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An assessment of the Government's options for state pension reform

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Introduction

In April 2011 the Government published a Green Paper: *A state pension for the 21st century.* In the Green Paper, the Government set out four guiding principles for state pension reform:

- **personal responsibility** – enabling individuals to take responsibility for meeting their retirement aspirations in the context of increased longevity;
- **fairness** – ensuring an adequate level of support for the most vulnerable, ensuring everyone with a full contribution record should be entitled to a state pension above the standard level of means-tested support, and ensuring all groups are treated fairly;
- **simplicity** – simplifying the state pension so that it is easier for people to plan and save for their retirement; and
- **Affordability and sustainability** – given longer-term pressures on the public finances, any state pension reform must be affordable. Any options for reform must be cost neutral in each and every year to avoid placing an unsustainable burden on future taxpayers.[1]

The Government has several concerns about the current state pension system. The Government is concerned:

- About the ways in which the current system of means-tested benefits could act as a disincentive to saving.
- That the complexity of the system creates too much uncertainty for people to understand what they will be entitled to when they retire and how to plan appropriately for their retirement.
- About the inequalities in the pension system; certain groups (for example, women and lower earners) receive lower than average incomes from the state pension.
- About the future sustainability of the state pension, in light of longevity increases and an ageing population.

In an attempt to address their concerns about the current state pension system, the Government has issued a Green Paper which consults on two broad options for reform of the state pension. The two suggested options for reform are:

1. An acceleration of the existing reforms so that the state pension evolves into a two-tier flat-rate structure more quickly, with State Second Pension (S2P) accruals becoming flat-rate by 2020 instead of 2030.
2. The creation of a single-tier flat-rate pension set above the current level of the Guarantee Credit element of Pension Credit (for example £140 per week in 2010 earnings terms) introduced for people reaching State Pension Age (SPA) after 2016, or the implementation date.

[1] Reproduced from DWP (2011)

This report has been commissioned by the NAPF who have asked the PPI to analyse each option of the Green Paper in detail, considering:
a. what each option would cost to implement, taking into account any flexibility that might be available in terms of benefit levels or changes to the means-tested benefits system which could make each option cost neutral;
b. how each option impacts incentives to save and eligibility to means-tested benefits;
c. who would gain and who would lose from each policy option; and
d. what the wider impacts on the pensions and retirement income sector would be.

The Green Paper also consults on the most appropriate mechanism for determining future changes to the state pension age. This report does not consider the mechanism for increasing the State Pension Age in future.

This report provides a fact-based assessment of the implications of the two alternative reform options:

- For individuals – in terms of exploring who the gainers and losers of the reforms might be.
- For Government expenditure - in terms of analysing what costs and savings may arise from introduction of the reforms.
- For pension schemes – in terms of exploring what wider consequences the reforms may have on occupational pension schemes in both the public and private sector.

This report is intended to contribute to the on-going policy debate. The PPI does not lobby for particular policy proposals.

Chapter one explores the implications for individuals and for Government expenditure of maintaining the current state pension system.

Chapter two summarises the analysis presented in the report and explores how the Government's two alternative reform options compare to current policy and to each other.

Chapter three explores the implications for individuals and for Government expenditure of faster flat-rating of S2P.

Chapter four explores the implications for individuals and for Government expenditure of introducing a single-tier pension.

Appendix one gives a description of the current pension system.

Appendix two gives the modelling methods and assumptions.

Summary of Conclusions

The Government has issued a Green Paper: *A State Pension for the 21st century* which contains two proposals for reform of the state pension system:

1. An acceleration of the flat-rating of the State Second Pension (S2P) so that the state pension evolves into a two-tier flat-rate pension by 2020, instead of by the mid 2030s.
2. The creation of a single-tier flat-rate pension set above the current level of the Guarantee Credit element of Pension Credit (for example £140 per week in 2010 earnings terms), introduced for pensioners retiring after the implementation date.

This report provides a fact-based assessment of the implications of the two alternative reform options:

- For individuals – in terms of exploring who the gainers and losers of the reforms might be;
- For Government expenditure - in terms of analysing what costs and savings may arise from introduction of the reforms;
- For pension schemes – in terms of exploring what wider consequences the reforms may have on occupational pension schemes in both the public and private sectors.

This report estimates the number of pensioners who 'gain' or 'lose' in terms of household income as a result of the reforms. The Government has made a commitment that no individual will lose state pension rights that they have already built up. The gains and losses shown in this report reflect the different amounts that pensioners might build up in future under the alternative reforms compared to how much they would build up if the current system continues.

Option 1: Accelerating the flat-rating of S2P
In the absence of any other reforms, accelerating the flat-rating of S2P into two tiers of flat-rate state pension by 2020 could lead to:

- No pensioners gaining any extra income from the state pension as a result of this reform and some pensioners receiving lower state pension incomes compared to the current system.
- Those individuals who would have accrued higher S2P under the current system between 2013 and 2033 could lose on average a relatively small amount of state pension income under this reform.
- Overall in 2034, 5.3 million pensioners could see lower household income (losing an average of £0.50 per week in 2011 earnings terms).
- By 2055 the number of losers increases to 6.7 million pensioners (losing an average of £1.50 per week).
- A negligible difference in the numbers of pensioner households eligible for means-tested benefits

- Marginal reductions in future Government expenditure on state pensions and means-tested benefits, saving up to £0.6bn (2011 earnings terms), or less than 0.1% of GDP, each year by 2055.
- An increase in the amount of National Insurance contributions collected by the Government in every year between 2013 and 2033, peaking at an additional £3bn (2011 earnings terms), or 0.1 % of GDP, in 2020. In 2016 the increase would be £1bn (£0.8bn from the public sector, £0.2bn from the private sector).
- Some additional pressure on employers running Defined Benefit schemes (including those in the public sector) who would have to pay higher National Insurance contributions than in the current system and still meet the costs of providing contracted-out pensions.

Option 2: A single-tier pension
Introducing a flat-rate single-tier pension at a level of £140 a week (2010 earnings terms) introduced for pensioners who reach State Pension Age from 2016 could lead to:

- An increase in the state pension income for some pensioners, but a decrease in state pension income for others.
- A single-tier pension could lead to higher state pension incomes for:
  - Some women and carers, particularly those who have taken time out of the labour market before 2002 or have had very low earnings and didn't qualify for the current state pension.
  - The self-employed, although the self-employed may have to pay higher National Insurance contributions in the future.
  - The unemployed claiming Job Seekers Allowance.
  - Older pensioners and those pensioners who do not claim the means-tested benefits they are entitled to.
  - Pensioner couples
- A single-tier pension could lead to lower state pension incomes for:
  - Individuals who would have qualified for more than 30 years of S2P under the current system.
  - Individuals who have less than seven years of National Insurance contributions.
  - Individuals who would have been eligible for Savings Credit.
- Overall by 2034, the single-tier reform could increase the household incomes of 6.8 million pensioners (gaining an average £23 a week in 2011 earnings terms) but could reduce the household incomes of 5.2 million pensioners (losing an average £18 per week), compared to the current system.
- By 2055 the number of pensioners with higher household incomes under the single-tier system could increase to 11 million (gaining an average £24 per week) and the number of pensioners with lower household incomes could reduce to 5 million pensioners (losing an average £17 per week).
- The reform would dramatically reduce the number of pensioners reliant on means-tested benefits. The proportion of pensioner

households eligible to claim Pension Credit could fall from 35% of pensioner households (4.4 million pensioners) in the current system to only 5% of pensioner households (0.8 million pensioners) by 2055.

- The reform would be broadly cost neutral to introduce, depending on exactly how the system is implemented. PPI estimates suggest the single-tier would be broadly cost neutral, costing less than the current system by less than 0.1% between 2019 and around 2050, and costing more than the current system by about 0.1% by 2055.
- The reform would increase the Government's National Insurance revenue by £6bn in 2016, £5bn of which would come from public sector pension schemes and £1bn from private sector schemes.
- As a result a single-tier pension could place additional pressure on employers and employees in Defined Benefit schemes in both public and private sectors as NI contributions would increase.
- Employers with DB schemes would pay higher NI contributions (£3.4bn public sector employers, £0.8bn private sector employers in 2016, 2011 earnings terms), and would have to choose whether to reform their schemes in response to the reform.
- Employees in DB schemes would pay higher NI contributions (£1.4bn public sector employees, £0.3bn private sector employees in 2016, 2011 earnings terms), but the impact on their pension incomes would depend on how employers react to the abolition of contracting-out.

Summary results table: comparing the impact of the Government's alternative state pension reforms compared to the current system

Impact on:	Option 1: Accelerating the flat-rating of State Second Pensions (S2P)	Option 2: A single-tier pension
Pensioner incomes	Would not increase state pension incomes for any pensioners. Could reduce state pension incomes for some pensioners. • In 2034, 5.3 million pensioners would see lower household income (losing an average of £0.50 per week in 2011 earnings terms). • By 2055 the number of losers increases to 6.7 million (losing an average of £1.50 per week).	Would increase state pension incomes for some pensioners, and reduce incomes for others. • Increase the household incomes of 6.8 million pensioners by an average £23 a week (2011 earnings terms) and could reduce the household incomes of 5.2 million pensioners (losing on average £18 per week) in 2034. • By 2055 the number of pensioners with higher household incomes under the single-tier system could increase to 11 million (gaining on average £24 per week) with 5 million pensioners having lower household incomes (losing on average £17 per week).
Means-tested benefits	Negligible	Substantially reduce eligibility to Pension Credit. By 2055 only 5% of pensioner households (0.8 million pensioners) would be eligible to Pension Credit in the single-tier system, compared to 35% (4.4 million pensioners) in the current system.
Government expenditure	Save the Government up to £0.6bn (2011 earnings terms), or less than 0.1% of GDP, each year until 2055.	Broadly cost neutral to introduce, depending on exactly how the system is implemented. Costs within 0.1% of GDP of the current system from introduction until at least 2055.
NI revenues	Increase Government NI revenue in every year between 2013 and 2033, peaking at an additional £3bn (2011 earnings terms), or 0.1% of GDP, in 2020. In 2016 the increase would be £1bn (£0.8 bn from the public sector, £0.2bn from the private sector).	Increase Government NI revenue in every year after introduction. In 2016 increase would be £6bn (2011 earnings terms), £5bn of which would come from public sector employers and employees, £1bn from private sector employers and employees.
DB schemes	Could place some additional pressure on employers running Defined Benefit schemes (including those in the public sector) who would have to pay higher NI contributions and still meet the costs of providing contracted-out pensions.	Could place additional pressure on employers and employees in Defined Benefit schemes in both public and private sectors as NI contributions would increase. Employers with DB schemes would pay higher NI contributions (£3.4bn public sector employers, £0.8bn private sector employers in 2016, 2011 earnings terms), and would have to choose whether to reform their schemes and how in response to the reform. Employees in DB schemes would pay higher NI contributions (£1.4bn public sector employees, £0.3bn private sector employees in 2016, 2011 earnings terms), but the impact on their pension incomes would depend on how employers react to the abolition of contracting-out.

