour's proposals (set out in the Green Paper "A New Contract for Welfare: Partnership in Pensions") will develop a new relationship between public and private pension provision which leads to a much wider role for means testing. We illustrate our argument by looking at faults written into the design of the pension system and by examining the experiences of the new regime that a range of hypothetical, low-income individuals would have. We find that, contrary to the government's message, the proposed State Second Pension will not be a replacement for SERPS but will, in fact, combine with the basic pension to provide a new flat-rate pension aimed at the poorest. Low-income individuals and those with broken work histories will face great difficulty in avoiding a means-tested old age. Furthermore, increased reliance on annuity income in retirement may also propel significant numbers of the middle classes into means testing. Far from simplifying the pension system, the proposals will add complexity, making it difficult for individuals to make an optimal pension choice. In conclusion, the proposed pension partnerships are likely to be unsustainable and therefore likely to lead to a continuance of the cycle of pension reform.

Keywords

Pensions; Social security; Inequality; Poverty

Introduction

The structure of the British pension system has posed a challenge to every postwar government. Pension reforms have occurred with alarming regularity and each reform has added a new layer of complexity to a now baffling pension system. The latest in this line of reforms is outlined in the government Green Paper, *A New Contract for Welfare: Partnership in Pensions* (DSS 1998a).

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Our focus in this paper is on how well the proposals serve the low-income population and protect against a means-tested old age. Concern with protecting the lifetime poor in retirement at the same time as fostering individual saving and private pension provision has a long pedigree in British pension policy. New Labour addresses this concern by proposing a new relationship between public and private pension provision and increased targeting of the State Second Pension towards the poorest. This paper analyses these proposals in order to see how far such new partnerships and targeting mechanisms lead to a wider role for means testing.

Our argument proceeds as follows. First, we outline the general principles inherent in the design of the British pension system. Second, we see how the balance of these principles is represented in the new "Partnership for Pensions". In this section we identify a number of design faults written into the Green Paper's proposals, each of which will have the effect of extending means testing to a large number of low-paid workers. Third, we discuss how a range of hypothetical, low-income individuals and their partners would experience the new regime. We then expand our analysis away from low earners to assess the potential of means-tested provision to affect those higher up the earnings distribution.

Partnership of Principles: Four Elements of Pension Provision

New Labour's proposed pension system consists of four elements.

- First, the *basic pension* remains unchanged, paid on a flat-rate basis to everyone who has fulfilled the contributory requirements when they reach pensionable age.[1] There are no plans to restore the indexation to earnings (introduced by Castle and abolished by Fowler). Continuing price indexation means that a decent income in old age will depend upon the performance of the other three elements.
- The second element is a *means-tested minimum*, which New Labour has renamed the Minimum Income Guarantee (MIG). But this new name uses the word "guarantee" in a misleading way. MIG is not guaranteed—it requires people to take it up and at present 18–24 per cent of all people entitled to Income Support do not do so (DSS 1998b, table H4.01). The older population are particularly reluctant to claim despite large-scale DSS efforts. MIG is provided through basic social assistance alongside passported housing allowances (housing benefits and council tax benefits) and concessions for charges related to healthcare.
- The third element is a *state-run secondary pension*. This is currently provided by SERPS, designed to supplement the basic pension for low earners who are unable to benefit from private and occupational pension schemes. Under the proposals, this will be replaced by the State Second Pension (S2P) targeted at those earning under £9,000 per annum.
- The fourth element is *private provision*: occupational and private pension schemes and also income from personal savings and investments. New Labour proposes a significant expansion of private pensions through

Table 1

Weekly rate of basic pension and Minimum Income Guarantee (April 1998)

Weekly rate for	Single	Couple
Basic pension	£66.95	£106.90
MIG	£75.00	£116.60
Basic pension as % of MIG	89.3	91.7

the Stakeholder Pension (SHP), which will be targeted at those earning between £9,000 and £18,500 per annum who do not have alternative private cover. The government proposes that SHPs will be regulated with the aim of ensuring low charges, ease of access and portability.

The interrelationship of these four elements is crucial to a balanced pension policy that meets needs and maintains incentives to work and save. It is the Green Paper's underlying view of these relationships that concerns us first. For low-paid workers, do the proposed levels of the basic pension and S2P provide incomes that are sufficiently above MIG? How far will SHP also provide an income above MIG as higher-paid workers move into and through retirement after 2050?

The partnership of the basic pension and MIG

The current rates of the basic pension and MIG are given in table 1. As the table shows, the basic pension now only satisfies 89 per cent of government-defined basic needs for single pensioners and 92 per cent for couples. While the government's generosity in increasing the level of MIG for pensioners has an obvious up side—better support for pensioners—it has a down side as it further undermines the ability of the basic pension to provide a non-means-tested platform for retirement.

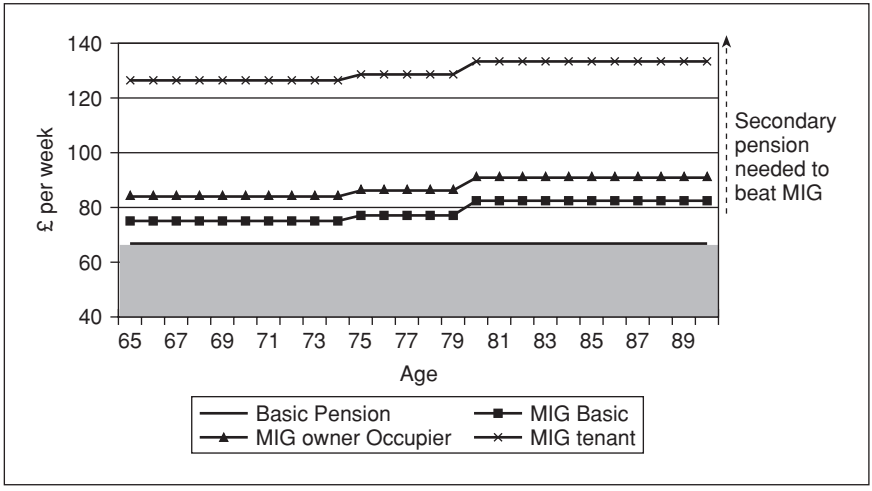
When we consider means-tested assistance for council tax and/or rent, the situation of the basic pension relative to means-tested benefits is actually worse than table 1 suggests. Housing benefits cover 100 per cent of rent and council tax on top of MIG—in 1998 an average of £8.87 was given towards rent and £42.46 towards council tax.[2] This means that, on average, the basic pension only covers 79 per cent of the needs of a single pensioner who owns their own home, and only 53 per cent of the needs of their tenant neighbour.

