SAGA MAGAZINE

GUIDE TO PENSION REFORM

By Paul Lewis

In May 2006 the Government proposed the most radical reform of the state pension for a generation. Nothing like it has happened since the changes Barbara Castle introduced 30 years ago which were themselves the first major improvement of the state pension since 1946. So it is likely that the plans set out in the Government white paper *Security in retirement: towards a new pensions system* will have to last at least 30 years.

The Government plans fall into two parts:

- Radical changes to all parts of the state pension.

- Giving everyone the chance to save up for a low-cost private pension.

Later this year a Bill will be presented to Parliament and no doubt changes will be made as MPs and peers scrutinise it. It should become law towards the summer of 2007. But none of the proposed changes begin until 2008 and the major ones not until 2010, almost certainly after the next General Election. If the Government changes – party rather than leader – then the plans could be altered again.

But assuming it goes ahead – and that seems a better than even chance – what will it mean for each of us?

STATE PENSION CHANGES

Little change for today's pensioners

If you already receive a state pension – or will before April 2010 – then the changes will not affect you much at all. You are stuck with the pension you have got. And of course new rules about paying into a private pension if you are at work will not affect you either – even if you still work you will be largely exempt from them. Two things will affect you in the long term.

- From some time between April 2012 and April 2015 the basic state pension will rise each year more quickly than it does now
- From 2008 part of Pension Credit will be rise each year more slowly than it does now. There are more details of those changes later.

Your pension age will go up – eventually

In the next few years the basic state pension will start to rise each year in line with earnings rather than prices. Since 1980 the state pension has been increased each April roughly in line with prices as measured by the Retail Prices Index. At the moment that is rising by 2.5% to 3% a year. Governments have fiddled around with this rule, so in fact the pension has risen slightly ahead of prices. But from 1975 to 1979 the pension was raised in line with earnings instead. Earnings rise about 1.5% to 2% faster than prices and if the pension had continued to rise with earnings it would be around £142 a week now instead of £84.25. The Government says it wants to link the pension to earnings from April 2012 but that is "subject to affordability" and it may be delayed until the end of the next Parliament, which means the change could happen as late as April 2015. When it does start it will add a pound or two a week more on to the pension at its annual increase and could add £30 to it over the next 20 years.

This change will affect anyone who gets the state pension. How much current pensioners benefit depends on how long they live after the change begins. Statistics show that around three million of today's pensioners will not survive to see it happen.

EASIER TO QUALIFY

Aged 56 or less (women); aged 61 or less (men)

Big changes in how you qualify for the basic state pension begin for everyone who reaches pension age on April 6, 2010 or later – women born on or after April 6, 1950 and men born on or after April 6, 1945.

Not everyone gets the state pension. To qualify for it you must have enough National Insurance contributions. Normally those are paid at work. But some people get them "credited" for example if they are claiming jobseeker's allowance, or if they are under 18 or over 60. Roughly speaking (and trust me you do not want to know the details) you need about 10 years' contributions (paid or credited) to get any pension and about 39 years to get a full pension of £84.25 a week. Not much for a lifetime's work!

From April 6, 2010 those rules are being simplified and it will be easier to qualify for a pension. There are four major changes.

1. You will only need 30 years of contributions to get a full pension. That will particularly benefit women who typically spend more of their lives out of paid work looking after children and other relatives rather than men do. But it will also benefit men who have incomplete or short working lives, including many who were part of the first university boom of the 1960s and missed too many years' contributions at the start of their working lives.

2. The rule that says you need at least 10 years' contributions to get any pension will be scrapped. So even if you have contributions for one year you will get something – only about £2.80 a week but that is better than nothing!