Chapter one: the implications of maintaining the current system

This chapter explores the implications of maintaining the current pension system for individuals, for Government expenditure, and for occupational pension schemes.

How is the UK pension system currently structured?
In its current form, the UK state and private pension system can be divided into three tiers.

- The Basic State Pension (BSP) and additional state pensions, which make up the first two tiers, are managed and delivered by the state and are funded through National Insurance contributions and general taxation.
- Pensioners with income and savings below a certain level can also qualify for a number of means-tested benefits. The main means-tested benefit for pensioners is Pension Credit.
- The third tier, private pensions, is funded by the employee and/or the employer and is supported by the Government through tax relief. In 2008 there were around 10m active members of private or occupational pension schemes in the private sector and around 5.4m active members of occupational pension schemes in the public sector.
- It is possible for members of occupational, stakeholder and personal pension schemes to contract-out of State Second Pension (S2P), though contracting out functions differently for different types of schemes.

The Government is concerned that the current system is not effectively promoting saving or addressing fairness in pension outcomes
The Government has several concerns about the current state pension system. The Government is concerned:

- About the ways in which the current system of means-tested benefits could act as a disincentive to saving, and that therefore the state pension system may not support auto-enrolment.
- That the complexity of the system creates too much uncertainty for people to understand what they will be entitled to when they retire and how to plan appropriately for their retirement.
- About the inequalities in the pension system; certain groups (for example, women and lower earners) receive lower than average incomes from the state pension.

The Government has proposed two potential state pension reforms
In an attempt to address their concerns about the current state pension system, the Government has issued a Green Paper consultation[2] which contains two proposals for reform of the state pension system. The consultation asks for comments on which, if either, of these proposals to

[2] DWP (2011) www.dwp.gov.uk/consultations/2011/state-pension-21st-century.shtml

take forward, and how best to structure the policy details of the chosen proposal. The two options for reform suggested by the Government are:

1. An acceleration of the existing reforms to S2P so that the state pension evolves into a two-tier flat-rate pension by 2020 instead of by around 2030.
2. The creation of a single-tier flat-rate pension set above the current level of the Guarantee Credit element of Pension Credit (for example £140 per week in 2010 earnings terms) introduced for pensioners reaching State Pension Age (SPA) long-term after the implementation date.

The Government would like the options to be considered alongside four guiding principles of reform

- **Encouraging personal responsibility** – the Government would like to ensure that the reforms encourage and enable people to save for their retirement.
- **Reducing complexity and uncertainty in the system** – The Government is hoping that the reforms may go some way towards addressing the uncertainty in the state pension system which makes it difficult for individuals to predict how much state pension they are likely to be entitled to.
- **Fairness** - the Government would like the reforms to help redress some of the inequalities in the pension system.
- **Affordability and Sustainability –** The Government feels that long-term sustainability must be an important factor in the reforms. Specifically they have stipulated that they want any reforms enacted to be cost neutral in every year.

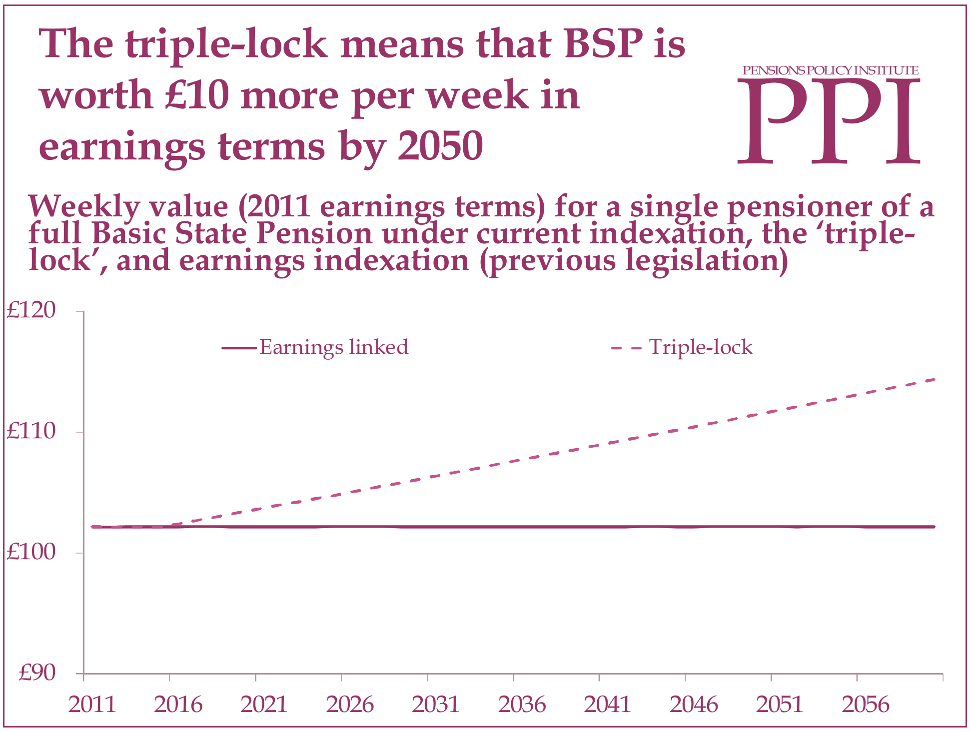
The rest of this chapter explores the implications of maintaining the current system

In order to contextualise the analysis of the potential impacts of the two reform options on individual incomes, Government expenditure and the wider industry impact later in the report, this chapter explores what the effect would be of maintaining the current system.

If there were no changes to the state pension system then BSP would continue to be triple-locked and S2P accrual would become flat-rate sometime around 2030

The current state pension system is already legislated to change in future. The Basic State Pension (BSP) has been indexed to the greater of the rise of earnings, the CPI or 2.5% (the 'triple-lock') and S2P accrual is scheduled to become flat-rate sometime around 2030, making it a fully flat-rate benefit in future. The introduction of the triple-lock means that pensioners will receive more income from the BSP in future than they would have if it was linked to earnings or prices (Chart 1). Prior to 2010 the BSP was indexed to a minimum of the rise in the Retail Price Index (RPI) though it was occasionally increased by more. In 2010, the Labour Government committed to linking BSP to earnings from 2012, however, the Coalition Government brought in the triple-lock from 2011.

Chart 1[3]



In the future, all S2P accrual will be flat-rate

Following legislation in the Pensions Act 2007, S2P is scheduled to become a flat-rate benefit by around 2030, which means that it will deliver a flat-rate of benefit to people based on the number of qualifying years they accrue and not based on their earnings. The flat-rating is set to be achieved through a gradual reduction in the real value of the upper S2P accrual limit, the Upper Accrual Point (UAP), of £40,040. The UAP has been frozen in cash terms since 2009 and the Lower Earnings Threshold (LET) of £14,400 is increasing in line with earnings. Current estimates are that the UAP could meet the LET sometime around 2034 (Chart 2). In Chart 2 the UAP starts at point A but gradually erodes in real terms until by 2034 it is eventually equivalent to the LET at point B of £14,400 in 2011 earnings terms. After this point, any qualifying year of NICs would automatically accrue entitlement to the equivalent in 2011 earnings terms of £1.70 per week[4] (Chart 3).

[3] PPI calculations

[4] DWP (2011) set out the fixed level of S2P accrual at £1.60 per week in 2010 terms to the nearest 10p. This is broadly £1.70 in 2011 earnings terms.

Chart 2[5]

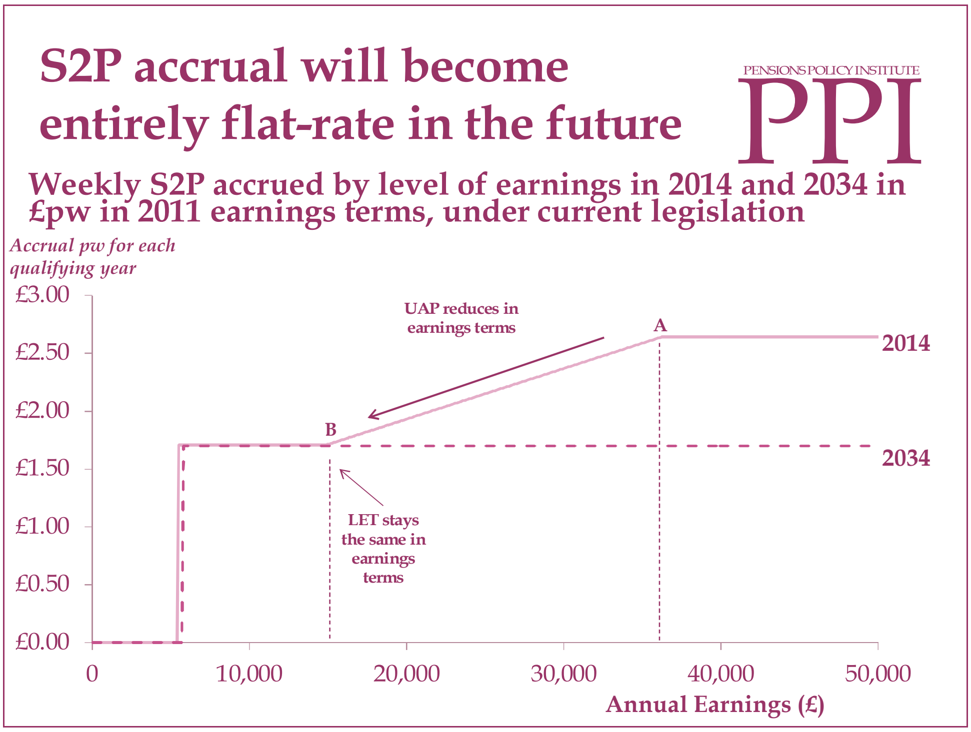


Chart 3[6]

[5] Assuming a 44 year working life, accrual rate varies based on an individual's age and SPA
[6] PPI calculations, assuming a 44 year working life

Under the current system, higher earners are likely to receive higher incomes from state pensions than lower earners
The following scenarios illustrate the incomes that people with different earning levels could receive in future from the current state pension system.