These rates apply the moment the pensioner retires. However, as pensioners grow older, MIG rises and the relative value of the basic pension falls further. For a 75-year-old single person MIG is £77.30 and £119.85 for a couple, and for an 80-year-old it is £82.25 for a single person and £125.30 for a couple (April 1999 rates).

Figure 1 plots the value of the basic pension against MIG (frozen at April 1999 prices for a single person) and shows the considerable shortfall between

Figure 1

Basic pension and the Minimum Income Guarantee (MIG)



All held constant at April 1999 rates. For a single person with average housing costs.

the basic pension, the basic rate of MIG and the average amount of means-tested support claimed by owner-occupiers and tenants. Meeting this shortfall between the basic pension and MIG is thus a major testing point for both S2P (the new state-run pension) and SHP (the new private provision).

The partnership between the basic pension, State Second Pension and MIG

Will S2P be successful in protecting lower earners from a means-tested old age? To avoid getting confused by transitional rules, let us jump to 2050, the first year that a whole working cohort will retire under the proposed reformed system. Because it is difficult to anticipate what actual prices will be in the future, pension income can be thought of as a proportion of earnings. The government expects MIG to rise in line with earnings and accordingly forecasts that MIG will be 17.5 per cent of average male earnings in 2050. Because New Labour's proposals continue the price indexation of the basic pension its value will wither to 7.5 per cent of average earnings in 2050. Finally, the government's projections in the Green Paper suggest that S2P will be worth around 10 per cent of average earnings in 2050.

If we use the illustrative figures from the government, then the combination of S2P and the basic pension will give an income equivalent to £76 a week compared to a basic MIG of £75.[3] The first point to raise is that this £1 above the *basic* level of MIG will leave those retiring on full S2P and the basic pension on a narrow tightrope above the means-tested minimum. Further, as we know from figure 1, there is an important issue of housing costs.

Unless there are major changes in local government and housing finance by the year 2050, most low earners, who are disproportionately concentrated in the rental sector, will still need help towards council tax and rent liabilities. After rent and council tax those reliant on S2P/basic pension alone will have a net income of only 20p above MIG. In our opinion, the new S2P does not look like a secondary state pension but rather a targeted flat-rate top-up to an inadequate contributory basic pension.

Still, it could be argued that £1 is some sort of protection against means testing. However, this £1 tolerance proves to be ephemeral as it will not stop the pensioners of 2050 sliding inexorably towards means testing during their retirement. Under the Green Paper's proposals S2P performs optimally for the first year(s) of retirement only. Why? First, indexing MIG to earnings while the basic pension and S2P are indexed to prices means that the £1 is whittled away by real earnings growth. As recent answers to parliamentary questions show, the government itself admits that once the scheme is matured those retiring on full S2P and the basic pension would fall below the level of MIG within five years of retirement.[4] This adds a new level of complexity to the picture shown in figure 1. Real earnings growth will mean that the shortfall between the basic pension and MIG will actually *increase* during an individual's retirement, while the real value of S2P relative to MIG will fall over time. Second, even if the effect of differential indexation was not built into the proposals, MIG is staggered upwards according to age (figure 1) and hence anyone who escapes the effect of relative loss of value of the basic pension/S2P will, in any case, be means-tested when they are 75.

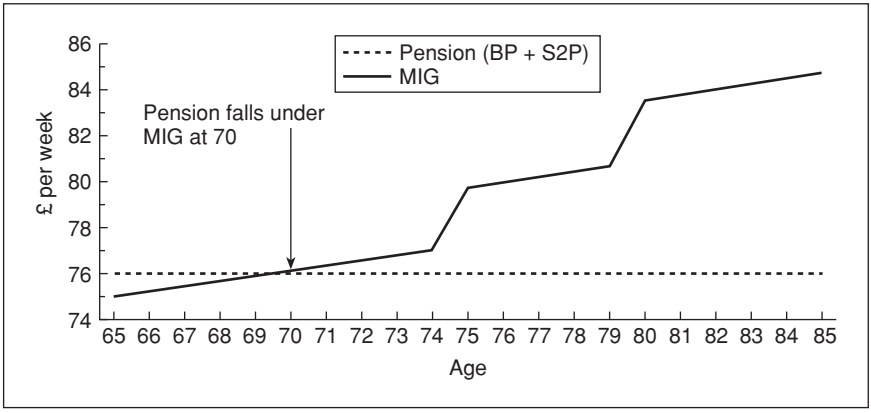
To illustrate this we take the case of a single person who has earned under £9,000 each year of their working life and who is in the first cohort of pensioners retiring in 2050 under the Green Paper's proposals. Using the government's assumptions that the rates will cross at the age of 70, figure 2 shows the changing relative levels of the combined income from basic pension and S2P (both price-indexed) and MIG (indexed to earnings).[5] To make the graph simpler we have ignored the impact of housing costs already shown in figure 1.

It is clear that there is an inbuilt problem in the new "partnership of principles". Even if S2P and the basic pension deliver an income above MIG at retirement, indexation to prices and an age-related increase in MIG mean that this will not be sufficient to maintain income above MIG through retirement. This phenomenon will not be limited to those reliant only on the basic pension and S2P, but, as we discuss below, also affects those with higher incomes drawing on private provision.