3. People who stay at home to look after their children up to the age of 12 will get National Insurance contributions credited to them. At the moment the person who gets the Child Benefit – normally the mother – can get a concession called Home Responsibilities Protection (HRP). Again, you really don't want to know how this horrible rule works and I for one will be very happy when it disappears on April 6, 2010. But briefly it gives a much smaller boost to the pension than if the mother had been in paid work. In addition it only works for whole tax years, so inevitably there are many weeks missed out. The new system will deal with both those problems by giving a full National Insurance credit for each week of child care when Child Benefit is received. Foster carers will be included.

4. People who spend at least 20 hours a week looking after a disabled person will get a weekly National Insurance contribution credited to them. At the moment carers can get National Insurance credits or HRP or nothing depending on the circumstances. They normally need to care for 35 hours a week to get anything. So the new weekly National Insurance credit will help many people who care for at least 20 hours a week.

Anyone who reaches pension age from April 6, 2010 will have any whole years of HRP converted into National Insurance credits. However, HRP only began in April 1978 and many women approaching retirement brought up their children before that date and will not have much HRP to convert and no credits will be given for time before April 1978. The Government will recoup some of the cost of this change by reducing the age of children whose parent qualifies from 16 to 12.

One group of people will be worse off under the new proposals. At the moment a man who get basic state pension can claim £50.50 a week extra for a wife or partner who is under 60 and dependent on him. That means they must not earn or have their own private pension of more than £57.45 a week. From April 2010 no new claims will be accepted for this adult dependency increase. From April 2020 any payments still being made will be stopped.

Anyone who reaches pension age on April 5, 2010 or before will be subject to the existing rules. There will be a lot of people who will fall just the wrong side of this line and who will get a much smaller pension than someone in the same circumstances just a few days younger.

(See table 1. above)

Table 1 Basic state pension changes

DATE	AFFECTING	CHANGE
April 6, 2010	**Men** born April 6, 1945 and later. **Women** born April 6, 1950 and later	Cut qualifying years to 30, HRP converted to contribution credits. Adult dependency addition abolished for new claims, carers and parents get weekly credits; women's pension age begins to rise
April 6, 2010	**Men** born April 6, 1950 and later	Age for autocredits rises with women's pension age
April 6, 2012 to April 6, 2015	**Everyone** claiming a basic state pension	State pension begins to rise each year in line with earnings
April 6, 2020	**Men and women** born April 6, 1955 or later. **Men** aged 75 with a dependant wife or partner under 60	Women's pension age rise complete; Autocredits disappear; any remaining adult dependency additions in payment are stopped
April 6, 2024 to April 6, 2026	People born April 6, 1959 or later	State pension age rises to 66
April 6, 2034 to April 6, 2036	People born April 6, 1968 or later	State pension age rises to 67
April 6, 2024 to April 6, 2026	People born April 6, 1977 or later	State pension age rises to 68

MISSING CONTRIBUTIONS

The Government says it wants to maintain the link between working – in paid work or caring – and qualifying for a pension. So it rejected suggestions that it should convert the state pension to a "Citizen's Pension" based on residence rather than the work record. However, by cutting the qualifying period to get a full pension from around 40 years to just 30 it will weaken the link between working and the state pension. Someone could start work at 16 and have paid 30 years contributions and earned a full state pension by the age of 46. But they would still have to pay full National Insurance contributions until they reach pension age 20 years later. It makes National Insurance contributions seem more like a tax which pays for the state pension rather than a way of earning it.

Another group of people are also going to feel very hard done by. Those who have got incomplete National Insurance records can pay extra contributions to fill in missing years back to 1996/97. Each autumn HM Revenue & Customs (HMRC) – which now collects National Insurance contributions – writes to people with missing contributions inviting them to do that. But people who already have 30 years – and would currently get a pension of about three quarters of the full amount – will get a full pension if they reach pension age from April 2010. So there is no point in their paying extra contributions now. In past years some people will have paid extra contributions which, if the changes go ahead, were unnecessary. It is very unlikely they will get those wasted contributions back. But it is worth complaining to your MP if you feel you have wasted your money in the past. Concessions are always possible as the Bill wends its way through Parliament. Meanwhile, it is wisest not to pay any extra contributions until the new rules are finally settled and you can see what, if anything is worthwhile.