Uses and limitations of hypothetical case study analysis
Hypothetical case studies are useful for looking at how certain individuals may fare under certain assumptions, however these case studies should not be considered predictions of how any particular income group will fare in the future. Each hypothetical individual has a specific history of working and saving behaviour and the behaviour and experiences of any individual in future may be very different from those of the case study individuals.

The assumptions in these case studies are based on expectations regarding the implementation of state and private pension reforms, and on the detail of how reform proposals in the Government's Green Paper may be implemented. If the reform proposals are enacted, they may be structured differently from the way in which this paper assumes. The state and private pension's landscape may experience changes in future that are not accounted for in the assumptions in this paper.

How could the current state pension system impact on individual's income in future?
The following analysis considers the impact of the current state pension system on different hypothetical individuals.

Box 1: a low-earning woman

- At the early ages of her life, she is out of the labour market due to caring responsibilities. She receives credits to Basic State Pension and additional state pension until her child reaches age 12, when she is aged 35. She remains out of the labour market between age 35 and age 50 but does not receive credits for state pensions during this time.
- At age 50, she begins working 3 days a week for ten years. She qualifies for auto-enrolment into work-based pension saving and does not opt out. Both she and her employer make the minimum level of contributions, a total of 8 per cent of band earnings.
- At age 60 she stops working to care for her parents and her grandchildren. She has caring responsibilities for 20 hours a week which earns her credit for the Basic State Pension but not for S2P.
- When she is in employment, she earns at the 30th percentile age-specific earnings level for women, pro-rated by part-time hours where appropriate.
- She stops work at her State Pension Age.

Box 2: a low-earning man

- He starts working full-time from age 21. He earns at low age-specific earnings for a man (30th percentile).
- He works in a job in which he is intermittently unemployed. He spends approximately one-third of his working life actively seeking work.
- During his unemployment he receives credit for the Basic State Pension but not for State Second Pension.
- When he is in employment, he and his employer contribute to a Defined Contribution pension scheme at 8% of band salary.

Box 3: a median-earning man

- He starts working full-time from age 21. He earns at median age-specific earnings for a man throughout his working life.
- Between the ages of 25 and SPA, he and his employer contribute to a DC pension scheme at 8% of his band salary.[7]

Box 4: a high-earning man

- He starts working full-time from age 21. He earns at high age-specific earnings for a man (90th percentile).
- Between the ages of 25 and SPA, he and his employer contribute to a DC pension scheme at average levels of around 9% of total salary.[8]

Box 5: a man who spends time in self-employment

- He starts working full-time from age 21. He earns at median age-specific earnings for a man (50th percentile).
- Between the ages of 25 and 35 and between the ages of 55 and SPA, he and his employer contribute to a DC pension scheme at 8% of band salary.[9]
- Between the ages of 35 and 55 he is self-employed. During this period he does not contribute to a private pension.

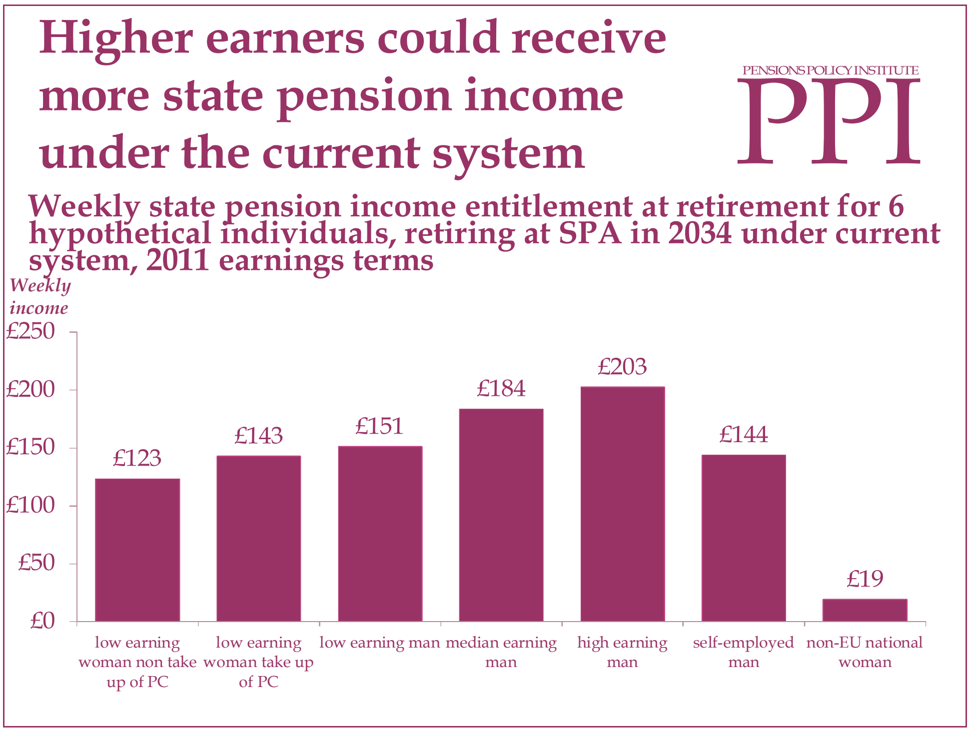
Box 6: a non-EU national woman

- She works in the UK, earning at median age-specific earnings for women, from age 22 to age 27, and makes 5 years of NICs.
- After this time she permanently leaves the UK.

The following analysis assumes that at SPA the individuals take their state pension and purchase a level annuity with their private pension (Chart 4).

[7] Minimum required contributions under auto-enrolment, if his earnings are below the auto-enrolment threshold he is assumed not to make contributions.
[8] Average contributions to a DC occupational pension in 2009, employee 3%, employer 6.4%, ONS (2010)
[9] Minimum required contributions under auto-enrolment, if his earnings are below the auto-enrolment threshold he is assumed not to make contributions.

Chart 4[10]



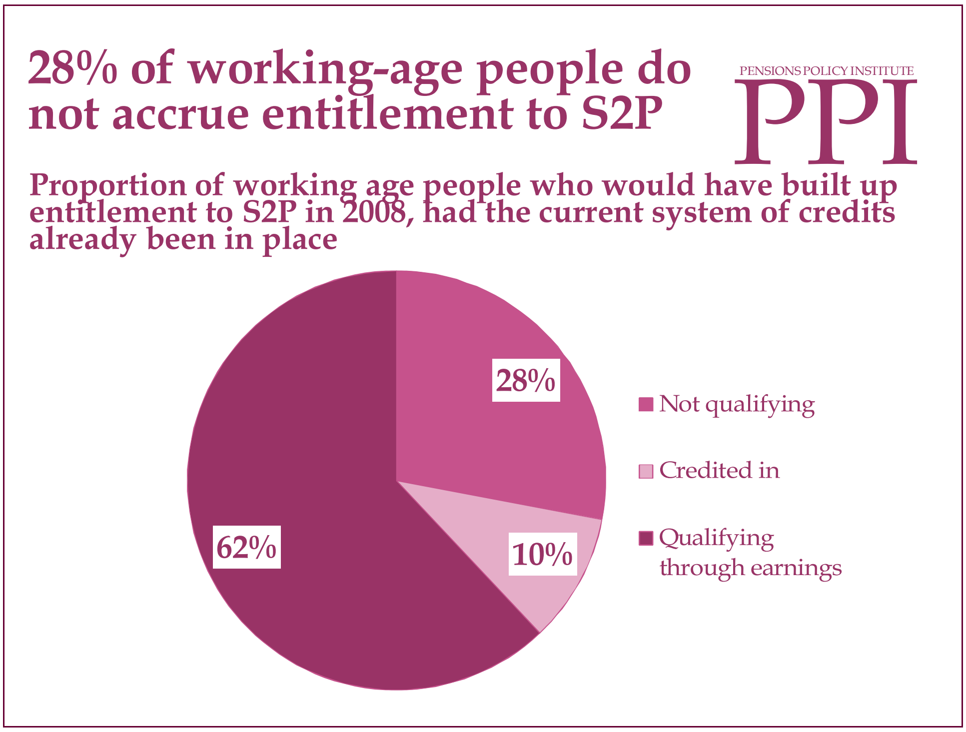
Under the current state pension system, median to higher earners and those who had few gaps in their work history receive higher state pension incomes

- Under the current state pension system, people who are employed and earning median to high earnings are more likely to accrue earnings-related S2P entitlement and receive a higher state pension income in retirement (Chart 4).
- People on lower earnings, or who take time out of the labour market to provide care may accrue some flat-rate S2P entitlement, but only if qualifying conditions are met. For example, those with two jobs earning below the Lower Earnings Limit (LEL) in each job, or caring for less than 20 hours a week, will not qualify for S2P or BSP.
- Around one quarter of all working-age people did not qualify for S2P (or contracted-out equivalent) in 2008/9, on the basis of the system of credits now in place (Chart 5).
- The unemployed and the self-employed will only accrue entitlement to the BSP.
- However, lower earners and those who spend time caring will receive higher incomes under the current system than they would have under the previous system (when BSP rises were indexed to RPI and crediting arrangements were less generous) as their BSP income is triple-locked and it is easier than it used to be to accrue entitlement to flat-rate S2P.

[10] PPI Individual Model

- The low earning female is eligible for Pension Credit (PC) (including some Savings Credit). If she did not claim PC her income would be £20 a week lower.

Chart 5[11]



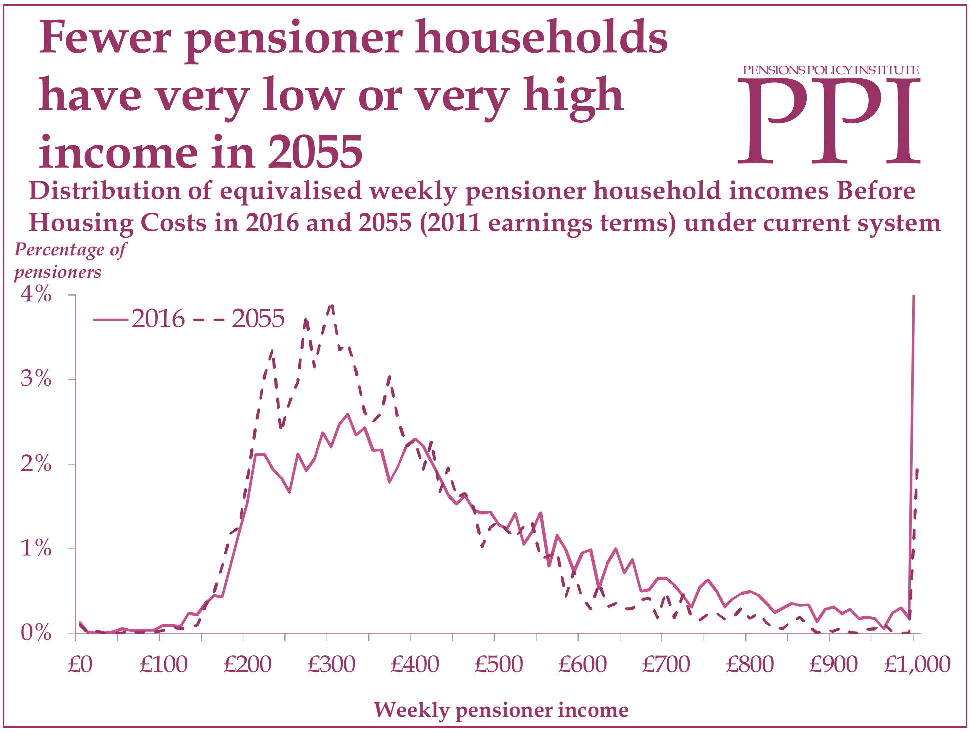
Pensioner income distribution
One way of illustrating the potential impact of the current system on individual pensioners and pensioner couples is to look at the likely make up of the pensioner income distribution today and in the future (Chart 6).