The problem of differential uprating of the pension components also leads to a cohort problem. The cohorts of pensioners retiring after 2050 will be faced by a basic pension that has fallen even further relative to earnings and hence to MIG. The rate of real increase in earnings will have a very significant impact. Figure 3 shows a single pensioner retiring in 2060. Using current inflation rates of 3 per cent for prices and 4.5 per cent for earnings, the basic pension will have fallen to 6.5 per cent and S2P to 9 per cent of average earnings in 2060, while MIG remains at 17.5 per cent. As a result,

Figure 2

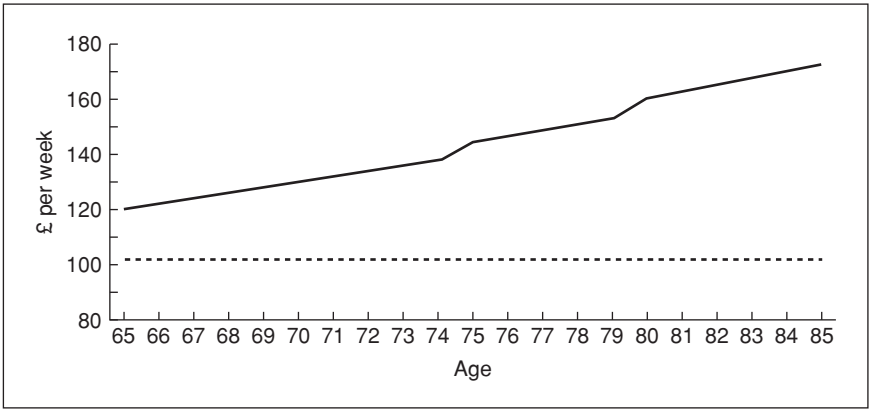
Single pensioner retiring in 2050: pension income and Minimum Income Guarantee



Rate of real wage growth set to meet government estimates.

Figure 3

Single pensioner retiring in 2060: pension income and Minimum Income Guarantee

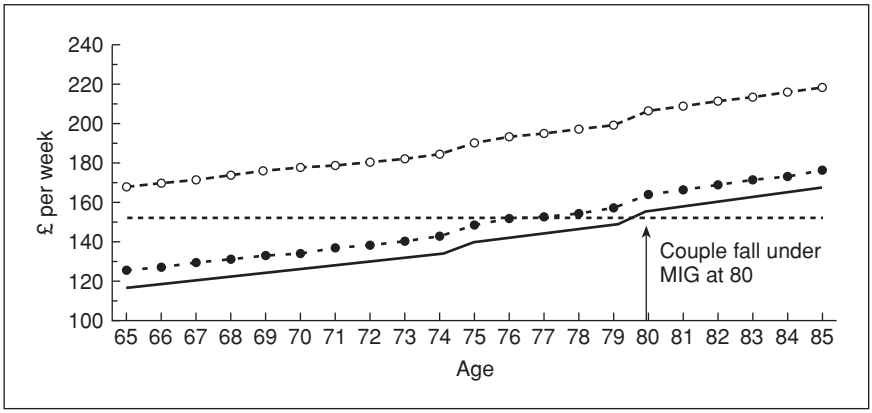


Based on Green Paper's projections of pension and MIG values in 2050.
Real rate of earnings growth 1.5%.

the combined income from S2P and the basic pension will *already* be under MIG at 65. For those whose retirement income comes from the basic pension and S2P alone, S2P will, in effect, be redundant as a second pension by the year 2060.

Figure 4

Couple pensioner retiring in 2060: pension income and Minimum Income Guarantee including housing costs



Based on Green Paper's projections of pension and MIG values in 2050.
Real rate of earnings growth 1.5%.
Housing costs inflated with prices.

Partnering and means testing

One obvious response to our calculations and examples is that we have focused on single pensioners only. Of course, many couples will build up joint entitlements to pensions. If each has entitlement to S2P then their combined incomes from basic pension and S2P will provide for them more adequately than we have so far described. Figure 4 shows the position of a couple retiring at 65 with equal entitlements to the basic pension and S2P. Even with differential price indexation, the problem of being on the borderline of basic MIG is only solved until the couple reaches the age of 80. Further, as figure 4 also shows, the problem of housing costs remains—tenants will face a means-tested retirement from age 65, and owner-occupiers from age 75.

In sum, all pensioners who rely on S2P and the basic pension to provide a decent income in old age will be walking on a narrow tightrope above means-tested benefits. For single pensioners, the age-related uprating of MIG and real earnings growth will mean that S2P alone will not protect them from claiming MIG through retirement. For single pensioners retiring after 2060, the basic pension and S2P will fall below the level of MIG even at the point of retirement. The arguments illustrate the centrality of means-tested provision to the working of the proposed pension system. The level of income promised by S2P, in combination with the basic pension, is so close to MIG that many will not benefit in retirement from their lifetime's contributions, and incentives to save are compromised.

Analysing Partnering and Partnerships in Pensions

Our discussion has so far focused on the details of the design of aggregate pension outcomes. What underlies such outcomes are the working lives of individual women and men. We now turn our attention to such lives and explore how different profiles of earnings, work histories and partnering will be affected by the structural problems we have identified so far. Problems that commonly lead to low pension entitlements are: interrupted working lives, part-time working, low earnings, being single and/or a combination of any of these four.

In order to examine how well the proposed pension system deals with such problems, our approach here is to compare pension entitlements for different individuals using a simulation model, *P*ensions and *Hy*pothetical *L*ifetime *I*ncome *S*imulation model, or PHYLIS. In an update of a previous version, PHYLIS has been programmed with the new pension proposals, and allows us to look at the accumulation of pension contributions and entitlements across a range of individuals and couples with different lifetime earnings profiles and work histories. Readers are pointed to previous papers that have employed PHYLIS for a more detailed explanation of her programming (Evans and Falkingham 1997; Johnson and Rake 1998; Rake *et al.* 1999).

While the specific details of the new pension plans are yet to come, there is sufficient detail to make reasonable assumptions about the operation of the proposed system (see Appendix). We begin our simulations using a simple whole working lifetime: continuous low-paid work from the age of 18 through to pensionable age at 65. We then introduce interruptions into working lives—due to unemployment and childcare—and see how these affect income at the point of retirement. For simplicity, couples are composed of two individuals of the same age, who retire at the same age on a joint pension entitlement.