Another group are not going to be helped by the changes announced so far. Some married women still have the right to pay lower National Insurance contributions. They are around 2% of their pay but they get nothing for them. No change is planned in those contributions. Anyone paying reduced married woman's contributions should consider stopping now – especially if they were born on April 6, 1950 or later.

PENSION AGE

Women aged 56 or more

Almost without anyone noticing, the last Conservative government decided that women would have to wait until they were 65 to get their state pension. And in 1995 it announced that the change would happen from 2010 to 2020 – dates that seemed more in the realm of science fiction stories than anything we had to worry about then. Now those years are almost upon us and women born on April 6, 1955 or later will have to wait until they are 65 to get their state pension. Women born between April 6, 1950 and April 5, 1955 will be able to claim their pension between 60 years 1 month and 65. You can check your approximate pension age in Table 2 or get an accurate date from the Pension Service website www.thepensionservice.gov.uk/resourcecentre/statepensioncalc.asp

People 47 or less – and especially 38 or less or 29 or less

The Government now plans to raise pension age further, eventually to 68. The change will happen in three phases. Anyone born from April 6, 1959 will retire after the age of 65 and those born on April 6, 1960 will retire at 66. Ten years later the same will happen again so people born from April 6, 1968 will reach pension age between 66 and 67 and those born from April 6, 1969 will reach pension age at 67. And a third phase will move the age up further for anyone born on April 6, 1977 or later with those born from April 6, 1978 getting their state pension at 68. The Government has said there will be reviews of state pension age from time to time and if life expectancy changes these dates could be revised.

Raising the pension age will mean a bigger income for the National Insurance fund. Contributions start at 16 and stop when pension age is reached, so women cannot pay National Insurance contributions for more than 44 years and the maximum is 49 years for men.

Table 2 State pension age for men and women

BORN FROM	TO	STATE PENSION AGE	STATE PENSION DATE**
Women only (current laws) Men's pension age is 65***			
Up to	April 5, 1950	60	Up to April 5, 2010
April 6, 1950	April 5, 1951	60 to 61	Between May 6, 2010 and March 6, 2012*
April 6, 1951	April 5, 1952	61 to 62	Between May 6, 2012 and March 6, 2014*
April 6, 1952	April 5, 1953	62 to 63	Between May 6, 2014 and March 6, 2016*
April 6, 1953	April 5, 1954	63 to 64	Between May 6, 2016 and March 6, 2018*
April 6, 1954	April 5, 1955	64 to 65	Between May 6, 2018 and March 6, 2020*
Men and women (White Paper plans)			
April 6, 1955	April 5, 1959	65	Between April 6, 2020 and April 5, 2024
April 6, 1959	April 5, 1960	65 to 66	Between May 6, 2024 and March 6, 2026*
April 6, 1960	April 5, 1968	66	Between April 6, 2026 and April 5, 2034
April 6, 1968	April 5, 1969	66 to 67	Between May 6, 2034 and March 6, 2036*
April 6, 1969	April 5, 1977	67	Between April 6, 2036 and April 5, 2044
April 6, 1977	April 5, 1978	67 to 68	Between May 6, 2044 and March 6, 2046*
April 6, 1978	And later	68	April 6, 2046 and later

** During the transition, state pension dates are the 6th of odd numbered months.*
*** The pension is actually paid from the first Monday on or after this date*
**** The age for claiming pension credit for men and women will rise as women's pension age rises.*

Eventually that could rise to 52 years for both. It will also bring to an end the current system which gives men automatic National Insurance credits from age 60 to 64 if they do not work. The age to get these autocredits will rise with women's pension age and so they will end in April 2020.
(See table 2. opposite)

