PENSIONS POLICY INSTITUTE

PPI

PPI response to the Work and Pensions Committee's inquiry: Understanding the new State Pension

Please find attached the Pensions Policy Institute's response to the Work and Pensions Committee's inquiry: *Understanding the new State Pension,* made up of this paper and the following attached Briefing Notes:

- *Single-Tier Series Paper 1: The impact of the Government's single-tier state pension*
- *Single-Tier Series Paper 2: Managing the transition between the current system and the single-tier pension*
- *Single-Tier Series Paper 3: The impact of a switch from the triple lock to uprating by earnings*
- *Single-Tier Series Paper 4: The impact of the abolition of contracting-out*
- *Single-Tier Series Paper 5: Changes to the SPA*
- *Single-Tier Series Paper 6: The long-term cost and spending implications of the single-tier pension*

Executive summary

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system.

2. This submission also includes the results of new modelling, conducted by the PPI, around the extent to which individuals who have accrued a Guaranteed Minimum Pension (GMP) gain or lose from the new State Pension.

Early years of the new State Pension

3. Many of those who receive less than the full amount will receive income from contracted-out benefits which may or may not be more than the amount not received in State Pension.

Impact of the ending of contracting-out

4. Changes to rules around contracting-out will increase National Insurance (NI) contributions for some individuals.

5. Individuals who have contracted-out and have time to build up more pension after the introduction of the new State Pension could gain from the reforms.

6. Most people who pay higher NI contributions and reach State Pension Age (SPA) within 20 years of the new State Pension implementation date will receive enough extra State Pension to offset their increased NI contributions.

Impact of the triple-lock

7. The triple-lock provides extra protection compared to a link to earnings growth – however, the new State Pension is currently low relative to the underpin to earnings provided in some other countries.

Women born between April 1951 and April 1953

8. Women who were born between April 1951 and April 1953 will not have the opportunity to benefit from the new State Pension unlike men in the same cohort, due to different SPAs.

Impact of the change on individuals with a GMP

9. Some individuals with a Guaranteed Minimum Pension (GMP) from when they were contracted-out who reach SPA in the early years of the new State Pension could lose out from the introduction of the new State Pension. However, younger individuals with the same characteristics who reach SPA from around 2019 could gain from the new State Pension, depending on when they stop building up State Pension. Individuals whose GMP is revalued by earnings-linked rates are more likely to lose out to a greater degree than those individuals whose GMP is revalued by fixed rates.

Levels of entitlement to means-tested benefits

10. Levels of entitlement to Pension Credit are expected to fall and the Department for Work and Pensions (DWP) projects small reductions to spending on Housing Benefit and Council Tax Support.

Introduction

11. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest), focused and expert in the field, and takes a long-term perspective across all elements of the pension system.

During the early years of implementation, a small proportion of individuals receive the full amount of the new State Pension, with the transition to the new State Pension occurring over the next two to three decades

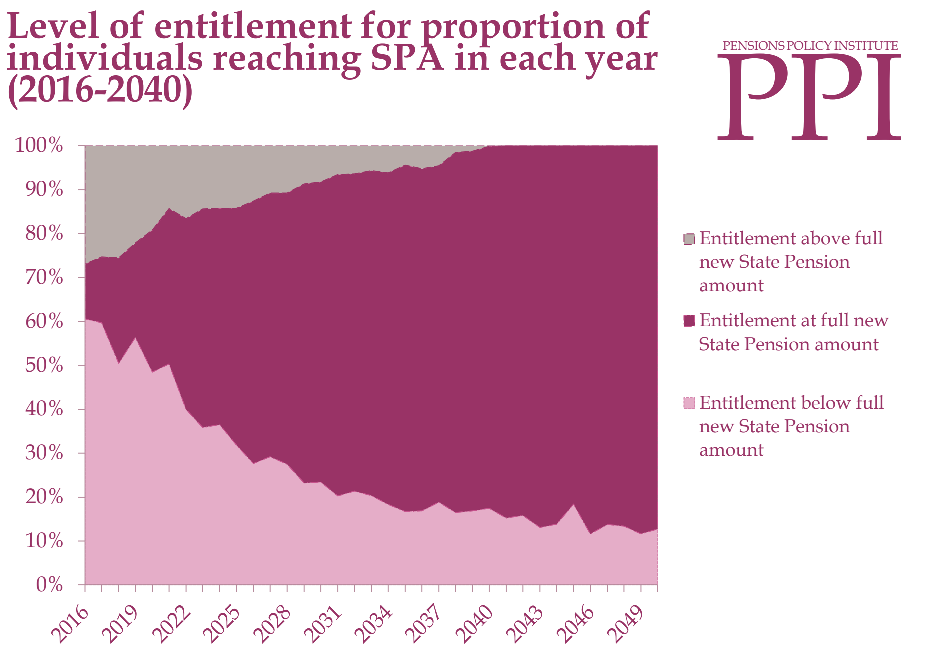
12. The way in which the new State Pension is implemented (with a comparison of the 'foundation amount' and the new State Pension) means that, in April 2016, there will be individuals reaching State Pension Age (SPA) with State Pension entitlements above or below the full new State Pension amount.

13. DWP's estimates of entitlement to the new State Pension (Chart 1) show that in 2016 61% of those reaching SPA have below full entitlement to the new State Pension, while 13% qualify for the full amount and 27% have above full entitlement. Reasons for this include individuals having fewer than 35 qualifying earnings and individuals having previously contracted-out (in which case a portion of the State Pension is effectively paid to these individuals through their private pension arrangements).

14. Men reaching SPA are more likely to have above full entitlement than women reaching SPA in 2016.

15. By 2040, over 80% are reaching SPA entitled to the full new State Pension amount.

Chart 1



Source: DWP estimates of level of entitlement to single-tier *(based on the modelling and economic assumptions in the October 2013 Pensions Bill Impact Assessment)*

Changes to rules around contracting-out will increase National Insurance (NI) contributions for some individuals

16. Since the introduction of SERPS (the State Earnings-Related Pension Scheme) in 1978 it has been possible to contract out of the additional pension part of the UK's State Pension system. In these cases employees and employers were able to receive a rebate on their NI contributions. This is on the condition that the pension scheme provides pensions broadly in line with, or better than, the future state benefits that the individual is giving up from contracting-out.