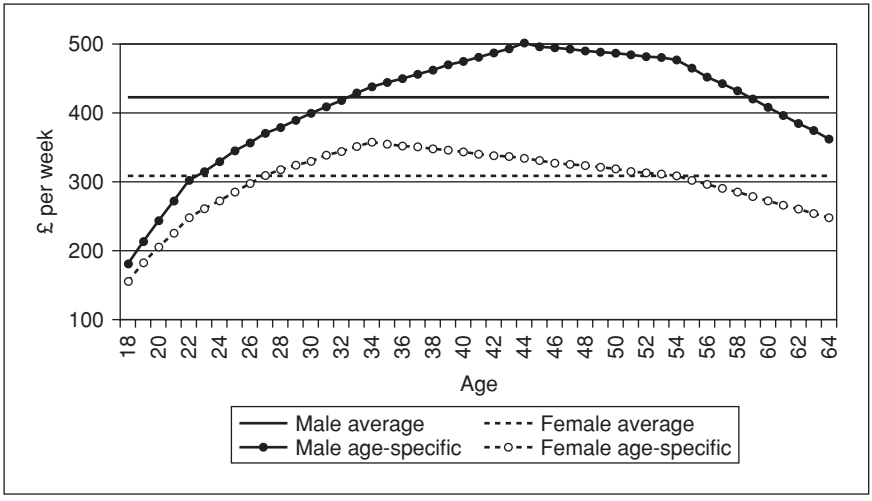
This type of simulation modelling does not, of course, produce representations of real social security outcomes. Instead, it illustrates how the proposed pension system would treat individuals in the absence of other policy changes and economic and demographic effects. Indeed, PHYLIS is constructed on the steady-state assumption that the pension system remains constant throughout the working life. This enables us to focus on the design of the Green Paper's proposals, although in reality alternative systems may be introduced before the proposed scheme fully matures.

The hypothetical cases we choose are not representative but illustrative of the experience of low earners. The Green Paper takes the case of a £9,000 earner as a central illustration of the functioning of their proposed reforms. In 1998, about 7 per cent of full-time male and 17 per cent of full-time female employees had earnings below £9,000 a year (ONS 1998a, table A32). Manual workers are obviously more likely to experience low earnings: just under 14 per cent of male and 41 per cent of female full-time manual workers had earnings below £9,000 (ONS 1998a, table F7).

The calculations of pension outcomes in the Green Paper appear to be based on the assumption that average lifetime earnings of £9,000 per annum mean that an individual earns £9,000 in each year that they are in

Figure 5

Age-specific earnings profiles and average full-time earnings, 1998



Source: New Earnings Survey 1998.
Male average £423, female average £307.

the labour market. As we know, actual earnings profiles are not flat, as the Green Paper's calculations suggest, but have gender-based age-specific profiles reflecting the premium attached to age, skills and labour market experience. In the following calculations we compare how outcomes change when the understanding of average is shifted from that of the Green Paper, to the more realistic assumption that individuals earn an average of £9,000 over the lifetime with periods above and below that lifetime average. We derive our age-specific profiles from a contemporary cross-section of British full-time male and female earnings from the 1998 *New Earnings Survey* (ONS 1998a, table F13). These age-specific earnings profiles are shown in figure 5, which demonstrates not only that women experience lower earnings but also experience less of an age-skills premium. Of course, this is not an accurate representation of any actual individual's lifetime earnings profile, as an individual's earnings profile will be affected by period as well as age effects. The use of a cross-sectional earnings profile is, however, consistent with our "steady-state" assumption that the policy world remains unchanged throughout the working life. Further, by including cases where there are periods spent at different earnings levels, we can evaluate the potential impact of the proposals on those whose earnings are for a period above £9,000 and who respond to government incentives and switch into the Stakeholder Pension for a period of their working lives.

Table 2

Pension for Frank (case 1)

	Flat earnings profile (£)	Age-related earnings profile (£)
Basic pension	32.00	32.00
S2P	44.00	23.00
SHP	—	24.36
MIG	—	—
Total	76.00	79.36

Note: Frank works 18–65, no gaps.
Source: Authors' calculations using PHYLIS.

Partnership in Practice: Results from Hypothetical Examples

Hypothetical case 1: Frank

Our first hypothetical case is male and we call him Frank. To start with a simple case and to show the basic workings of S2P, Frank works continuously from the age of 18 until he retires at 65 in 2050. He never meets a lifetime partner, and retires a single man. Frank earns 40 per cent of average male full-time earnings. On a flat earnings profile, he earns just under the £9,000 annual limit for S2P proposed by the Green Paper all his working life (£169 a week, £8,798 per annum). On the age-related earnings profile, his earnings go above £9,000 for 24 years out of a total of 47 years.

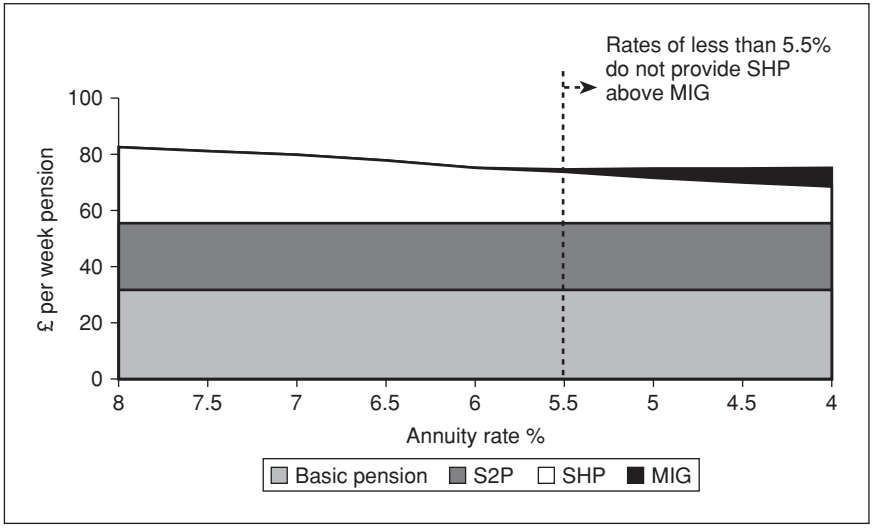
Table 2 shows that assuming a flat earnings profile, the reward from state pensions for a lifetime of hard work is to have a basic pension worth £32 and S2P worth £44. These together leave him with an income of £76 a week. This is £1 gross above the MIG. If he is a tenant, Frank will still need to claim benefits to pay his council tax and rent and this reduces his net income after housing costs to the princely sum of 20p a week. Soon after retirement (depending on inflation) Frank would be eligible for MIG itself.

Using an age-related earnings profile, table 2 shows that Frank would do slightly better overall than the Green Paper suggests. His total income of £79.36 is £4.36 above MIG; hence he would still need help with his council tax and rent if he was a tenant.