Chart 6 shows the distribution of household incomes of pensioners in 2016 and 2055 under the current system. In this Chart income is calculated at a household level, includes all income in the household (including that of non-pensioners) and is shown on a Before Housing Costs (BHC) basis – that is, before any expenditure on rent or other housing costs has been deducted.

The income used in Chart 6 is also equivalised – meaning that it is adjusted so that the income of single pensioners can be compared with pension couples. This is because smaller households need less income to achieve a particular standard of living. This adjustment is done by using a method called equivalisation, which implies multiplying each household net income by a factor that is related to the size of the household.

[11] FRS data 2008/09

Chart 6[12]



The distribution of income of pensioner households is likely to become less polarised in future

The evolution of the current state pension system will mean that more individuals reaching pension age in future will qualify for more state pension benefits (as a result of increasing coverage of both BSP and S2P). The use of the triple-lock to increase BSP will also mean that older pensioners are likely to have higher state pensions in future than older pensioners today. This means that there are likely to be fewer pensioners living in low income households in the future (Chart 6).

However, the decline in Defined Benefit (DB) provision may mean that there are also fewer future pensioners living in households with very high incomes. Members of DB pension schemes may also be affected in future by planned changes to S2P.

One of the Government's main concerns is the long-term sustainability of the state pension

Government expenditure on state pensions is facing growing pressure as a result of increases in longevity and a decrease in the ratio of working-age people to pensioners. These factors result in a reduction in tax coming in to help fund the state pension but an increase in the number of people claiming the state pension. The Government is already attempting to tackle threats to the sustainability of the state pension through legislative changes such as increases in the SPA. The long-term sustainability of the state pension is a priority for the Government in

[12] PPI Distributional Model: See appendix on modelling methodology for further information.

assessing the relative merits of the options for reform and they are keen that any reform made will be cost neutral in every year.

The effect of reform on Government spending on both state pensions and means-tested benefits will impact on whether a reform proposal is cost neutral or not.

The following analysis explores what Government spending might be under the current state pension system if there were no further changes and what Government spending may have been under previous policy of indexing BSP to earnings. The analysis uses the following assumptions:

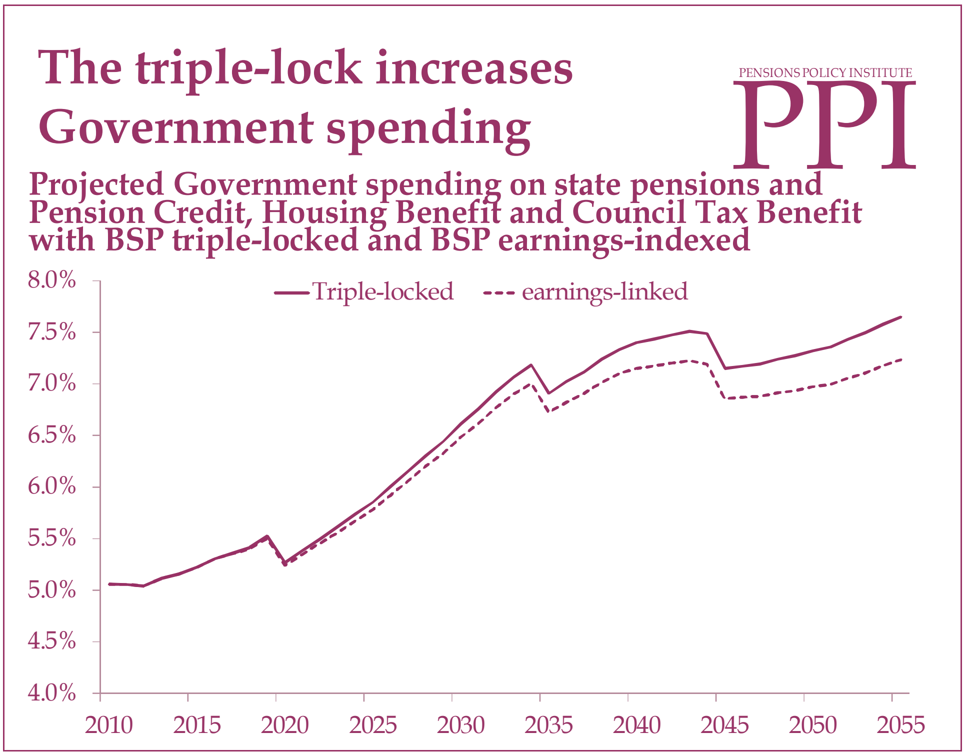
- The BSP is increased each year in line with the 'triple-lock' assumption which is assumed to be an average of 4.76%[13] (0.26% above earnings growth assumption). Under the previous Government's policy, BSP was linked to earnings, assumed to be 4.5%.
- S2P Credits and qualifying income between the Lower Earnings Threshold (LET) and the Lower Earnings Limit (LEL) accrue S2P entitlement of £1.60pw (in 2010 prices terms) from 2012.
- SPA is increased in line with current legislation and current Government plans: Men and women's SPA is equalised at 65 in 2018, then increased to 66 by 2020. SPA increases to 67 between 2034 and 2036, and to 68 between 2044 and 2046.

In 2010 the total cost of state pensions, Pension Credit, Housing Benefit and Council Tax Benefit was £76bn (in 2011 earnings terms), 5.1% of GDP

If it is assumed that the state pension system continues in its present form and under current legislative plans including uprating the BSP by the higher of earnings, prices or 2.5%, the triple-lock, then spending on state pensions, and means-tested benefits could be around 5.3% of GDP by 2020, and 7.7% of GDP by 2055 (Chart 7).

[13] PPI assumption of average increase of 'triple-lock' – higher of the rise in earnings, the Consumer Price Index or 2.5%

Chart 7[14]



If BSP was indexed to earnings from 2012 (as in previous legislation) rather than triple-locked, spending on state pensions would be 0.4% of GDP lower in 2055

If the BSP was indexed to earnings from 2012 then spending on state pensions, and means-tested benefits could be around 5.2% of GDP by 2020, and 7.2% of GDP by 2055 compared to 5.3% of GDP by 2020, and 7.7% of GDP by 2055 under triple-locked indexation for the BSP. However, under a system where BSP is indexed to earnings, there is likely to be higher eligibility amongst the pensioner population for means-tested benefits (Table 1).

Table 1:[15] **Government expenditure on state pensions and means-tested benefits for pensioners, under the current system and with BSP indexed to earnings, % GDP and £ billion (2011 earnings terms)**

	2016	2020	2030	2040	2055
BSP linked to earnings	5.3% £84bn	5.2% £84bn	6.5% £104bn	7.1% £115bn	7.2% £118bn
Current system	5.3% £84bn	5.3% £84bn	6.6% £106bn	7.4% £119bn	7.7% £125bn
Difference	-	+ less than 0.1% + less than £1bn	+ 0.1% + £2bn	+ 0.3% + £4bn	+ 0.4% + £7bn

[14] PPI Aggregate Model
[15] PPI Aggregate Model

Eligibility for means-tested benefits is projected to fall in future
Eligibility for means-tested benefits is projected to fall in future as a result of reforms to the state pension contained in the Pensions Act 2007, and further reforms since then. The reforms which are most likely to impact upon future levels of eligibility for means-tested benefits are the indexation of BSP to the triple-lock and those reforms which will make it easier for people to accrue entitlement to BSP. Of particular relevance, the Pensions Act 2007 legislated for the following changes:

- From 6 April 2010 the number of qualifying years needed to receive a full BSP was reduced to 30 years for both men and women.
- Carers are now able to accrue weekly credits towards BSP entitlement if they meet certain criteria, for example, providing care for more than 20 hours per week.
- The requirement that people must have a minimum number of qualifying years to receive any state pension was abolished for people reaching SPA after 6 April 2010.
- Annual increases in the BSP were legislated to be linked to earnings rather than prices (however the Coalition Government has since revised this and BSP has been linked to the greater of the rise in earnings, CPI, or 2.5% from April 2011, the triple-lock).

Under the current system, pensioner households entitlement to Pension Credit could decrease by 10% by 2050
In 2010, 45% of pensioner households were eligible for Pension Credit. If it is assumed that the state pension system and means-testing system continue in their present forms and under current legislative plans, then around 40% of pensioner households could be eligible for Pension Credit by 2020, and around 35% of pensioner households could be eligible for Pension Credit by 2050 (Table 2).

Table 2:[16] Proportion of pensioner households and number of pensioners eligible for Pension Credit under current system

Year	Proportion of pensioner households eligible for Pension Credit	Number of pensioners eligible for Pension Credit (millions)
2010	45%	4.5
2020	40%	4.1
2030	40%	4.9
2040	40%	5.1
2050	35%	4.4

There are other means-tested benefits; Housing Benefit and Council Tax Benefit. These benefits are for a specific purpose, helping with housing costs, rather than for providing a basic income (like Pension Credit). In 2010, 60% of pensioner households were eligible for one or more of the means-tested benefits: Pension Credit, Housing Benefit or Council Tax

[16] PPI Distributional Model

Benefit.[17] If it is assumed that the state pension system and means-testing system continue in their present forms and under current legislative plans, then the proportion of pensioner households eligible for any means-tested benefits could reduce from 60% in 2010 to around 45% of pensioner households by 2050 (Table 3).