17. Some employers may have deducted and retained an amount equal to the NI rebate from the salaries of contracted-out individuals in order to cover the additional pension to be paid through the private pension arrangements. In these cases, where the employer no longer deducts this amount, equivalent to the NI rebate, the employee will not experience any change to their take-home pay. However, in other organisations, such as public sector organisations, individuals will experience the increased NI contributions as lower take-home pay.

Individuals who have contracted-out and have time to build up more pension after the introduction of the new State Pension could gain from the reforms

18. As part of their 'state' pension will be delivered through a private pension scheme for contracted-out individuals, an equivalent value will be calculated and deducted from their 'foundation' amount at the time the new State Pension is introduced. This means that an individual who has been contracted-out will have a lower foundation amount than an identical individual who has not been contracted-out.

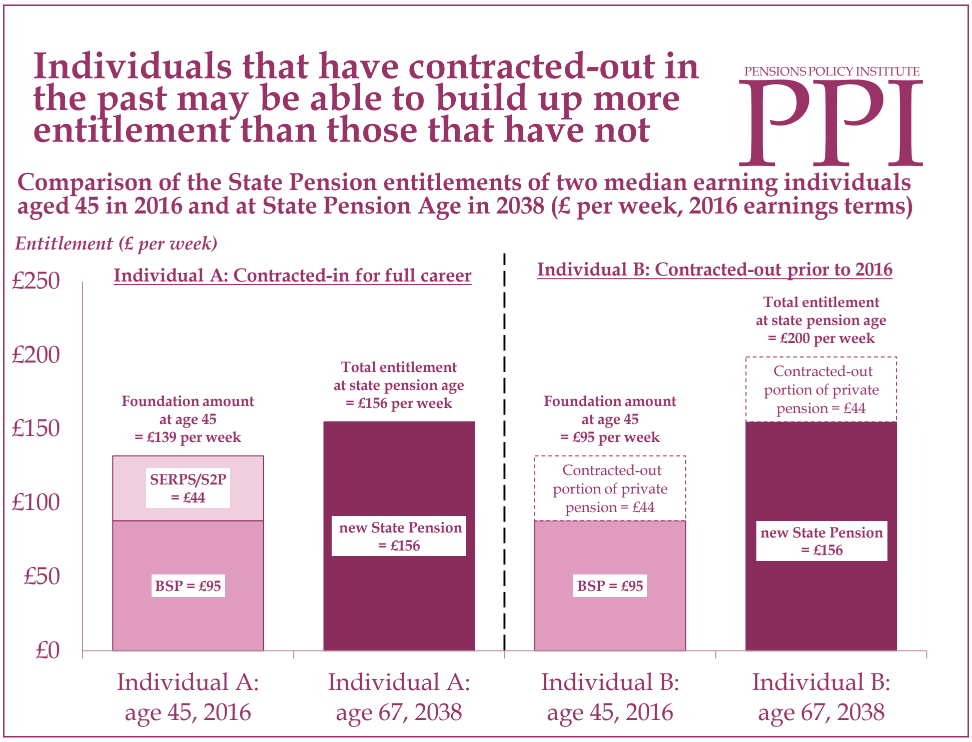
19. If these individuals are close to retirement, then the contracted-out individual is likely to receive a lower new State Pension amount than the individual who has not contracted-out. However, if these individuals are younger and have a number of years still to go to retirement, the contracted-out individual is likely to receive a similar or equivalent new State Pension at SPA to the individual who has not contracted-out. This is because the individual with the lower 'foundation amount' can continue to build up new entitlement to the new State Pension up to a maximum of 35 years whilst still receiving their contracted-out SERPs/S2P, built up before April 2016, through their private pension. They are therefore getting a greater return on their NI contributions than the individual who has not contracted-out.

20. Chart 2 illustrates this, using the example of two median earning individuals, aged 45 in 2016, who started to build up entitlement to the State Pension from the age of 21. These individuals have identical earnings histories, but one has contracted-out of SERPS/S2P for their entire working life, while the other has remained contracted-in.

21. Based on their 24 years of contributions, both have built up higher entitlement at age 45 under the current system in 2016 than if the new State Pension had been in place, so this becomes their foundation amount. However, the contracted-out individual has a lower foundation amount, reflecting the fact that they paid lower NI contributions and so part of this 'state' pension is being provided through their private pension.

22. By the time the individuals reach SPA, both have enough qualifying years on top of their foundation amounts to reach the full new State Pension level. However, the contracted-out individual will still receive the contracted-out private pension, equivalent to the SERPS/S2P that they would have built up before 2016 if they had been contracted-in. The contracted-in individual does not receive this, as it was included as part of their foundation amount.