On the face of it, Frank's loss of S2P is more than compensated for by his income from SHP. However, this is based on an assumed annuity rate of 7 per cent. Given that annuity rates track the changes in interest rates, and that we expect interest rates in general to fall (especially if we join the Euro), this may be an over-optimistic assumption. In figure 6, we plot Frank's SHP income according to a range of annuity rates between 8 and 4 per cent. As the figure shows, annuity rates in 2050 of less than 5.5 per cent will not lift

Figure 6

Annuity rates and MIG: the effects on a single low-earner pensioner



Pensions calculated using age-specific earning profile.
See table 2 for basic assumption at 7%.

Frank above MIG. This raises several concerns. First, for low-income individuals, the Green Paper's conclusions about the performance of SHP in bringing people above MIG is highly sensitive to its assumptions about annuity rates. Rates of 5.5 per cent and less provide no guarantee against a means-tested old age. What is more, even annuity rates of 7 per cent will not protect tenants from reliance on means-tested benefits. Second, the low level of protection afforded by SHP for incomes at the margin of £9,000 leads to real problems of choice and incentives. If individuals had perfect foresight and knew in advance that annuity rates at retirement would not deliver a sufficient income, they would do better to remain within S2P. As individuals cannot hope for perfect foresight, the absence of a minimum guaranteed level of SHP coverage equal to S2P weakens the equity of the overall system. Despite tighter regulation of SHP provision, there is an inbuilt potential to oversell to low-income individuals for whom membership would only be of marginal value.

Hypothetical case 2: Frank suffers unemployment

Using our second hypothetical case, we explore the impact of breaks in employment. Case 2 allows us to examine the issue of how the proposals will cover gaps in the working life. There is inconsistency in the credits offered by the basic pension and the new S2P. Periods of unemployment as well as

Table 3

Pension for Frank (case 2)

	Flat earnings profile (£)	Age-related earnings profile (£)
Basic pension	32.00	32.00
S2P	36.00	13.00
SHP	—	23.56
MIG	7.00	6.44
Total	75.00	75.00

Note: As Frank (case 1) but with unemployment between ages of 25 and 27, and 57 and 65.
Source: Authors' calculations using PHYLIS.

sickness, and home responsibility will continue to generate credits towards final basic pension entitlement. The proposed S2P, however, credits only some periods of home responsibility,[6] and offers no coverage for spells of unemployment, sickness or time spent in education or training. This could be a potentially serious omission for low-paid workers. The low-paid experience a far higher risk of unemployment than other groups. Stewart, for example, has identified a cycle of "low pay, no pay" with the low-paid experiencing a greater propensity to move in and out of employment (Stewart 1999: 72; Stewart and Swaffield 1999). Such periods of frictional unemployment coexist with low overall earnings mobility for the low-paid.

To illustrate the potential impact of this, our second hypothetical case is Frank with exactly the same earnings and exactly the same life story except that this time he has two periods of unemployment. He is first unemployed for two years between the ages of 25 and 27. Then later in life, aged 57, following an ideological disagreement with his employer he is made redundant and does not work again. Recent evidence suggests that extended periods of unemployment at the end of the working life are now a common experience—the proportion of older men without work has doubled to two-fifths since 1979 (Campbell 1999). It should also be noted that this history of two spells of unemployment is an optimistic scenario as an early spell of unemployment has been found to increase significantly the risk of subsequent spells out of the labour market (Gregg 1998).

Table 3 shows the effect that these gaps to his working life have on Frank's pension entitlement. Assuming a flat earnings profile, Frank continues to receive £32 basic pension but his S2P entitlement is now only £36, leaving him eligible to claim £7 MIG a week. Similarly, under the age-related profile, Frank is eligible to claim MIG and, as argued above, will be even more dependent on MIG if annuity rates are less favourable than the assumed 7 per cent. Under either assumption, the effect of these spells of unemployment is to leave Frank reliant on MIG. Partial crediting of S2P, unlike the rules for the basic pension, makes unemployment a tripwire for low earners which propels them into a means-tested old age.

Table 4

Pensions for Frank and Harriet

	Flat earnings profile (£)		Age-related earnings profile (£)	
	Frank	Harriet	Frank	Harriet
Basic pension	32.00	32.00	32.00	28.90
S2P	44.00	44.00	23.00	36.24
SHP	—	—	24.36	—
Individual total	76.00	76.00	79.36	65.14
MIG	—		—	
Household total	*152.00*		*144.50*	

Note: Frank works continuously aged 18–65 with no gaps. Harriet works 18–22 full-time, cares for their children 23–34, and returns to work part-time from 35 to 65.
Source: Authors' calculations using PHYLIS.

Hypothetical case 3: Frank and Harriet

Our third hypothetical case is Frank (case 1) with the same lifetime earnings profile, but this time he does find a life partner. We call her Harriet. Marrying early, they have two children and Harriet leaves work between the ages of 23 and 34 to look after the children. This pattern is typical for women with low or no educational qualifications: for example, in 1998, 73 per cent of women with no educational qualifications and children under 5 were "inactive" (ONS 1999a, table E). Before having children Harriet works full-time earning 45 per cent of average female full-time earnings (£138 a week or £7,196 per annum). When she returns to work at 35, she works part-time (joining the 43 per cent of all women whose youngest child is aged 5 to 10 who work part-time; ONS 1998b, table 4.12) and earns 50 per cent pro-rata (£69 a week or £3,598 per annum). On the age-related earnings profile, her earnings do not go above £9,000, but fall below the lower earnings limit during her last six years of employment.

Assuming a flat earnings profile, Frank and Harriet each receive the full-rate basic pension of £32 and full S2P of £44. This gives them a joint income of £152, which means that they will probably only need means-tested help if they are tenants. Using an age-related earnings profile, Frank has a slightly higher pension income (as in case 1)—but this is more than offset by Harriet's loss in income of £10.86. For both the basic pension and S2P this loss in income is a result of her years spent below the lower earnings limit (LEL). The loss of S2P is, however, larger in both absolute and relative terms. Under S2P Harriet has already lost some entitlement by spending more years caring for her children than her credits cover (we make the generous assumption that she has her second child when the first goes to primary school and so receives a full 10 years' credits); this loss of entitlement

Table 5

Pensions for Frank (unemployed) and Harriet

	Flat earnings profile (£)		Age-related earnings profile (£)	
	Frank	Harriet	Frank	Harriet
Basic pension	32.00	32.00	32.00	28.90
S2P	36.00	44.00	13.00	36.24
SHP	—	—	23.56	—
Individual total	68.00	76.00	68.56	65.14
MIG	—		—	
Household total	*144.00*		*133.70*	

Note: Frank works continuously aged 18–65 with unemployment between ages of 25 and 27, and 57 and 65. Harriet works 18–22 full-time, cares for their children from 23 to 34 and returns to work part-time from 35 to 65.
Source: Authors' calculations using PHYLIS.

is compounded by the years spent below LEL resulting in an 18 per cent reduction in her S2P income.