Table 3:[18] Proportion of pensioner households eligible for Housing Benefit, Council Tax Benefit or any of the means-tested benefits (including Pension Credit), under the current system

Year	Housing Benefit	Council Tax Benefit	Any means-tested benefit
2010	20%	50%	60%
2020	20%	45%	50%
2030	20%	45%	50%
2040	15%	40%	50%
2050	15%	35%	45%

Current plans to make S2P a flat-rate benefit mean that employers with occupational pension schemes will pay higher NICs in the future

Employers with contracted-out DB schemes pay lower National Insurance rates than employers of schemes that are contracted in. In return employers of contracted-out DB schemes make a commitment to pay pensioners an amount of pension in retirement that is equivalent to the value of the state pension benefit forgone.

Under the current system, the contracted-out rebate will be reduced as S2P accrual moves toward becoming flat-rate by around 2030. When S2P accrual becomes flat-rate, people will only be able to accrue an S2P benefit of £1.60pw (in 2010 earnings terms) for every year of accrual. This means that the amount of NIC rebate will be capped at the actuarial equivalent of the accrued flat-rate benefit, rather than reflecting the level of member earnings as in today's system. This means that DB schemes will still be responsible for paying out actuarially equivalent amounts of benefits to existing pensioners with earnings-related S2P entitlement while only receiving contracted-out NICs based on a flat-rate of accrual.

The contracted-out rebate is also already set to be reduced from its current level of 5.3% to 4.8% (of earnings between the Lower Earnings Limit (LEL) and the Upper Accrual Point (UAP)) from 2012, which means that from 2012, employees in contracted-out schemes will need to pay higher NICs and may accrue lower private pension entitlement.[19]

In the future employers in contracted-out DB schemes are likely to have to pay higher NICs. This could impact on decisions made by employers

[17] PPI Distributional Model
[18] PPI Distributional Model, all figures rounded to nearest 5%
[19] HMT (2011)

with private sector DB schemes, where many schemes are facing funding difficulties.

This might also impact on the level of funding that the state needs to provide public sector pension schemes as the liabilities to existing pensioners with earnings-related contracted-out S2P accrual will not be matched by the rebates paid in from current members' flat-rate S2P accrual.

Conclusions
Under the current state pension system, people who have been employed with high earnings are more likely to accrue earnings-related State Second Pension (S2P) entitlement and receive a higher state pension income in retirement.

People on lower earnings and who take time out of the labour market to provide care may accrue some flat-rate S2P entitlement, and the self-employed will only accrue entitlement to the Basic State Pension (BSP).

However, lower earners and those who spend time caring will receive higher incomes under the current system than they would have under the previous system (when BSP rises were indexed to RPI and crediting arrangements were different), as their BSP income is triple-locked and it is easier than it used to be to accrue entitlement to flat-rate S2P.

The income distribution of pensioner households is likely to be less polarised in future. State pension reforms could reduce the number of pensioners living in low income households, while the decline in Defined Benefit schemes could reduce the number of pensioners living in high income households.

Government spending would be lower if BSP was indexed to earnings: If the BSP was indexed to earnings from 2012 then spending on state pensions, and means-tested benefits could be around 5.2% of GDP by 2020, and 7.2% of GDP by 2055 compared to 5.3% of GDP by 2020, and 7.7% of GDP by 2055 under triple-lock indexation for the BSP. However, under a system where BSP is indexed to earnings, there is likely to be higher eligibility amongst the pensioner population for means-tested benefits.

Eligibility for Pension Credit is projected to fall in future: In 2010, 45% of pensioner households were eligible for Pension Credit. If it is assumed that the state pension system and means-testing system continue in their present forms and under current legislative plans, then this could fall to around 35% of pensioner households being eligible for Pension Credit by 2050.

Employers with contracted-out DB schemes and their scheme members will have to pay higher NICs in the future due to the flat-rating of S2P and a reduction in the level of rebate. In the future DB schemes are likely to have to pay higher NICs. This could impact on decisions made by employers with private sector DB schemes, where many schemes are facing funding difficulties.

The reduction in the rebate may also impact on the level of funding that the state needs to provide public sector pension schemes. This is because the Government will still have liabilities to existing public sector pensioners with earnings-related contracted-out S2P accrual however, current members will only be paying in rebates on flat-rate S2P accrual.

Chapter two: a comparison of the two reform options against current policy and each other

This chapter summarises the analysis presented in the report and explores how the Government's two alternative reform options compare to current policy and to each other. This chapter considers:

- The impact of each reform option for individuals i.e. the likely characteristics of the gainers and losers under each reform option;
- What each option would mean for the total impact on Government expenditure on state pensions and other means-tested benefits paid to pensioners and for potential future levels of eligibility for means-tested benefits;
- What the wider impact of each reform option might be on private pensions in both the public and private sector.

The Government has issued a Green Paper: *A State Pension for the 21st century* which contains two proposals for reform of the state pension system:

1. An acceleration of the flat-rating of State Second pension so that the state pension evolves into a two-tier flat-rate pension by 2020, instead of by the mid 2030s.
2. The creation of a single-tier flat-rate pension set above the current level of the Guarantee Credit element of Pension Credit (for example £140 per week in 2010 earnings terms), introduced for pensioners retiring after the implementation date.

Who are the gainers and losers from the reform options?

Chart 8 shows the characteristics of those that could gain and lose out under each of the reform options compared to the current state pension system.

This report estimates the number of pensioners who 'gain' or 'lose' in terms of household income as a result of the reforms. The Government has made a commitment that no individual will lose state pension rights that they have already built up. The gains and losses shown in this report reflect the different amounts that pensioners might build up in future under the alternative reforms compared to how much they would build up if the current system continues.

Chart 8[20]

The gainers and losers from the different reform options - compared to the current system

	Gainers	Losers
Option 1: accelerate reforms set out in the Pensions Act 2007	• **No-one gains** any additional income from the state pension under this option • **Members of DB schemes** may benefit if employers keep these schemes open due to the retention of contracting-out	• **Around 5 million pensioners** could receive a lower pension income in 2034. • **Workers with earnings between £14,400 and £40,040** could accrue less S2P from 2013 to 2020, and all those with earnings between £14,400 and £40,040 would accrue less S2P from 2020 to around 2034.
Option 2: introduction of a Single-Tier Pension of £140 a week	• **Around 7 million pensioners** could receive higher pension income in 2034. • People with few or no NI credits for S2P - often **women or carers and very low earners** who have taken time out of the labour market could receive a higher pension. • The **unemployed** and the **self-employed** may get higher pensions but the self-employed may need to pay higher NIC's. • People who are entitled to but **fail to claim Pension Credit** would get a higher pension. • Future **older pensioners** gain due to the more generous indexation.	• **Around 5 million pensioners** could receive a lower pension income in 2034. • People who **would have accrued high S2P** in the current system could get a lower pension. • Some people who would have been entitled to **Savings Credit** could lose income. • People with **less than 7 years of NIC's** could be worse-off.

In 2034 no pensioners would gain higher state pension income and around 5.3 million pensioners would receive lower pension income under faster flat-rating than they would have received under the current system

Under an acceleration of the Government's plans to make S2P flat-rate by 2020 instead of by around 2030 as currently planned, no-one would accrue entitlement to more state pension income than they would have received under the current system in 2034 and around 5.3 million pensioners would receive lower state pension income, with an average weekly loss of income of around £0.50p a week (Table 4).

Employees earning between £14,400 and £40,040 between 2013 and 2020 could lose out due to a less generous build-up of their S2P rights. Employees earning between £14,400 and £40,040 between 2020 and around 2033 would all lose some S2P accrual.

This report estimates the number of pensioners who 'gain' or 'lose' in terms of household income as a result of the reforms. The Government has made a commitment that no individual will lose state pension rights that they have already built up. The gains and losses shown in this report reflect the different amounts that pensioners might build up in future under the alternative reforms compared to how much they would build up if the current system continues.

[20] Income changes for the single-tier pension include the change in private pension income arising from the ending of contracting-out. It has been assumed that all DB schemes (including public sector pension schemes) reduce the level of contributions and benefits to offset the higher required NI contributions.

Table 4:[21] Number of gainers and losers under faster flat-rating compared to the current system in 2034 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2034	Couples	Singles	Total pensioners
number of pensioners who gain	none	none	none
number of pensioners who lose **average loss**	1.3 million pensioner couples - £0.50 a week (2011 earnings terms)	2.8 million single pensioners - £0.50 a week (2011 earnings terms)	5.3 million pensioners - £0.50 a week (2011 earnings terms)

In 2055 no pensioners would gain higher state pension income and 6.7 million pensioners would receive lower pension income under faster flat-rating

Under faster flat-rating, no-one would accrue entitlement to more state pension income than they would have accrued under the current system in 2055. In 2055 around 6.7 million pensioners would receive lower state pension income, with an average weekly loss of income of around £1.50 per week (Table 5).

Table 5:[22] Number of gainers and losers under faster flat-rating compared to the current system in 2055 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2055	Couples	Singles	Total pensioners
number of pensioners who gain	none	none	none
number of pensioners who lose **average loss**	1.4 million pensioner couples - £2 a week (2011 earnings terms)	4 million single pensioners - £1 a week (2011 earnings terms)	6.7 million pensioners - £1.50 a week (2011 earnings terms)

[21] PPI Distributional Model
[22] PPI Distributional Model

Option 2: the introduction of a single-tier pension of £140 per week in 2010 earnings terms

There are a number of different groups who may be particularly likely to gain from a single-tier pension:

- **People with low entitlement to S2P/SERPS** – often **women and carers** who have taken time out of the labour market, particularly if they took time out before 2002. And **lifelong low earners** – for example, people who earn below the Lower Earnings Limit (£5,304 in 2011) in one or more multiple jobs and don't qualify for S2P or BSP.
- **Self-employed -** who have not been entitled to accrue SERPs/ S2P entitlements – but who currently pay lower National Insurance contributions as a result.
- **Unemployed –** currently those who claim Job Seekers Allowance earn credits for the Basic State Pension but not for SERPs/ S2P.
- **Pensioners who would have been entitled to but would have failed to claim Pension Credit –** between 27% and 38% of pensioners who were entitled to Pension Credit did not claim it in 2008/09.[23]
- **Future Generations of Older Pensioners retiring after 2016 –** because the single-tier pension will be indexed to the higher of earnings, prices or 2.5% (the triple-lock) it will maintain its value in real terms better than current entitlements to SERPs/S2P which are indexed to CPI. This means that older pensioners are likely to receive a higher state pension income under the single-tier proposal than under the current system.