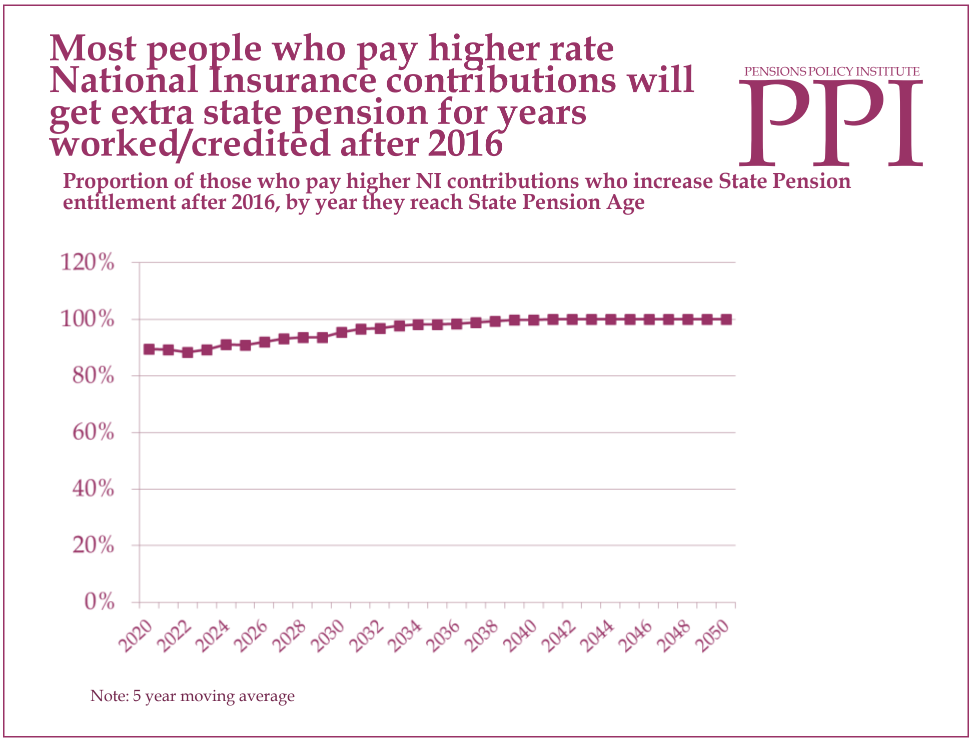
Chart 2



Most people who pay higher NI contributions and reach SPA within 20 years of the new State Pension implementation date will receive enough extra State Pension to offset their increased NI contributions

23. Chart 3, taken from the DWP's impact assessment shows that, under the new State Pension, from 2020 onwards, at least 90% of those people who pay a higher rate of National Insurance contributions as a result of the ending of contracting out will be able get extra State Pension for years worked or credited after 2016, up to the full new State Pension. The DWP estimates that approximately 90% of people who pay higher contributions and reach SPA within 20 years of the implementation date of the new State Pension will receive enough extra State Pension in their retirement to offset the increase in National Insurance contributions and any adjustment to their occupational pension schemes.

Chart 3[1]



The triple lock provides extra protection compared to a link to earnings growth – however, the new State Pension is currently low relative to the underpin to earnings provided in some other countries

24. There is a commitment to maintain the triple lock until the end of the current parliament only. After this date the law will require the new State Pension to be uprated by earnings, although subsequent governments may decide to continue the triple lock.

25. Historical data suggest that the earnings growth rate is likely to be the largest component of the triple lock, and therefore the triple lock growth might be the same as earnings growth. However, over the longer term there are likely to be instances when earnings growth is exceeded by either CPI or 2.5%.

26. Chart 4 sets out the level of the full new State Pension from 2016 to 2066 in 2016 earnings terms. The earnings linked new State Pension remains at a constant £156 a week in current earnings terms.

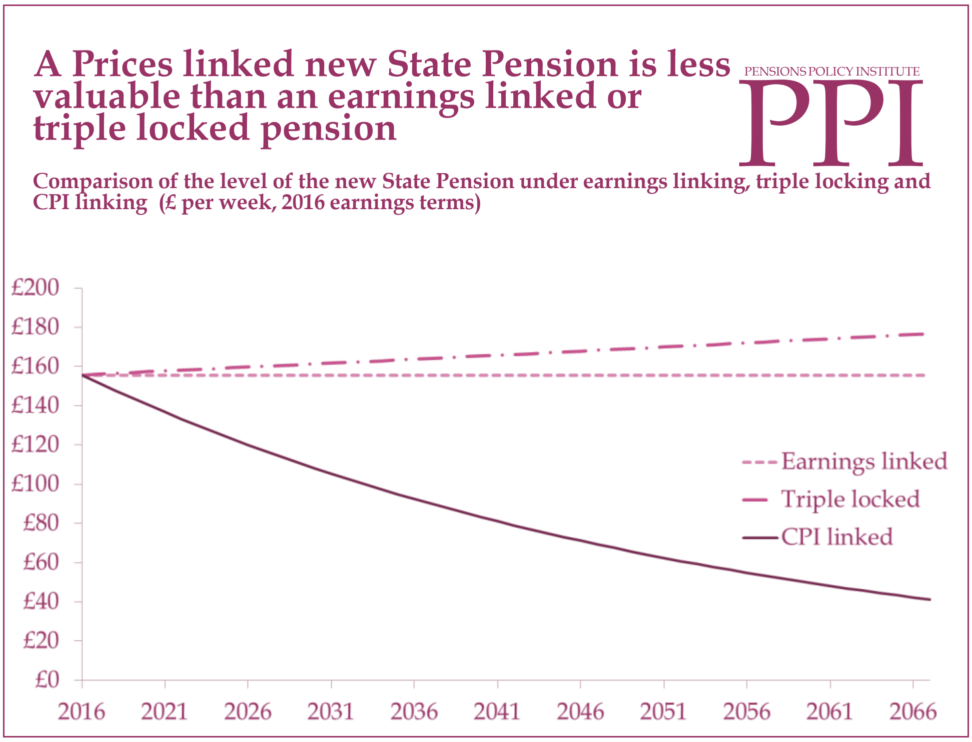
27. The triple locked new State Pension reaches around £165 a week in 2040

[1] DWP (2013) *Single-tier impact assessment*

(expressed in 2016 earnings terms). The level of the triple locked new State Pension in 2065, could be around £176 a week (in 2016 earnings terms). This is around 14% higher than the earnings linked pension.

28. A CPI linked new State Pension might be expected to fall in current earnings terms, being worth half of a triple locked new State Pension by 2040, and around 25% of a triple locked new State Pension by 2065.