Men under 56; women under 54

If you think the basic state pension is complicated, then wait until you try to get your head round the additional pension introduced by Barbara Castle in 1978. It used to be called SERPS (State Earnings Related Pension Scheme) but since April 2002 has been called State Second Pension or S2P. Barbara Castle's original idea was that everyone who was not in a good company or public service pension – and in the 1970s that was most of us – should get as good a pension from the state. SERPS was an earnings-related pension paid for by slightly higher National Insurance contributions which would give a pension as a proportion of your earnings in the best 20 years of your working life – a rule designed to help women and manual workers particularly. But even her own Cabinet colleagues baulked at the cost and reduced its terms and SERPS was then slashed in half and half again by the next Conservative government. The change of name to S2P from April 2002 signalled that the pension would be more skewed towards the lower paid. Each year complex sums are done to work out how much S2P you have earned, based on three different percentages of your earnings between £4,368 and £33,540. The only detail you need to know is that anyone earning less than £12,500 is counted as if they earned that much.

Starting at some point between April 2012 and 2015 (linked to the date when the basic pension is raised with earnings) the amount of S2P earned each year will slowly change to make it less related to earnings and more flat rate. By April 2030 it is anticipated that the amount of S2P earned will be completely flat-rate and will be worth a pension of around £1.50 per week for each full year's work. Someone retiring this year could, in theory, have a maximum SERPS/S2P of £146 a week on top of their state pension of £84.25. Very few do of course for various reasons. But after these changes are fully in force – and that will be for people retiring in the mid 2060s – the maximum S2P will be £60 a week after 40 years' work.

When SERPS was introduced the deal was that you paid National Insurance contributions as a percentage of your earnings – they had been partly flat-rate before that – and got a pension that was at least partly related to your earnings. Under the new plans S2P will eventually be flat-rate but contributions will still be earnings-related. This will be yet another reason to see National Insurance as just a tax to pay for the state pension.

Other changes to S2P will ensure that carers and parents will qualify for S2P on the same terms as they qualify for basic state pension – and will be assumed to earn £12,500 when S2P is worked out. However, S2P will not be increased in line with earnings – it will rise just with prices. And in a disappointing change of policy it will not be extended to self-employed people.
(See table 3. above) ▶

Table 3 **SERPS/S2P changes – qualifying age will rise with state pension**

DATE	AFFECTING	CHANGE
April 6, 2010	**Men** born before April 6, 1945 and paying or being credited with NI contributions **Women** born before April 6, 1950 and paying or being credited with NI contributions	Weekly credits for carers count for S2P
April 6, 2012 to April 6, 2015	People under pension age and in work	Contributions to S2P earn a more flatrate pension
April 6, 2030	People under pension age and in work	Contributions to S2P earn a flatrate pension pension of approximately £1.50 a week

PENSION CREDIT
From April 6, 2008 – people aged 65 or more

The final element of the state pension is pension credit and the changes here are fiddly to explain. At the moment pension credit guarantees a single person aged 60 or more (with savings under £6,000) that their income will be raised to £114.05 a week (£174.05 for a couple). The guarantee credit rises each year in line with earnings and the Government has said that will continue indefinitely.

The second part of Pension Credit is called savings credit and adds a bit more for people aged 65 or more who already have extra income on top of the amount of the basic state pension. It can add another £17.58 to your income (£23.58 for a couple) – though most get less than that. Because of the weird arithmetic this extra amount for savings is rising faster even than earnings. From April 2008 it will rise just in line with earnings and from April 2015 savings credit will rise in line with prices. The guarantee credit will continue to rise in line with earnings so the gap between the two will narrow and could eventually close. That will mean that the two million people who currently get this savings credit will see their income rise more slowly than it has in the past.

At the moment men and women can claim the guarantee part of pension credit at 60. That age will rise for both sexes as women's pension age rises. So by April 6, 2020 men and women will be able to claim both parts of pension credit only at 65. That age will almost certainly rise with pension age later in the century.