Around 6.8 million pensioners could receive higher state and private pension income and around 5.2 million pensioners could receive lower state and private pension income under a single-tier pension in 2034

Under a single-tier pension, around 2 million single pensioners and 2.4 million pensioner couples could receive higher state and private pension income in 2034 under a single-tier pension, at an average gain of £11pw more (singles) and £28pw more (couples) (Table 6). Under a single-tier pension, around 3 million single pensioners and 1.1 million pensioner couples would receive lower state and private pension income in 2034, at an average loss of £15pw less (singles) and £24pw less (couples) (Table 6).

[23] DWP (2010a) Table 1.5.1

This report estimates the number of pensioners who 'gain' or 'lose' in terms of household income as a result of the reforms. The Government has made a commitment that no individual will lose state pension rights that they have already built up. The gains and losses shown in this report reflect the different amounts that pensioners might build up in future under the alternative reforms compared to how much they would build up if the current system continues.

Table 6:[24] Number of gainers and losers under a single-tier pension compared to the current system in 2034 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2034	Couples	Singles	Total pensioners
number of pensioners who gain **average gain**	2.4 million pensioner couples £28 a week (2011 earnings terms)	2 million single pensioners £11 a week (2011 earnings terms)	6.8 million pensioners £23 a week (2011 earnings terms)
number of pensioners who lose **average loss**	1.1 million pensioner couples - £24 a week (2011 earnings terms)	3 million single pensioners - £15 a week (2011 earnings terms)	5.2 million pensioners - £18 a week (2011 earnings terms)

In 2055, 11 million pensioners could receive higher state and private pension income and around 5 million pensioners could receive lower state and private pension income under a single-tier pension

In 2055, around 3.5 million single pensioners and 3.8 million pensioner couples would receive higher state and private pension income under a single-tier pension, at an average gain of £10pw more (singles) and £30pw more (couples) (Table 7). In 2055, around 3.4 million single pensioners and 0.8 million pensioner couples would receive lower state and private pension income under a single-tier pension, at an average loss of £15pw less (singles) and £24pw less (couples) (Table 7).

[24] PPI Distributional Model, income changes include the change in private pension income arising from the ending of contracting-out. It has been assumed that all DB schemes (including public sector pension schemes) reduce the level of contributions and benefits to offset the higher required NI contributions.

Table 7:[25] Number of gainers and losers under a single-tier pension compared to the current system in 2055 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2055	Couples	Singles	Total pensioners
number of pensioners who gain **average gain**	3.8 million pensioner couples £30 a week (2011 earnings terms)	3.5 million single pensioners £10 a week (2011 earnings terms)	11 million pensioners £24 a week (2011 earnings terms)
number of pensioners who lose **average loss**	0.8 million pensioner couples - £24 a week (2011 earnings terms)	3.4 million single pensioners - £15 a week (2011 earnings terms)	5 million pensioners - £17 a week (2011 earnings terms)

The key groups of losers under a single-tier pension, compared to a continuation of current policy would include:

- **Individuals who would have accrued higher State Second Pension** entitlements under the current system; by accruing S2P from earnings or credits, will receive lower state pension income under a flat-rate single-tier pension system when they retire, though some may receive a higher state pension in later retirement as a result of the single-tier being triple-locked.
- **Some people who would have been entitled to the Savings Credit element of Pension Credit may lose out**, because Savings Credit is abolished as part of this reform.
- **Those with less than 7 years of National Insurance Contributions** – this is because the Government proposes to introduce a 7 year de minimis rule such that those individuals with less than 7 Years National Insurance entitlement do not build-up any state pension rights. The Government has suggested that many of these individuals will be foreign nationals who came to work in the UK for only a short period. Available data suggest that no more than 1.5% of men and 3% of women in Great Britain will have less than 7 qualifying years in total at State Pension Age (SPA) in 2016.[26]

When the system is fully implemented in 2072, (meaning that all existing pensioners have retired after the single-tier was implemented) individuals who would have accrued more than approximately 30 years of S2P at the flat-rate of £1.60 a week per year of entitlement (in 2010 earnings terms) would initially be worse off under the single-tier pension, in contrast individuals who would have accrued less than approximately 30 years of S2P would initially be better off under the single-tier pension.

[25] PPI Distributional Model
[26] DWP estimates

Both a single-tier pension and faster flat-rating could have little impact on Government spending on state pensions
In 2010 the total cost of Government Expenditure on state pensions, Pension Credit, Housing Benefit and Council Tax Benefit was £76bn (in 2011 earnings terms), or 5.1% of GDP.

If it is assumed that the state pension system were to continue in line with current policy, including the indexation of the Basic State Pension (BSP) in line with the triple-lock - the higher of earnings, prices or 2.5%, then spending on state pensions, and means-tested benefits could be around 5.3% of GDP by 2020, and could increase to 7.7% of GDP by 2055 (Table 8).

Table 8 shows how the costs of the reform options compare to current policy, and each other in 2020, 2030 and 2055.

Table 8:[27] **Government Expenditure on State Pensions, Pension Credit, Housing Benefit and Council Tax Benefit (2011 earnings terms)**

	2020	2030	2055
Current Policy	£84 billion 5.3% GDP	£106 billion 6.6% GDP	£125 billion 7.7% GDP
Option 1 – faster flat-rating of S2P	£84 billion 5.3% GDP	£106 billion 6.6% GDP	£125 billion 7.6% GDP (- less than 0.1% GDP)
Option 2 – flat-rate single-tier pension of £140 a week in 2010 earnings terms	£84 billion 5.3% GDP	£105 billion 6.6% GDP (- less than 0.1% GDP)	£126 billion 7.7% GDP (+0.1% GDP)

Chart 9 shows Government Expenditure on State Pensions, Pension Credit, Housing Benefit and Council Tax Benefit under current policy and under the two reform options.

Introducing a single-tier pension would lead to the ending of contracting-out for Defined Benefit (DB) pension schemes. It is necessary, in order to analyse the impact of the single-tier pension, to model how employers who run DB schemes would respond to the subsequent increase in their National Insurance (NI) Contributions.

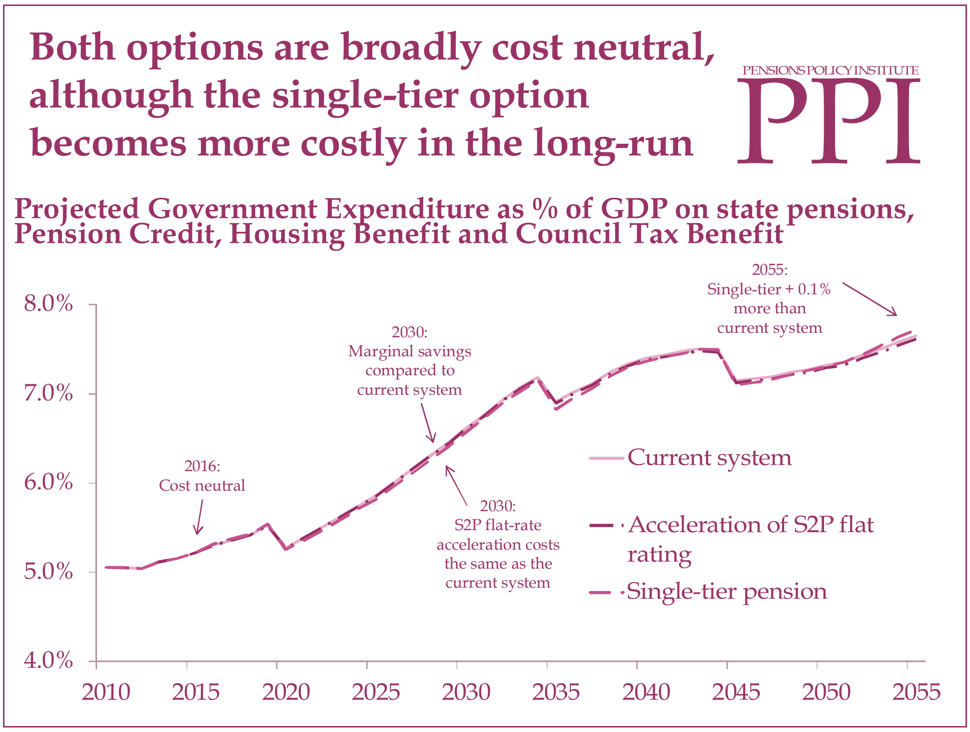
In reality, employers are likely to respond in different ways. Some might choose to absorb the extra NI costs, and leave their pension scheme unchanged. Some might change the contributions to, and benefits from, their scheme to offset the higher NI contributions. Others may take the

[27] PPI Models

opportunity to change their pension provision arrangements altogether, perhaps moving to Defined Contribution provision.

The analysis in this report assumes that the sponsors of DB schemes (including those in the public sector) adjust the contributions to, and benefits from, DB schemes to exactly offset the extra NI contributions they would have to pay. This leads to lower long-term private pension incomes for DB scheme members, offset by the changes in their state pension arrangements. This is a more pessimistic assumption than assuming that all employers keep schemes as they are, but not as pessimistic as assuming that all employers change arrangements completely.

Chart 9[28]



It can be seen from Chart 9 that both reform options cost broadly similar amounts to the current system and are broadly cost neutral, although in some years the reform options are projected to cost slightly less than the current system and in the long-run the single-tier pension may cost slightly more than the current system or faster flat-rating.

- Option 1 – the faster flat-rating of S2P, saves the Government less than 0.1% of GDP per year by 2055.
- Option 2 – the single-tier pension, would be broadly cost neutral with differences between expenditure on the current system and the single-tier differing by less than 0.1% of GDP from year to year. A single-tier pension could:
  - Be broadly cost neutral from 2016 to 2050

[28] PPI Aggregate Model

- Cost less than current system by less than 0.1% between 2019 and around 2050.
- Cost more than current system by about 0.1% by 2055

Introducing a single-tier could reduce levels of entitlement to Pension Credit in the future

There are three means-tested benefits that pensioners may currently qualify for: Pension Credit, Housing Benefit and Council Tax benefit.

Pension Credit is the main means-tested benefit for pensioners and is intended to ensure that pensioners do not have to live on incomes below a 'guaranteed' minimum level. Pension Credit has two elements, Guarantee Credit (GC) and Savings Credit (SC). From 6 April 2011, GC tops pensioners' income up to £137.35 per week for single pensioners and £209.70 for couples. SC aims to ensure that those who have made some private provision for retirement will be better-off than those who have made no provision. From 6 April 2011 the maximum SC is set at £20.52 per week for singles and £27.09 for couples until 2014. In addition pensioner households may also be eligible for Housing Benefit and Council Tax Benefit.