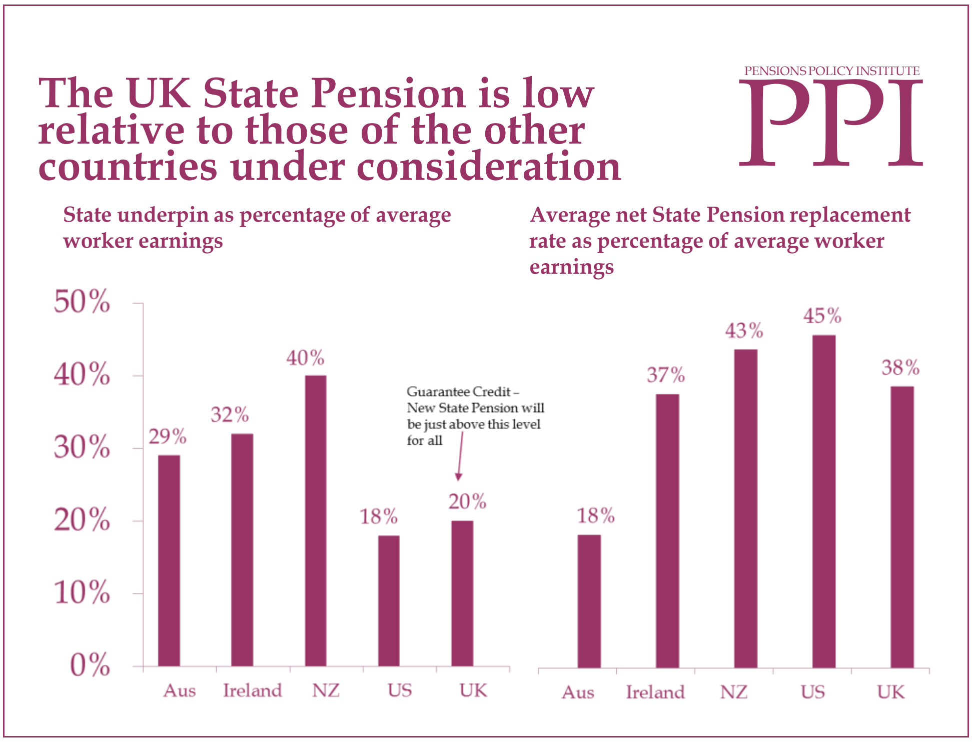
Chart 4



The UK new State Pension will be low relative to some other countries' state provision

29. Chart 5 shows the average State Pension received and the underpin (typically the minimum income that an individual would receive in retirement) provided by the state as a percentage of average earnings.

Chart 5



30. The UK additional State Pension, currently in place, is earnings-related and, therefore, the average State Pension received shown on the right-hand side of Chart 5 is higher than the state underpin. However, as the new State Pension will be introduced at a level just above Guarantee Credit, the average State Pension received by UK individuals is likely to decrease to just above this level, depending on earnings (once the new State Pension is fully introduced).

31. Therefore, the new State Pension will be low, in terms of average worker earnings, relative to some other countries. While the triple lock alone is unlikely to reverse this situation, removal of the triple lock so that the State Pension is uprated by earnings or CPI would remove one lever by which the value of the State Pension is maintained.

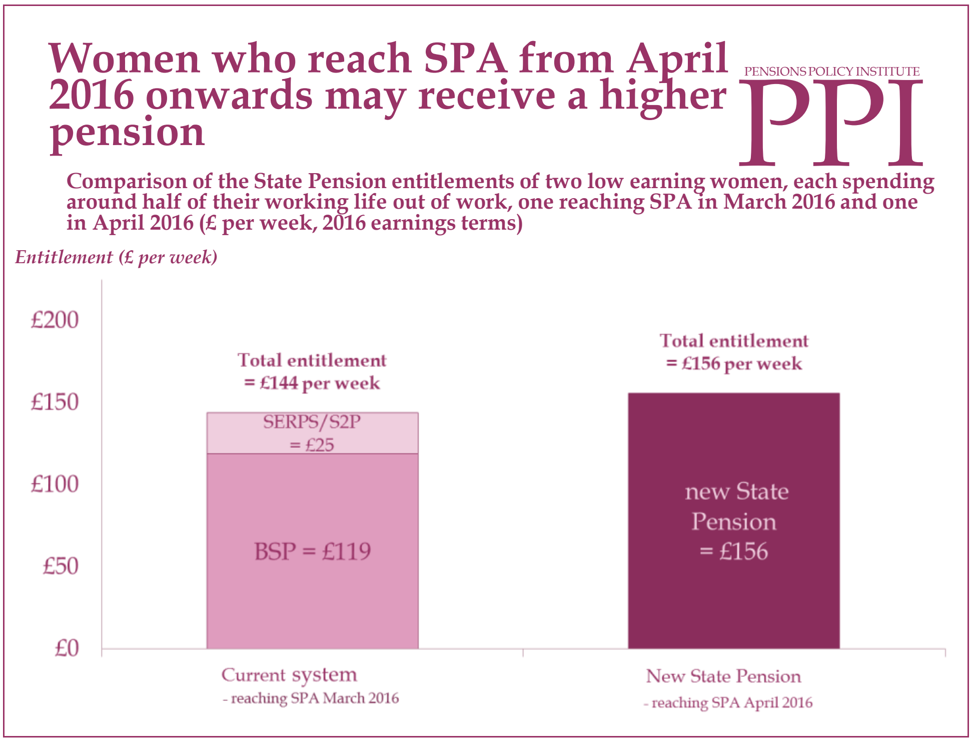
Women who were born between April 1951 and April 1953 will not have the opportunity to benefit from the new State Pension when men in the same cohort will

32. Women in this cohort will have a SPA under 65, meaning that they will reach SPA before the implementation date of April 2016, compared to men born at the same time whose SPA is 65 and who will, as a result, reach SPA from April 2016 onwards. In 2011, there were around 718,000 women in this cohort.[2]

33. Chart 6 illustrates how women of very similar ages could have different outcomes depending on whether they reach SPA before or after April 2016. This uses the example of two low earning women, one reaches SPA in March 2016 while the other reaches SPA in April 2016. These individuals have identical earnings histories and each has spent around half of their working life out of work. While the woman who reaches SPA under the current system will receive £144 per week, the woman who retires in April 2016 will benefit from the comparison of her accrued rights under the current system with what she would have accrued under the new State Pension—and consequently receives the higher new State Pension amount of £156 per week. However, if she does not have any other sources of income, the women who reaches SPA under the current system would have her payment increased to the current level of Guarantee Credit. This is currently £155.60.