See table 4 above:

Table 4 Pension credit changes

DATE	AFFECTING	CHANGE
April 6, 2008	Anyone getting savings credit	Savings credit will rise only in line with earnings
April 6, 2010	**Men** and **Women** born April 6, 1950 and later	Age to get guarantee credit rises with women's pension age
April 6, 2015	Anyone getting savings credit	Savings credit threshold rises only with prices
April 6, 2020	**Men** and **Women** born April 6, 1955 and later	Age to get guarantee credit now 65
April 6, 2024 to April 6, 2026	People born April 6, 1959 or later	Age to get guarantee credit now 66
April 6, 2034 to April 6, 2036	People born April 6, 1968 or later	Age to get guarantee credit now 67
April 6, 2024 to April 6, 2026	People born April 6, 1977 or later	Age to get guarantee credit now 68

PENSION SAVING AT WORK
Forced to save

Changes to the state pension are only part of the plans in the White Paper. The Government is also worried that fewer people are saving up for their own pension at work. Even where there is a good scheme, which promises a pension related to salary, a growing number of employees don't join it. One reason is that since 1988 companies have not been able to force their staff to join the company scheme. Instead, most companies let their new recruits know about the pension plan but leave it up to them whether they join or not. Many other employers do not have a company scheme for their staff to join even if they wanted to. As a result the number of people paying into any sort of company pension scheme is falling.

Once again the Government turned its back on a radical option – making every employer offer their own scheme and forcing all employees to join it. Instead it will do two things:

- In April 2012 a new national pension saving scheme will begin – confusingly called a "personal account" – with low charges which will be run by the insurance industry on behalf of the state.
- From April 2012 every employee will automatically join the company scheme or, if there isn't one, to the national pension savings scheme.

Although joining will be automatic, everyone will be free to leave if they choose to. However, by doing it this way round – what is called opting out rather than opting in – inertia keeps people in rather than out. The figures are variable but in one case quoted by the Government, moving from opt-in to opt-out led to an increase in new members of staff joining the pension scheme from 25% to 80%. And overall it seems that participation in an employer scheme could rise from 40% to 60% of the workforce just by this simple change. Those who opt out will be opted in again when they change jobs or every three years.

Some people will not be automatically opted in.

They include people who are
- aged 16 to 22
- over pension age
- earning less than £84 a week (the lower limit for National Insurance contributions)
- self-employed
- not in paid work

But they will all be eligible to join the personal accounts pension scheme if they wish and employees will be entitled to join the company pension scheme if the rules permit. The only exception will be people aged 75 or more who cannot pay into a pension of any sort.

The new personal account will be the pension scheme for anyone who is in a job where there is no occupational scheme set up. Every employee will pay in 5% of their gross pay and the employer will add 3% of pay on top of that – a total of 8% of pay going into a pension scheme. The 5% paid in by individuals will not be taxed so that will be the same as a Government contribution of around 1% of gross pay. There will also be a Government tax relief subsidy to the employer's 3% contribution, probably also representing about 1% of pay (tax relief is explained in more detail below). These percentages will only be applied to earnings between roughly £5,000 and £33,000 a year. People may be able to pay more than that if they wish; details of how much have yet to be announced.

This proposal goes half way to being radical. First, it compels employers to contribute to a pension for all their employees who choose to stay in it. That will mean extra costs for employers both in the contributions they pay and extra administration. There has been some concern that unscrupulous bosses will offer staff a cash bonus for opting out. That might be made illegal. But then so is paying below the minimum wage and a lot of that goes on. More worrying is that employers will see this new overhead as deferred pay and will cut or scrap pay rises to fund it. In Australia where a similar compulsory scheme was introduced, that was part of the deal agreed with the unions – pay rises were reduced or stopped to pay for the extra pension contributions.

The burden on employers will be eased by phasing in the new scheme. It is planned to start the personal accounts in April 2012. But the employer contributions will be phased in over three years, so it will not be until April 2015 that the full 8% will be going into people's personal pension accounts. It also seems certain the government will introduce some subsidy for small firms to ease the costs in the early years, perhaps through a reduction in National Insurance contributions.