Tables 9 and 10 give the PPI's projections of the future eligibility of pensioner households and total numbers of pensioners for Pension Credit under current policy compared to under the two reform options.

Table 9: Projections of the proportion of pensioner households eligible for Pension Credit under current policy and under the state pension reform options

Year	Proportion of pensioner households eligible for Pension Credit under the current system (Guarantee Credit + Savings Credit)	Proportion of pensioner households eligible for Pension Credit under Option 1 - faster flat-rating of S2P (Guarantee Credit + Savings Credit)	Proportion of pensioner households eligible for Pension Credit under Option 2 - the single-tier system (Guarantee Credit + Savings Credit for those over SPA in 2016)
2010	45%	45%	45%
2020	40%	40%	35%
2030	40%	40%	20%
2040	40%	40%	10%
2050	35%	35%	5%

Table 10: Projections of the numbers of pensioners eligible for Pension Credit under current policy and under the state pension reform options

Year	Numbers of pensioners eligible for Pension Credit under the current system (millions)	Number of pensioners eligible for Pension Credit under Option 1 - faster flat-rating of S2P (millions)	Number of pensioners eligible for Pension Credit under Option 2 - the single-tier system (millions)
2010	4.5	4.5	4.5
2020	4.1	4.1	3.7
2030	4.9	4.9	2.6
2040	5.1	5.1	1.4
2050	4.4	4.4	0.8

Eligibility for means-tested benefits is projected to fall in future as a result of reforms to the state pension contained in the Pensions Act 2007, and further reforms since then. The reforms which are most likely to impact upon levels of eligibility for means-tested benefits are the indexation of BSP to the triple-lock and those reforms which will make it easier for people to accrue entitlement to BSP.

Table 9 shows that the proportion of pensioner households eligible for Pension Credit is projected to decline in the future under a continuation of current policy from 45% of pensioner households in 2010, to 35% of pensioner households by 2050.

- Faster flat-rating of S2P, makes very little difference to the proportion of pensioner households who would be eligible for means-tested benefits in the future. The PPI estimates show that there may be very small increases in the proportion of pensioner households eligible for Pension Credit in the future. However, the differences are not significant enough to affect the rounded estimates of eligibility.
- The introduction of a flat-rate single-tier pension of £140 a week in 2010 earnings terms, does lead to a substantial reduction in the proportion of pensioner households who are likely to be eligible for means-tested benefits in the future. Under the single-tier option the Government has said it would abolish the Savings Credit as part of the reforms. The single-tier pension is indexed to the higher of earnings, prices or 2.5% - the triple-lock. If the Government were to continue to index the Guarantee Credit to earnings significantly fewer pensioners are likely to be eligible for the Guarantee Credit in the future under a single-tier pension. PPI projections suggest that by 2050 only around 5% of pensioner households could be eligible for Pension Credit under a single-tier option, compared to 35% under the current system and under faster flat-rating.

This is significant because it means that many pensioners will be able to avoid the means-testing trap in which private pension saving simply disqualifies them from potentially being eligible for means-tested benefits.

Employers and members of occupational pensions are impacted by regulations on 'contracting-out' of S2P
The state pension system in the UK is an extremely complex one. The state pension currently has two elements – a Basic State Pension that is paid at the same level to all based on an individual's National Insurance (NI) contribution history, and an earnings-related part – currently called the State Second Pension (S2P) and previously called SERPs – the State Earnings-related Pension.

Employers and individuals are able to "contract-out" of the S2P if they are saving in a private pension that offers equivalent benefits to the value of the S2P foregone. In return the employer and the individual either both pay lower rates of National Insurance in occupational pension schemes, or in the case of contract-based defined contribution schemes a rebate is paid directly into the pension scheme itself.

The Government Actuary makes a recommendation on the level of the National Insurance rebates that is appropriate to compensate for the equivalent S2P benefit given up.

Current Government policy on S2P is already likely to impact employers and members of occupational pensions

The Government has already announced that it intends to phase out the earnings-related element of S2P. On current plans it is estimated that by the mid 2030s, S2P will pay a flat-rate benefit to all of £1.60 per week, per year of accrual (in 2010 earnings terms). As a result of the declining generosity of S2P it can be expected that the value of the National Insurance rebate is likely to continue to fall over time.

Public sector pension schemes currently count for the majority of the contracted-out NIC rebates

The contracted-out rebate is already set to be reduced from its current level of 5.3% to 4.8% from 2012 (of earnings between the Lower Earnings Limit and the Upper Accrual Point.) As a result employers and individuals in contracted-out schemes can expect their National Insurance contributions to rise, and scheme rebates are likely to decline. This could impact on decisions made about the future of DB schemes in the private sector, where many schemes are facing funding difficulties. This could also result in public sector employers and employees having to pay higher National Insurance contributions at a time when other changes are being made to the structure of public sector pension schemes.

The majority of the current NI rebates are made in respect of public sector schemes. The PPI projects that ending contracted-out rebates to DB pension schemes could increase the amount of NI collected by the Government in 2016 by around £6bn[29] (2011 earnings terms). Of these, £5bn are in respect of increased NICs from public sector pension schemes (including the funded LGPS), and £1bn is in respect of increased NICs from private sector schemes

Faster flat-rating would reduce the amount that schemes receive from the rebate more quickly than under the current system

Faster flat-rating would marginally reduce Government spending on state pensions, by less than 0.1% of GDP per year by 2055. However the Government would also receive an increase in revenue from increased NICs between 2013 and 2033, peaking at £3bn a year in 2020.

Faster flat-rating could therefore impact upon DB schemes, as they are partially funded by the contracted-out NIC rebate. Faster flat-rating would reduce the amount that schemes receive from the rebate more quickly than under the current system. However, contracted-out DB schemes would still qualify for some kind of a rebate under faster flat-rating because contracting-out is retained in this option, whereas it would be abolished altogether under a single-tier pension.

[29] PPI Aggregate Model

If the Government chose faster flat-rating over a single-tier pension, open DB schemes would be better off

The only potential gainers from the Government choosing faster flat-rating over a single-tier pension are members of open DB schemes. In this option the Government would retain contracting-out, which would be abolished under a single-tier pension and therefore private pensions schemes would continue to benefit from the National Insurance rebate. If the retention of the rebate means that employers keep their DB schemes open in the future, then members of those schemes could benefit from this reform option. There were 2.4 million active members of open private sector DB schemes in 2009[30] – however not all of these scheme members would necessarily be likely to be affected by the Government's decision on state pension reform. Some of these schemes may be able to absorb any increased costs, others may make compensating changes to the scheme and others may be planning to close anyway. However, it is possible that at the margins the loss of the National Insurance rebate may exacerbate the funding challenges already faced by some private sector DB schemes.

Under a single-tier pension, employers and individuals in occupational DB schemes in both the public and private sectors would have to pay higher National Insurance rates

The Government has indicated that under the flat-rate single-tier option the whole concept of contracting-out of the state pension would be abolished because essentially the two different parts of the state system would be collapsed into a single-tier state pension.

As a result schemes would no longer be able to contract-out of S2P and the National Insurance rebates would be abolished. As a result employers and individuals in occupational DB schemes in both the public and private sectors would have to pay higher National Insurance rates. In 2016 this could mean that:

- Public sector employee NI contributions would increase by 1.4%, equivalent to an estimated increase of £1.4bn.
- Public sector employer NI contributions would increase by 3.4%, equivalent to an estimated increase of £3.4bn.
- Private sector employees in DB schemes' NI contributions would increase by 1.4%, equivalent to an estimated increase of £0.3bn.
- Private sector employers who offer DB schemes would see their NI contributions increase by 3.4%, equivalent to an estimated increase of £0.8bn.

The Government could choose to compensate for the impact on public sector employees and employers by altering public sector wages and Government Departmental spending limits but the impact on private sector DB schemes would be real.

[30] ONS (2010)

Private sector DB schemes might choose to alter the generosity or contribution levels to their schemes to compensate for the increased National Insurance costs, but there may be practical issues and costs to schemes to make such changes.

Chapter three: the implications of faster flat-rating of State Second Pension (S2P)

This chapter explores the implications of faster flat-rating for individual's income in retirement, for Government expenditure and for the wider impact on private pensions.

The first proposal in the Green Paper is to bring the flat-rating of S2P forward so that S2P accrual becomes flat-rate from 2020 instead of around the mid-2030s as in current plans
The first policy option set out in the Green Paper is to bring forward the flat-rating of S2P that is already scheduled to occur by around the mid-2030s[31] so that people begin to accrue S2P on a flat-rate basis from 2020. This would be accomplished by reducing the Upper Accruals Point (UAP) in cash terms, starting in 2013, until the UAP meets the Lower Earnings Threshold (LET) in 2020.

Under the proposal:

- There would still be two tiers to the state pension.
- People would still be able to accrue S2P entitlement for any year between the age of 16 and their SPA.
- Income from additional state pensions would continue to be uprated by CPI while BSP is uprated by the greater of the rise in earnings, the CPI or 2.5%.
- Both elements of the means-tested benefit Pension Credit (Guarantee Credit and Savings Credit) would remain part of the system.
- DB schemes would still be able to contract-out of S2P, although they would receive lower NI rebates as a result of the flat-rating of S2P.

Faster flat-rating would save the Government money at a cost of lower incomes for some pensioners
Faster flat-rating would reduce the cost of the state pension when compared to the current system at a cost of lower pension incomes for some people. The Government savings from faster flat-rating would arise from the elimination of earnings–related S2P accrual by 2020, instead of by 2034, and reducing accrual more quickly from 2013 by lowering the UAP in cash terms.

Individuals who are contracted-in and earning below the LET would build-up the same S2P each year irrespective of how quickly S2P became flat-rate.