[2] ONS (2011) *Census*

Chart 6



34. Despite this type of example, the DWP estimates that approximately 90% of women in this cohort would, overall, receive more in lifetime State Pension and other benefits under the current system than if they had a SPA of 65 and received the new State Pension.[3]

Individuals with a GMP who reach SPA in the early years of the new State Pension are more likely to lose out, while those individuals with a GMP who reach SPA from around 2021 are more likely to gain

35. Between 1978 and 1997 where those individuals who were contracted-out of the State Earnings Related Pension Scheme (SERPS) through a Defined Benefit (DB) pension scheme, the scheme had to promise them a Guaranteed Minimum Pension (GMP).

36. Where an individual left the pension scheme before reaching SPA, they had an entitlement to an annual amount of GMP. This amount is increased each year according to the scheme's particular rules around revaluation. Schemes can either adopt a fixed rate that is specified by legislation or use an index based on earnings. Fixed rates are set according to the date that an individual leaves the employment that

[3] DWP (2013) Note on the cohort of women born between 6 April 1951 and 5 April 1953

relates to the GMP – the fixed rates that apply to each period of employment are included in Annex A.

37. The approach to revaluation adopted by the scheme has an impact on the amount of GMPs accrued. Historically fixed rate revaluations have generally yielded higher increases to GMPs than earnings-linked revaluations. Once an individual reaches SPA the pension scheme pays them the revalued annual amount, that includes the increases that have accrued between the individual leaving the pension scheme and reaching SPA.

38. From the individual's SPA onwards, the pension scheme continues to pay the GMP and limited indexation (described below) each year. Under the current system, the DWP makes an annual calculation of the amount that an individual would have received from SERPS, compares this amount with the individual's GMP and, if the SERPS value is higher, pays the difference to the individual. In practice individuals with GMPs that have been revalued at the fixed rate may be higher at the individual's SPA than the SERPS that they have foregone by contracting-out. The state will not pay any amounts over to them until the uprated SERPS exceeds the GMP, which may be several years into their retirement.

39. Under the new State Pension, the DWP will no longer pay the difference to the individual between the amount an individual would have received from SERPS and their GMP. Not all individuals with GMPs will be affected by the introduction of the new State Pension and the extent to which this will affect an individual's outcomes depends on the following:
    - The level of GMP
    - The period over which they accrued their GMP
    - The length of time over which they accrue the new State Pension

The period of time over which they accrued their GMP

40. Once in payment, the pension scheme is not required to provide increases on a GMP accrued between 1978 and 1988. This means that over this period there can be a bigger difference between the GMP that an individual has and the SERPS that an individual would have accrued if they had not contracted-out than in later periods. As the DWP currently pays an amount equivalent to this difference to the individual, individuals with large amounts of GMP accrued between 1978 and 1988 are more likely to lose out from the new State Pension arrangements under which the DWP will no longer make this payment.

41. In contrast, the pension scheme is required to provide increases in line with inflation on a GMP accrued between 1988 and 1997, up to a maximum of 3%. This means that there is a smaller difference between the GMP that an individual has and the SERPS that an individual would have accrued if they had not contracted-out. Therefore, individuals with a relatively large proportion of their GMP accrued between 1988 and 1997 benefit less from the DWP paying the difference between their GMP and SERPS (which is indexed by the Consumer Price Index). In turn, they are less likely to lose out from the new State Pension arrangements under which the DWP will no longer make this payment.

The length of time for which they accrue the new State Pension

42. From April 2016 onwards, individuals are able to accrue the new State Pension, up to the maximum new State Pension of £155.65 (in 2016 earnings terms). This contrasts with the previous system where a contracted-out individual was able to accrue the Basic State Pension, £119.30 (in 2016 earnings terms). Therefore, individuals who work for several years after April 2016 are able to accrue the entire new State Pension of £155.65 as well as retaining the contracted-out amount related to the additional state pension, including their GMP, paid to them by their occupational pension scheme. In addition, the entire amount is uprated by the triple lock whereas under the current system an individual would have had their basic state pension only uprated by the triple lock while the amount of pension related to contracting-out would have effectively been uprated by CPI only.

43. Some individuals with a Guaranteed Minimum Pension (GMP) from when they were contracted-out who reach SPA in the early years of the new State Pension could lose out from the introduction of the new State Pension. However, younger individuals with the same characteristics who reach SPA from around 2019 could gain from the new State Pension, depending on when they stop building up State Pension. Individuals whose GMP is revalued by earnings-linked rates are more likely to lose out to a greater degree than those individuals whose GMP is revalued by fixed rates.

44. The first two examples in the remainder of this paper, including Charts 7 to 10, assume that individuals are contracted-out throughout their working lives and that their GMPs are revalued at earnings rates prior to retirement. As SERPS is also revalued at earnings rate up to retirement, this approach gives the maximum differences between GMP and SERPS from SPA onwards. Therefore, this approach also gives the maximum losses/minimum gains from the shift from the current to the new State

Pension. The third example (Chart 11) assumes that an individual has £10 GMP accrued before 1988 and £10 accrued after 1988, revalued by earnings. Finally, this submission includes description of analysis conducted for those individuals whose GMP is revalued at fixed rates.