Another fear is that employers who already have a pension scheme that they pay into will cut their contributions to the 3% set down for the personal account pension. At the moment the average amount paid by employers into a pension plan of this type is 7.6%. So if employers cut their contribution to 3%, that would cut their contributions by more than half and have a big effect on the pension that was eventually paid out in retirement.

There is another hidden cost to employers which makes a cut in their contributions more likely. At the moment, employers who provide an occupational pension scheme of this sort can get a 1% reduction in their National Insurance contributions if their employees leave the State Second Pension – called contracting out. If that happens the employees also pay slightly lower National Insurance contributions. Not all schemes take this opportunity and it is to be scrapped when personal accounts begin. It will only continue for those schemes which promise to pay a pension related to the salary of the employee. Employers with other schemes that are currently contracted out may try to recover the extra cost by reducing the amount they pay into the company scheme.

TAX RELIEF

The government says it will contribute 1% of the money going into these personal account schemes through tax relief. When you put money into a pension you do not have to pay tax on that income. But as you have already paid the tax, the Revenue gives it back by paying it into your pension. So if you put £100 out of your net income into a pension, HMRC puts in £28.20. That's because the basic rate tax on £128.20 is £28.20 leaving a net cost to you of £100. But if you are a higher rate taxpayer for every £100 you put into a pension the Chancellor adds another £66.67. The arithmetic is a bit complex but in fact you write a cheque for £130, the Chancellor adds £36.67 making a total of £166.67 in your pension and you then reclaim the excess higher rate tax of 18% x £166.67 = £30 so your pension investment of £166.67 has in fact cost you £130 - £30 = £100.

Because it is all so complex, few people understand what a big subsidy the government is giving to pension contributions. And it doesn't stop there – the biggest cost is the fact that employers' contributions are free of corporation tax and employers' National Insurance contributions. Pension funds themselves also have some tax relief on investment returns and growth. Altogether this tax relief costs around £20 billion a year net and just over half of it goes to the benefit of higher-rate ▶

taxpayers – the 5% of the adult population with an income high enough to pay 40% tax.

The radical solution would have been to scrap higher rate tax relief – after all it goes to the people who need it least – and pay everyone the same percentage of say 35% on every taxed pound they put into a pension. That would have shared out the subsidy more fairly. And it would have been a much bigger incentive to those on modest incomes – the ones who are doing the least to save for a pension anyway. It would also have made the system easier to understand. A recent Government survey found that barely one in four people listed tax relief as an advantage of saving for a pension. And fewer than half knew that tax relief boosted their pension contributions.

Instead, the existing unfair and obscure system will continue. Higher-rate taxpayers who pay into the personal account pensions will get more than double the tax relief enjoyed by the vast majority of savers who pay tax at the basic rate.

LOW-COST SCHEME

The Government has not yet decided exactly how the personal accounts national pension savings scheme will be run. It wants to keep costs low. At the moment the standard charge for a personal pension is 1.5% a year taken out of the pension fund just to run it. Some pensions charge less than that but many charge more. The White Paper says that someone on average earnings of £23,000 a year who saves up for a pension over 40 years would end up with £80,800 in their fund if there were no charges. An annual fee of 1.5% would cut that fund by £21,800 – more than a quarter of the total. But a charge of 0.5% would take just £8,300 over the 40 years. The Government wants a charge of as little as 0.3% if possible – a level that is achieved in similar schemes in other countries but which our insurance industry says is impossible. Further proposals will be published later in 2006.

CONSULTATION

The Government has already held public meetings and conducted market research on its pension plans. It has also asked for comments on the White Paper.

The full 212-page report is available online free at www.dwp.gov.uk/pensionsreform and there is a similarly long Regulatory impact assessment and appendices document as well as a 32-page summary.

You can get a printed copy of the summary by calling 08457 31 32 33.

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