Hypothetical case 4: Frank and Harriet with unemployment for Frank

Our fourth hypothetical case brings forward Frank's experience of unemployment from case 2 (he has two periods of joblessness, between the ages of 25 and 27 and from 57 until 65). Harriet has the same earnings history as in case 3 (she works full-time 18–22, looks after their children 23–34 and returns to work part-time at 35 until 65). Table 5 shows that they both receive £32 basic pension but their S2P differs. Harriet continues to receive S2P at the maximum rate, because of the credits she receives to cover most of her years of childcare. However, Frank's S2P is reduced because of 10 years' unemployment. This gives them a total of £144 per week which, while above the MIG, will mean they need means-tested help with their rent if they are tenants. Using the age-related profile, Frank does marginally better but this does not offset the loss experienced by Harriet because of her years below the LEL.

Hypothetical case 5: Frank (unemployed) and Harriet (unemployed)

Our fifth case is the same as case 4 except that Harriet now stops work and becomes unemployed when Frank becomes unemployed aged 57. This is perhaps encouraged by the heavy use of means testing during unemployment that provides little incentive for Harriet to keep working. In the early 1990s only 33 per cent of the wives of the unemployed were themselves in paid work, compared to 74 per cent of those married to working husbands (Hills 1997: 26). Table 6 shows the pensions that result from this scenario.

Table 6

Pensions for Frank (unemployed) and Harriet (unemployed)

	Flat earnings profile (£)		Age-related earnings profile (£)	
	Frank	Harriet	Frank	Harriet
Basic pension	32.00	32.00	32.00	32.00
S2P	36.00	33.65	13.00	33.65
SHP	—	—	23.56	—
Individual total	68.00	65.65	68.56	65.65
MIG	—		—	
Household total	*133.65*		*134.21*	

Note: Frank works continuously aged 18–65 with unemployment between ages of 25 and 27, and 57 and 65. Harriet works 18–22 full-time, cares for their children from 23 to 34 and returns to work part-time from 35 to 57. She is unemployed from 57 to 65.
Source: Authors' calculations using PHYLIS.

Assuming flat-rate earnings they both receive a basic pension of £32 and a reduced level of S2P. Harriet, however, receives less S2P as she has no credits for either her years of unemployment or the years of childcare she undertakes without credits. This gives them a total of £133.65 and they are over the MIG, but will require means-tested help with rent if they are tenants. Under an age-related earnings profile a very interesting thing happens to Harriet: here she loses some S2P but has full entitlement to the basic pension because of credits for her years of unemployment. This leaves her with a higher individual income than in case 4, where she is working part-time up to the point of retirement with some years under the LEL. As we can see, Harriet would be better-off in retirement if she is registered unemployed at the end of her working life, than if she continues to have earnings below the LEL.

Hypothetical case 6: Frank (unemployed) and Harriet (very low earnings)

To illustrate further the impact of the LEL on Harriet's entitlements, our last hypothetical case is identical to case 5 except that Harriet *continues to work* but earns a lower amount than in the previous cases. Her earnings are reduced to 35 per cent of average female full-time earnings (£108 per week), with her part-time earnings set at 50 per cent of that amount (£54 per week) as before. Thus, between the ages of 35 and 65 under both flat-rate and age-related earnings she falls below the lower earnings limit. Table 7 shows the pensions that result. Under both scenarios, Harriet's entitlements amount to £19 dependant's addition under the basic pension. Her earnings below the LEL count for nothing towards her pension and her period of earnings before she had children are insufficient to give her entitlement to any S2P, even when combined with credits for childcare.[7] They receive MIG and are

Table 7

Pensions for Frank (unemployed) and Harriet (very low earnings)

	Flat earnings profile (£)		Age-related earnings profile (£)	
	Frank	Harriet	Frank	Harriet
Basic pension	32.00	19.00	32.00	19.00
S2P	36.00	—	13.00	—
SHP	—	—	23.56	—
Individual total	68.00	19.00	68.56	19.00
MIG	30.00		29.44	
Household total	*117.00*		*117.00*	

Note: Frank works continuously aged 18–65 with unemployment between ages of 25 and 27, and 57 and 65. Harriet works 18–22 full-time, cares for their children from 23 to 34 and returns to work part-time from 35 to 57.
Source: Authors' calculations using PHYLIS.

means-tested from the date they retire. The proposed pension rules thus severely affect incentives to work at the margins of the lower earnings limit. McKnight et al. (1998) have already shown that 3 million workers currently earn below this level, and that they are primarily in poor households—real-life Franks and Harriets.

These six hypothetical cases show that the Green Paper's proposals only work to provide a minimum pension significantly above MIG for low-income *couples*, and only where their working histories are complete. The treatment of gaps provides very strange patterns of potential coverage for low earners whose periods of unemployment, sickness and education are excluded from the proposed State Second Pension coverage. On the other hand, some cover is provided for time spent undertaking unpaid caring. The differences in crediting periods of unpaid caring and unemployment may lead to unusual inequalities of income within poor working households at retirement—women with shorter earnings histories or with lower lifetime earnings can have higher pensions than their spouse where their partners have experienced periods of unemployment.

The limits placed on the caring credits (paid only until the child reaches school age) have a negative impact on women's incomes where caring periods are extended and/or caring for school-age children is combined with some years of earnings under the LEL. As the age-related profile for Harriet in case 4 demonstrated, uncredited caring plus a few years below the lower earnings limit has a particularly pernicious impact on S2P entitlements. Indeed, if some years of uncredited caring are taken, pension income will be higher if this is followed by unemployment rather than by years below the lower earnings limit—at least ensuring entitlement to some basic pension.