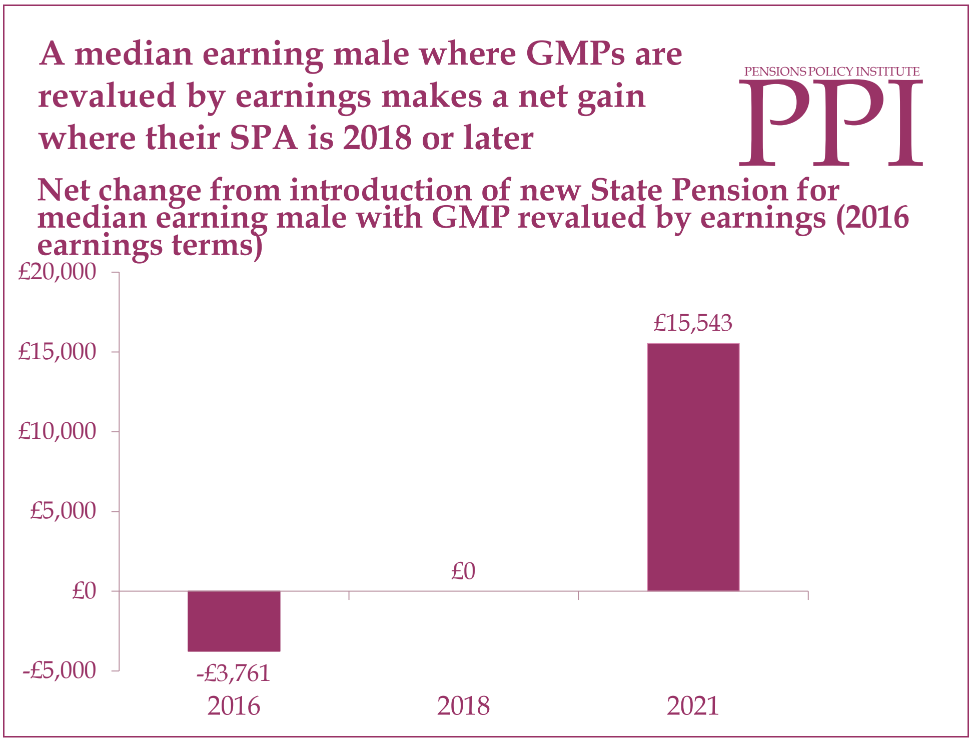
45. The figures in this report assume that individuals remain contracted-out for the entire periods in which it is possible to contract-out. Therefore these figures represent outcomes from the extreme end of the range. In practice, individuals may have spent only a portion of their working life contracted-out and, in these cases, their respective losses or gains may be significantly lower. We are not aware of any publicly available information as to how many individuals have different levels of GMP and so might be at risk of lower income in retirement as a result of the introduction of the new State Pension.

46. The calculations contained in this paper consider only the amount of State Pension that individuals receive under the two systems. In the new State Pension system, while individuals receive a higher State Pension they also pay higher National Insurance contributions. If the current system had continued beyond 2016, individuals may also have accrued additional private pension benefits through contracting-out. Neither of these factors are taken into account in these calculations.

47. Chart 7 shows the net lifetime gains and losses that a median earning male might make from the introduction of the new State Pension, depending on the year in which they reach SPA, in 2016 earnings terms. While this individual who reaches SPA in 2016 makes a net loss of £3,761, they are no longer making a loss where they reach SPA in 2018 and the individual who reaches SPA in 2021 makes a net gain of £15,543.

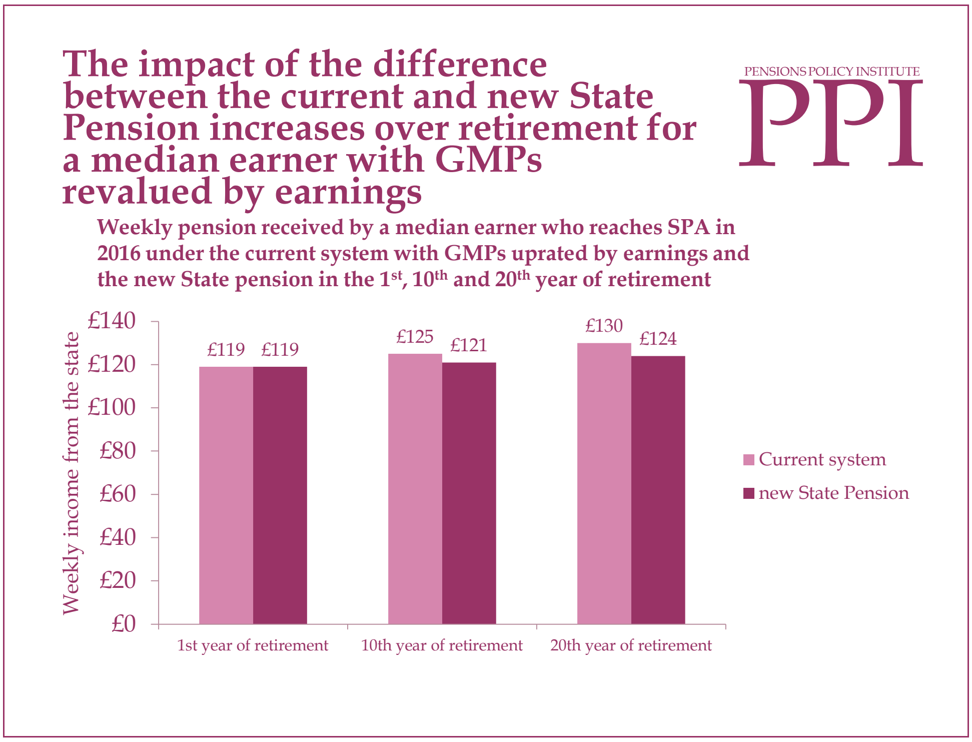
48. Individuals who reach SPA later make a net gain for the following reasons:
   - They are able to accrue the whole new State Pension. This new State Pension is uprated by the triple lock
   - They accrued a higher proportion of their GMP after 1988, meaning that they receive the uprating of this portion of their GMP from their occupational pension scheme

Chart 7



49. In the first year of the new State Pension, there is no difference between the amount of income received from the state under the current and new State Pension (Chart 8). In this year, the individual receives a state pension of £119 per week, under both systems, and £49 of GMP. However, under the new State Pension, the individual no longer receives an amount to account for the uprating of their GMP from the state. Therefore, the difference between the weekly amounts paid under the current and new State Pension increases over the course of retirement. In the 10th year of retirement, the median earner would receive weekly income from the state of £121 under the new State Pension compared to £125 under the current system.

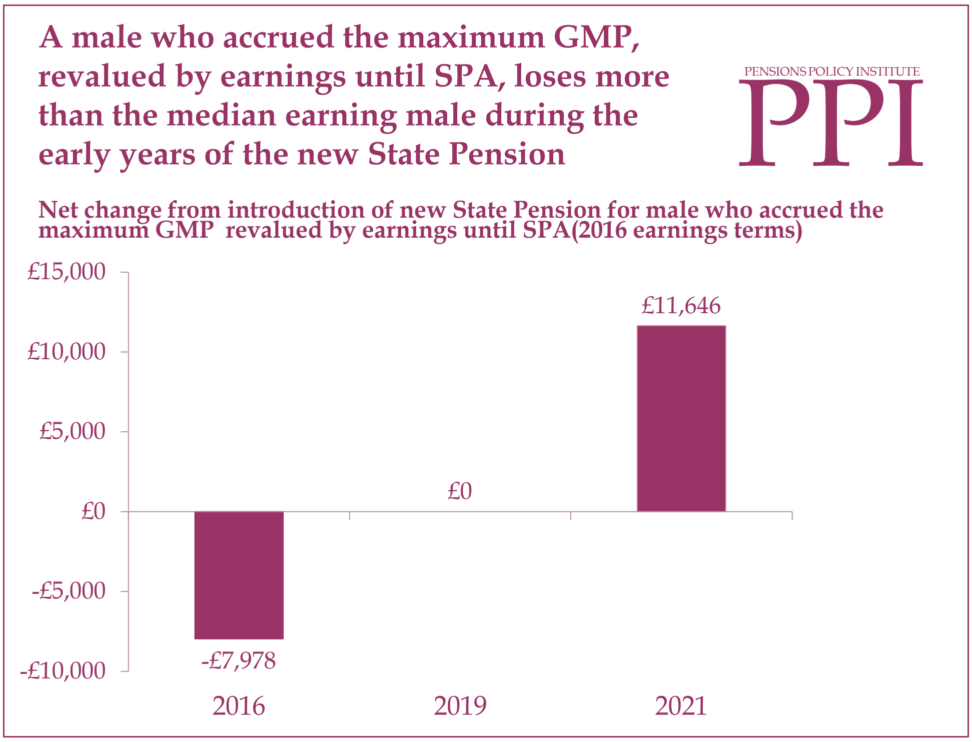
Chart 8



50. Chart 9 shows the net lifetime gains and losses that a male who accrued the maximum GMP, revalued by earnings until SPA, might make from the introduction of the new State Pension, depending on the year in which they reach SPA.

51. Overall, the individual with maximum GMP makes higher losses and smaller gains than the median earner. Relative to the median earning male, the individual with the maximum GMP reaching SPA in 2016 makes a larger net loss of £7,978. While median earning males retiring from 2018 onwards no longer makes a loss, males with the maximum GMP who retires from 2019 no longer make a loss. The individual who accrues the maximum GMP who reaches SPA in 2021 makes a net gain of £11,646.

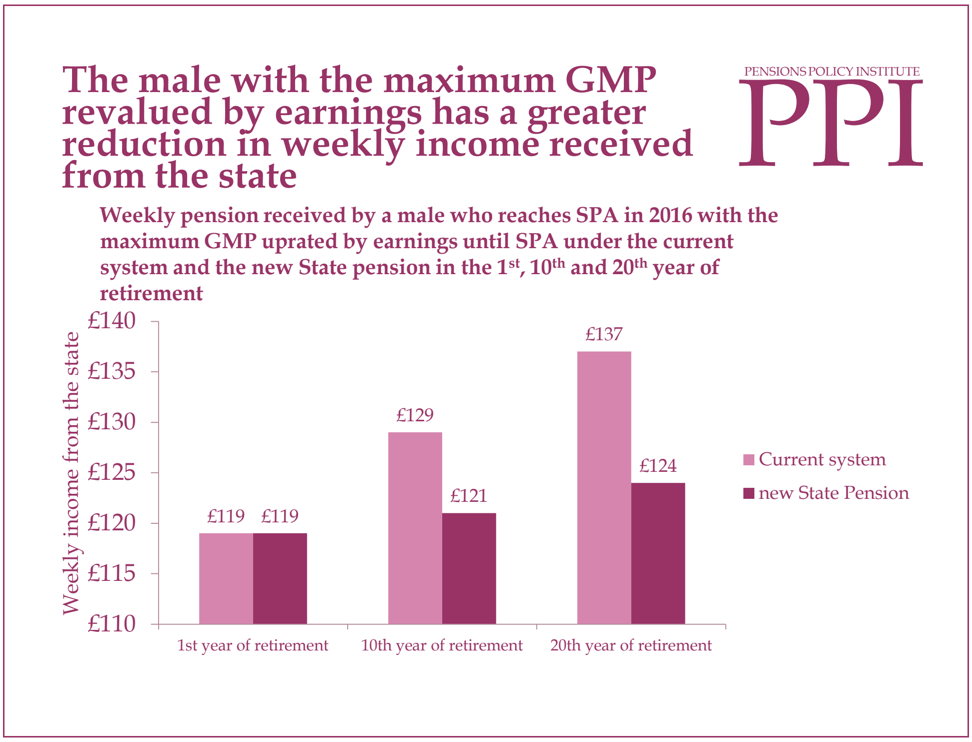
Chart 9



52. Again, the difference between the weekly amounts paid under the current and new State Pension increases over the course of retirement for the male who has accrued the maximum GMP (Chart 10). In the first year, the individual receives a state pension of £119 per week, under both systems, and £92 of GMP.

53. The decrease to weekly income received from the state will be greater for the male with the maximum GMP than for the median earner. In the 10th year of retirement, the male with the maximum GMP would receive weekly income from the state of £121 under the new State Pension compared to £129 under the current system.