Table 8

Stakeholder pension needed to avoid MIG by age at death

Age at death	Target SHP at the point of retirement (£)	% of average male earnings needed over the lifetime to reach target SHP	
		Case 1	Case 2
75	57.82	86	104
80	67.96	99	121
85	75.68	108	134
90	84.00	120	147

Source: Authors' calculations using PHYLIS.

The hypothetical individuals have illustrated that the tripwires to pension coverage are not only uncovered gaps in lifetime labour market history, but also periods of working below the contributory threshold. This leads to perverse lifetime incentives to work and save, especially where linked to periods of unemployment.

Private Partnerships and the Means Test: Not Only the Poor?

Having demonstrated how widespread means testing will be for low earners, we now examine how far up the lifetime earnings distribution means-tested support in old age will extend. Figures 2 to 4 have already shown that the gap between *state* pensions and MIG is too small for low earners and, for all, it narrows as retirement continues. We now explore how, faced with this narrowing gap, higher earners fare with the new stakeholder pensions—what level of secondary pension (and level of lifetime earnings) is needed to escape means testing during retirement?

To avoid falling into means testing at any stage during retirement, a person needs to accumulate entitlement to a stakeholder pension that will be payable throughout retirement at a rate above age-related MIG. Income in retirement from stakeholder pensions (and indeed money purchase schemes in general) is derived from an annuity. Pension companies currently offer a range of products. At its simplest an annuity is a fixed sum for life, which will decrease in real value over time. With such an annuity the longer an individual lives, the more likely they are to become reliant on a means-tested income. Protection against inflation and/or protection for survivors can be purchased, but at the cost of a lower annual income.

Table 8 illustrates the level of annuity income a single individual needs at the point of retirement to keep above MIG for their entire retirement assuming four different ages at death (the most recent life tables for the UK show that a man aged 65 can expect to live, on average, a further 15 years while a

woman has a life expectancy of a further 18.5 years; ONS 1999b, table 5.1). We assume that the annuity purchased from SHP is fully price-indexed, and to take into account the cost of this, our calculations in this illustration use an annuity rate of 5.5 per cent. Two hypothetical work histories are used: case 1 assumes a full working life (18–65) whilst case 2 introduces two spells out of the labour market, ages 25–27 and 57–65 (see discussion above).

Case 1 shows that for those living to 80, an average of 100 per cent of mean male earnings over a complete working life is needed to have a level of SHP that avoids falling below MIG while those "fortunate" enough to live to 90 would need to have earned 120 per cent of average male full-time earnings. Gaps in labour market participation (through unemployment, further education or caring duties, none of which are credited to SHP) increase the earnings needed in work. As case 2 shows, even someone who dies at 75 needs to have earned in excess of average, while those dying at 85 will need lifetime earnings of 134 per cent of average.

How many individuals will achieve the projected level of lifetime earnings needed to avoid MIG? The figure for average earnings used above is *mean* earnings for full-time male employees: in 1998, 60 per cent of full-time males and 78 per cent of full-time females fell below this "average" (the distribution of earnings is positively skewed; ONS 1998a, table F7). If we include part-time workers, 65 per cent of all male employees fell below this average as did 88 per cent of all females and 98.5 per cent of part-time female workers (our calculations, based on ONS 1998a, table A32). The implication of this is that even with the extreme assumption of a full working life, individual lifetime earning profiles will be insufficient to avoid a means-tested solo retirement for the majority. This is especially true for women.

This again demonstrates the importance of partnering and joint earnings profiles in raising pension income above the level of MIG. But even lifetime partnering is no guarantee without average or above average earnings. For example, a couple has a common age of death of 85; the man works 18–65 without gaps and the woman has childcare gaps like Harriet's in cases 3 to 6. To avoid MIG we calculate that he needs to earn 100 per cent of average male full-time earnings while she needs to earn 100 per cent of female full-time average.

These examples suggest that the Green Paper's proposals risk extending means-testing in old age beyond the low earners to a significant proportion of the population and will affect not only the poor.

Conclusion: Partnership in Principles and in Practice

New Labour has proposed significant changes to the partnership of principles that underpin British social security pensions. The divide between four elements of pension provision (contributory basic pension, means-tested minimum, contributory state secondary pension, and private secondary provision) has been significantly muddied. The basic pension and the proposed new State Second Pension will *de facto* combine to provide a new flat-rate pension aimed at the poorest. However, the design of this new two-stage minimum pension is inherently flawed for several reasons.

First, the principles of citizenship in the system of contribution credits have not been designed to be consistent. There are different rules for citizenship-based credits for the basic pension and for the new S2P with no clear reasoning of why they need be different. With one hand the Green Paper maintains credited contributions to carers of disabled people, while with another it removes such credits for unemployment, sickness, and caring for children over 5. This means that individuals with broken work histories will face great difficulty in acquiring entitlement to the necessary combination of basic pension and S2P. Second, even for those whose unbroken work records entitle them to the full level of these two pensions, it will not be enough to beat the means testing in old age. Today's 14-year-olds will face a retirement where state pensions dip into means testing when they are 70 or younger. Today's 4-year-olds face a retirement where state means-tested benefits will outstrip contributory benefits immediately they retire at 65. Third, the new partnership of principles reduces the rewards of contribution and of independent saving by increased levels of means testing. In doing so, it has turned a long-held policy trade-off inside out. Means testing used to be proposed as a way of avoiding middle-class capture of benefits (Goodin and Le Grand 1987). But with insufficient non-means-tested contributory provision, the proposals will result in the means test encroaching ever higher up the lifetime income distribution to capture more of the middle classes. Indeed, faced with increased use of means testing, the government admits that current treatment of income from capital and savings by social assistance rules will have to be amended and hence this will further increase the encroachment of means-tested provision up the income distribution.

These problems of principle have practical implications for several key areas of partnership. The issue of economic incentives to save for old age is central to sustainable partnerships of state and private initiative, and our analysis suggests that such incentives will be poor for low-paid workers. Indeed, the proposals will mean that individuals and couples with low earnings *must* have full working lives and permanent partnerships to avoid a means-tested retirement. Given the current and growing risk of interruptions to earnings histories and the trend to unstable partnering this provides a large number of potential tripwires in the new pension system that will result in many facing a means-tested retirement. Once certain periods of low earnings or gaps in working have been experienced there will be little chance of recovering entitlement to a non-means-tested retirement. We have shown that periods of unemployment and of childcare for both single people and couples will mean that the low-paid could easily be faced with little or no return to their retirement income from continued work participation.