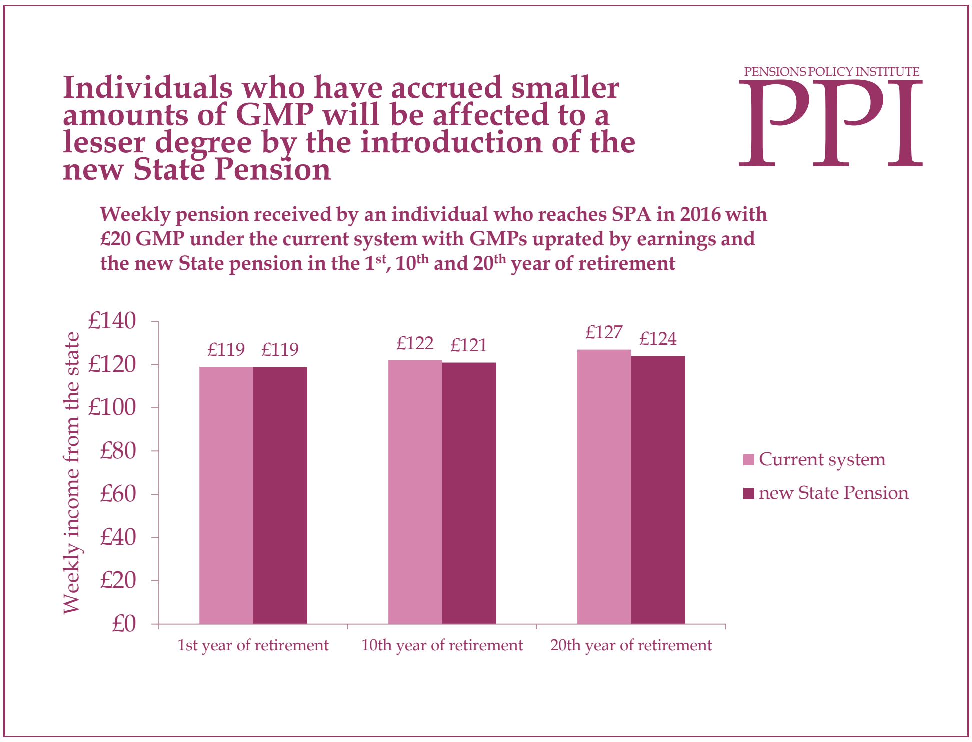
Chart 10



54. The previous examples assume that individuals have remained contracted-out for their entire working life and, therefore, that they have accrued relatively large amounts of GMP. Where an individual is assumed to have accrued a smaller amount of GMP they may also lose out where they reach SPA in the early years of the new State Pension. An individual who reaches SPA in 2016 and has accrued £10 of GMP pre-1988 and £10 post-1988 will make a net loss of £1,462 from the introduction of the new State Pension. The majority of this loss, £1,314, relates to GMP accrued pre-1988. This reflects the fact that the pension scheme is not required to provide increases on a GMP accrued between 1978 and 1988.

55. Chart 11 shows weekly income under the current and the new State System for an individual who has accrued £20 of GMP (£10 pre-1988 and £10 post-1988). Individuals with smaller amounts of GMP are affected to a lesser degree by the introduction of the new State Pension. In the 10th year of retirement, the male with the maximum GMP would receive weekly income from the state of £121 under the new State Pension compared to £122 under the current system.

Chart 11



56. The previous examples have assumed that individuals' GMPs are revalued by earnings prior to retirement. In addition, the PPI conducted analysis of those individuals whose GMP is revalued fixed rates. The fixed rate approach leads to higher value GMPs at retirement that are greater than SERPS. Where individuals' GMP is revalued at the highest fixed rates of 8.5% and 7.5% these individuals would not receive any payment in respect of their GMPs as the SERPS amount does exceed the GMP received during their lifetime. In turn, these individuals do not experience any loss from the introduction of the new State Pension.

Levels of entitlement to Pension Credit are expected to fall and the Department for Work and Pensions (DWP) projects small reductions to spending on Housing Benefit and Council Tax Support

57. Levels of entitlement to some means-tested benefits are expected to fall; eligibility for Pension Credit, set at just below the level of the new State Pension, for those reaching SPA from April 2016 is expected to fall significantly. The DWP's Impact Assessment projected small reductions in spending on Housing Benefit and Council Tax Support. However, this depends on how local authorities, now responsible for the rules around Council Tax Support, choose to assess eligibility for this.

58. As the level of the new State Pension has been set so close to the Guarantee Credit level (£155.65 for the new State Pension, £155.60 for Guarantee Credit), there is a smaller gap between State Pension benefits and means-testing than envisaged in the Impact Assessment in which the new State Pension was assumed to be £146.30 and Guarantee Credit was assumed to be £145.40.[4] This, combined with the number of people expected to receive less than the full new State Pension amount as a result of contracting-out and freedom and choice as to how contracted-out DC pensions can now be taken in retirement might mean that future entitlement to means-tested benefits could be higher than expected.

[4] Single-tier impact assessment (2013)

Annex A: Fixed rates for GMP revaluations[5]

Leavers after 5 April 1978 but before 6 April 1988	8.5% p.a.
Leavers after 5 April 1988 but before 6 April 1993	7.5% p.a.
Leavers after 5 April 1993 but before 6 April 1997	7.0% p.a.
Leavers after 5 April 1997 but before 6 April 2002	6.25% p.a.
Leavers after 5 April 2002 but before 6 April 2007	4.5% p.a.
Leavers after 5 April 2007 but before 6 April 2012	4.0% p.a.
Leavers after 5 April 2012	4.75% p.a.

[5] SI 1996/1172 as amended

Annex B: Assumptions

- Figures are in 2016 earnings terms
- For fixed rate revaluations calculation are based on patterns of employment that would lead to the highest value of GMPs. Figures for fixed revaluation are 8.5% pre-1988 and 7.5% post-1988
- After the individual reaches SPA, the pension schemes pays annual uprating of 0% for GMP accrued pre-1988 and CPI up to 3%, which is assumed to be 1.8%
- Emerging SERPS payments to contracted-out individuals from the government under the current system are in line with providing full CPI increases on GMPs
- Long-term earnings growth is based on an July 2015 OBR projection of 4.3%
- CPI is based on an July 2015 OBR projection of 2%
- The individual retires at SPA
- The triple lock is maintained
- The male individual dies at age 85