More worrying still is that the rewards from pensions will not be readily increased by breaks from the labour market to improve education and skills. Any time spent in education will reduce pension entitlement and this may not be offset by actual returns to improved human capital. The trade-off between lifetime learning and adequate retirement pensions seems ill-thought through and in poor partnership with the government's concerns elsewhere about improving opportunities to upskill for the low-paid (for example, through Individual Learning Accounts).

Turning to better-off workers and their partnerships with private pensions, the issue of incentives again appears crucial. We have shown how an individual will need at least average male earnings over the entire working life to acquire a Stakeholder Pension sufficient to avoid a means-tested retirement. Our projections are, in fact, a best-case scenario for the government. If SHPs are to be index-linked, and to provide for survivors, then the underlying annuity rate will be lower than that modelled and so the propensity to fall into a means-tested retirement higher. This uncertainty about how well annuities will perform against the means test is heightened by the probability that interest rates, and consequently annuity rates, will fall over the next 50 years after European monetary union.

Another issue of importance is that the proposals add to the complexity of an already complex pension system. This complexity makes it very difficult for individuals to make an optimal pension choice. The choice of the most appropriate pension vehicle depends upon lifetime earnings, interruptions to labour market participation and the prevailing annuity rate at the point of retirement. Clearly this information is never available to the individual trying to save for their own old age, and for low and moderate earners the risks that the wrong choice will lead to a means-tested old age are high.

A further test of the practicality of the proposed pension partnerships is their *sustainability*. Even if one accepts the partnerships put forward for the first cohort of retirees in 2050, which we do not, it is difficult to see how the system works at all as subsequent cohorts retire. With each new wave of retirees the proposed partnerships are more fragile, leading to an in-built obsolescence in the pension system. Thus, New Labour's proposals are unlikely to break the cycle of continuous pension reform.

APPENDIX

The key rules written into PHYLIS about the reformed scheme are:

1. Following the Green Paper, benefits are paid at the following weekly rates: full basic pension of 7.5 per cent of average male wages (the equivalent of £32 per week at current prices); full S2P of 10.4 per cent of average male wages (£44 per week); MIG at age 65 of 17.5 per cent of average male wages for a single individual (£75 per week and £117 for a couple). We follow the Green Paper's example by expressing benefit rates as a percentage of current average earnings.
2. We assume that S2P entitlement is calculated in the same way that entitlement to the basic pension is currently calculated. Full entitlement follows if contributions have been made for nine-tenths of the working life, with payment reduced proportionately for shorter contribution periods. If the contribution period is less than 25 per cent of that required for full entitlement, no payment is made at all. The assumption that entitlement is lost if the contribution period is less than 25 per cent of the required period affects case 6 only. For that case we looked at the alternative assumption that some payment is made regardless of the years of contributions (an assumption that more closely mirrors the rules which currently apply to

SERPS) and found it to have no impact on raising estimated pension income above MIG.

3. As with the current basic pension, we assume that S2P credits for care reduce the number of contributory years needed (e.g. 5 years of credits reduces the contributory requirement for full S2P from 44 to 39 years).
4. Contributions to the Stakeholder Pension (SHP) are set at the rate of NIC rebates for those opted out of S2P. Following the outline given in the Green Paper, on the tranche of earnings above the lower earnings limit (LEL) but below £9,000 we assume a flat-rate contribution of £524 (equivalent to a 9.2 per cent rebate), for the tranche of earnings between £9,000 and £18,500 the rate of contribution is 2.3 per cent while for earnings above £18,500 the rate is 4.6 per cent. After management costs, the real rate of return is assumed to be 1.75 per cent and the default annuity rate is set at 7 per cent (we show the effect of changing the annuity rate in figure 6).
5. The LEL is assumed to rise in line with earnings. The level of the LEL is a policy choice, so we cannot accurately predict the future level. We examined the impact of changing this assumption on simulations where earnings fell below LEL and this was not found to have a significant effect on overall income.
6. Our age-specific lifetime earning simulations lead us to model hypothetical cases where incomes across the working life are both above and below the £9,000 ceiling for S2P. This means that we had to assume rules about entry and exit from S2P and SHP for a single individual. We thought that any one-way exits from S2P for low-income workers would be inherently unjust if their earnings later fell to a level that was better covered by S2P. We have therefore allowed free flows between schemes, even though this is a promise that the government may not actually be making.

Notes

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1. Currently 60 for a woman and 65 for a man, harmonizing to 65 in 2020.
2. The average rent of housing benefit recipients aged over 60, and the average council tax for council tax recipients over 60 (from DSS 1998b, tables A3.06 and A4.04 respectively).
3. We follow the Green Paper's example by presenting the projected value of the matured system relative to current earnings. The Green Paper estimates the percentage of earnings that S2P and the basic pension will offer under a fully matured system in 2050, and then presents this as a percentage of *current* (1998) average earnings. In 2050, the nominal rates of S2P and the basic pension will depend on earnings growth and price inflation.
4. The government's calculation appears to be based on a very conservative estimate of earnings growth. We estimate that its figures have set earnings growth at a level only 10 per cent above the rate of inflation (i.e. if price inflation is 3 per cent then earnings growth is 3.3 per cent).
5. Figures 2 to 5 show projected benefit levels in 2050 in 1998 prices. After 2050, we adjust these levels for real earnings growth.
6. S2P credits will be given to those caring for a child under 5, and for those caring

for someone in receipt of Disability Living Allowance and Attendance Allowance or who themselves are in receipt of Invalid Care Allowance. The proposed system of credits to S2P is, therefore, less generous than that currently operating for the basic pension as under Home Responsibility Protection, those caring for a child up to its sixteenth or eighteenth birthday are given credits (see Falkingham and Rake 1999).

7. This assumes that S2P pays out nothing if contributory years fall below 25 per cent of the contributory requirement. On the alternative assumption that S2P works like SERPS and pays out something regardless of total years in the system, Harriet would get an additional £3.88 from S2P, raising her total individual income to £22.88. This would still leave the couple below the level of MIG, and they would claim £25.56 top-up.

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