Between 2013 and 2020 some individuals contracted-in and earning above the LET would continue to build up earnings-related S2P, at the same rate

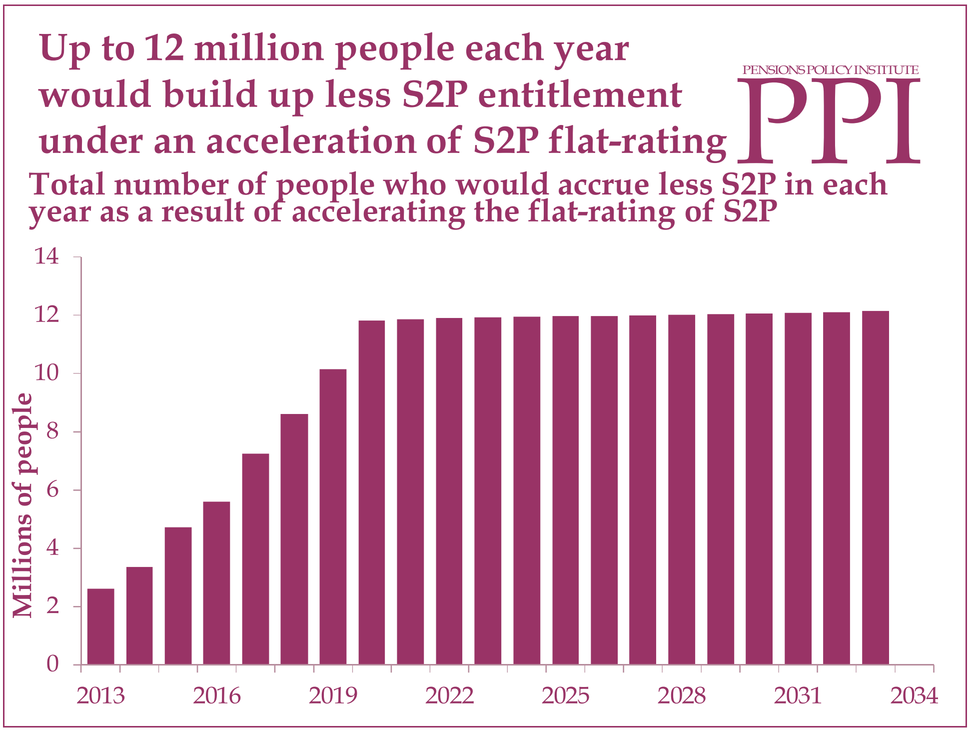
[31] Expected to be around 2034 - calculation from PPI modelling based on assumptions concerning inflation and earnings growth as set out in the Technical Appendix. The precise date that S2P would become flat rate under the evolution of the current system is uncertain and would depend on how fast earnings grow faster than prices.

as in the current system, but the number of these individuals would reduce as S2P becomes closer to being flat-rate and more people are earning above the UAP.

Any individuals contracted-in and earning above the UAP (which is assumed to be reduced towards the LET in the accelerated flat-rating) would build up less S2P as a result of the accelerated flat-rating – a smaller earnings-related component until 2020, and then only the flat-rate component.

People who are contracted-in to the State Second Pension and earning between £14,400 (the LET) and £40,040 (the UAP) between 2013 and 2033 might therefore lose some extra entitlement to S2P that they would have accrued under the current system. In 2013, the number of individuals building up less S2P each year as a result of faster flat-rating could be around 3 million, increasing up to 12 million people each year by 2020 (Chart 10). From around 2034, when S2P accrual would become flat-rate under the current system, S2P build up is the same for all individuals under both systems.

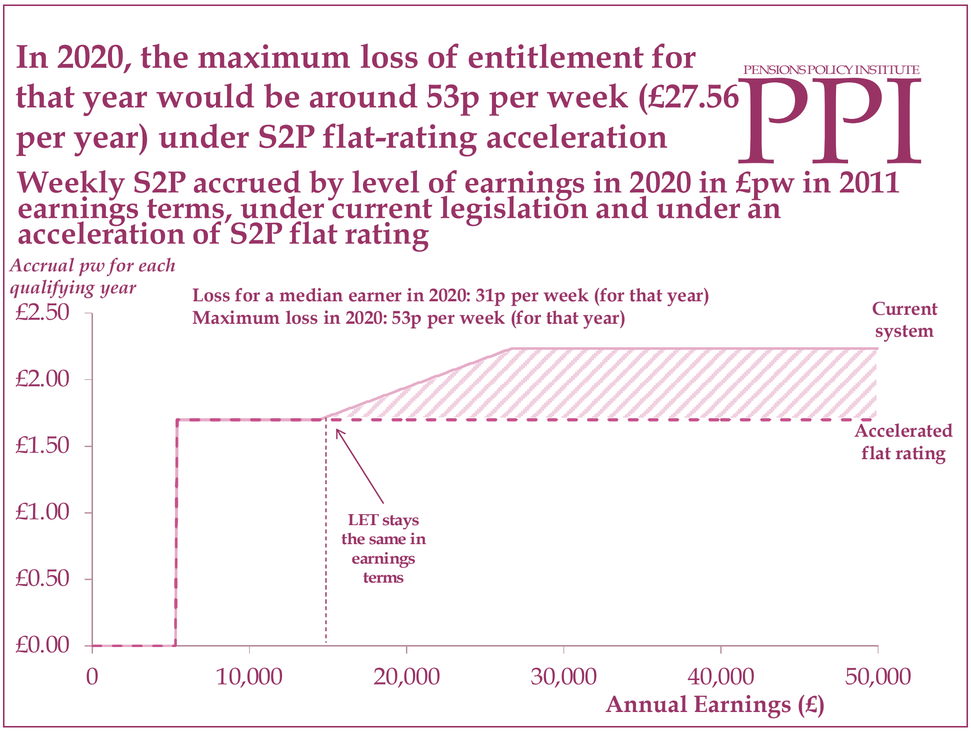
Chart 10[32]



[32] PPI Aggregate Model

Accelerating flat-rating of S2P will affect the amount of S2P entitlement people can accrue in each year. The amount of total loss will depend on how many years of S2P accrual a person makes between 2013 and (around) 2033 and on how much they earn in any given year (Chart 11).

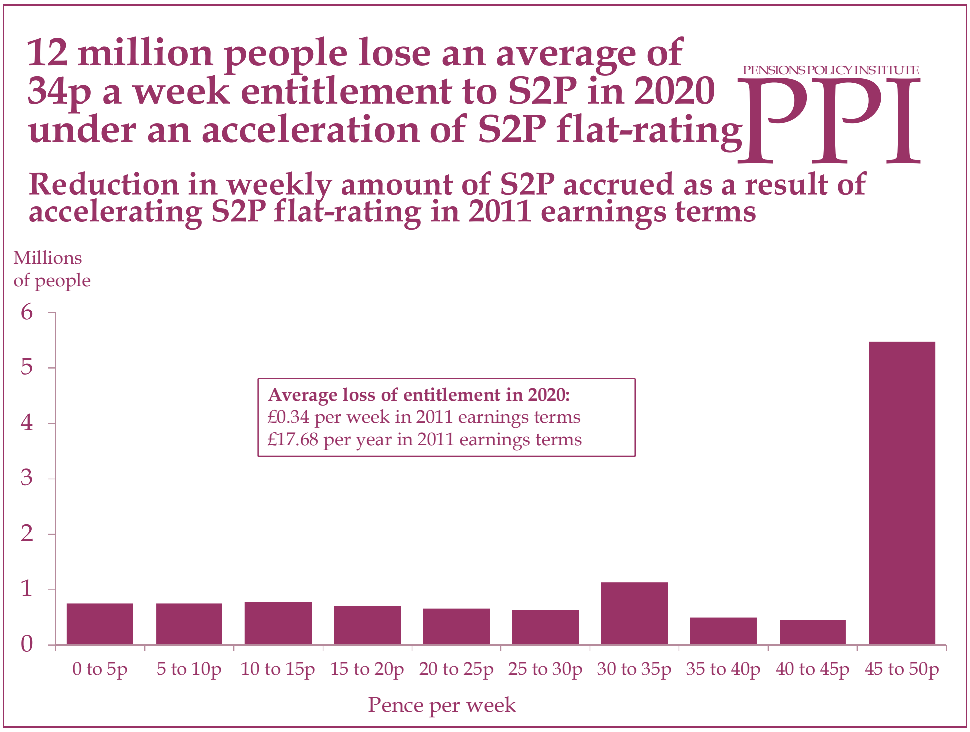
Chart 11[33]



As an example, a median earner in 2020 would receive entitlement of around 31p less per week (£16.12 per year) than under the current system (2011 earnings terms) in respect of the S2P accrued *in that year*. The maximum that an individual earning over the UAP could lose in 2020 would be entitlement of around 53p per week, for that year (£27.56 per year) (Chart 11). The effect will be cumulative for individuals: for each year of earning over the LET they could accrue lower entitlement to S2P.

[33] PPI calculations, inflation assumptions consistent with OBR short term assumptions until 2015, post 2015, long term assumptions are 4.5% for earnings, 2% for CPI

Chart 12[34]



For the 12 million individuals building up less S2P in 2020 as a result of the accelerated flat-rating of S2P, the average loss is 34p a week *for that year* (£17.68 a year 2011 earnings terms) (Chart 12).

Under faster flat-rating no-one accrues entitlement to higher state pension income than they would have under the current system
Under faster flat-rating, no-one would accrue entitlement to more state pension income than they would have under the current system (Table 11). Employees earning between £14,400 and £40,040 between 2013 and 2020 could lose out due to a less generous build-up of their S2P rights. Employees earning between £14,400 and £40,040 between 2020 and around 2034 would all lose some S2P accrual. PPI estimates that each year between 2013 and around 2033 up to 12 million people could be building up less generous S2P under this option compared to the current system (Chart 12).

In 2034 no pensioners would gain higher state pension income and around 5.3 million pensioners would receive lower state and private pension income under faster flat-rating than they would have under the current system
Under an acceleration of the Government's plans to make S2P flat-rate by 2020 instead of by around 2030 as currently planned, no-one would accrue entitlement to more state pension income than they would have under the current system in 2034 and around 5.3 million pensioners

[34] PPI Aggregate Model

would receive lower state and private pension income, with an average weekly loss of income of around £0.50 (Table 11).

Table 11:[35] Number of gainers and losers under faster flat--rating compared to the current system in 2034 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2034	Couples	Singles	Total pensioners
number of pensioners who gain	none	none	none
number of pensioners who lose **average loss**	1.3 million pensioner couples - £0.50 a week (2011 earnings terms)	2.8 million single pensioners - £0.50 a week (2011 earnings terms)	5.3 million pensioners - £0.50 a week (2011 earnings terms)

In 2055 no pensioners would gain higher state pension income and 6.7 million pensioners would receive lower state and private pension income under faster flat-rating

Under faster flat-rating, no-one would accrue entitlement to more state pension income than they would have under the current system in 2055. In 2055 around 6.7 million pensioners would receive lower state and private pension income, with an average weekly loss of income of around £1.50 per week (Table 12).

Table 12:[36] Number of gainers and losers under faster flat-rating compared to the current system in 2055 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2055	Couples	Singles	Total pensioners
number of pensioners who gain	none	none	none
number of pensioners who lose **average loss**	1.4 million pensioner couples - £2 a week (2011 earnings terms)	4 million single pensioners - £1 a week (2011 earnings terms)	6.7 million pensioners - £1.50 a week (2011 earnings terms)

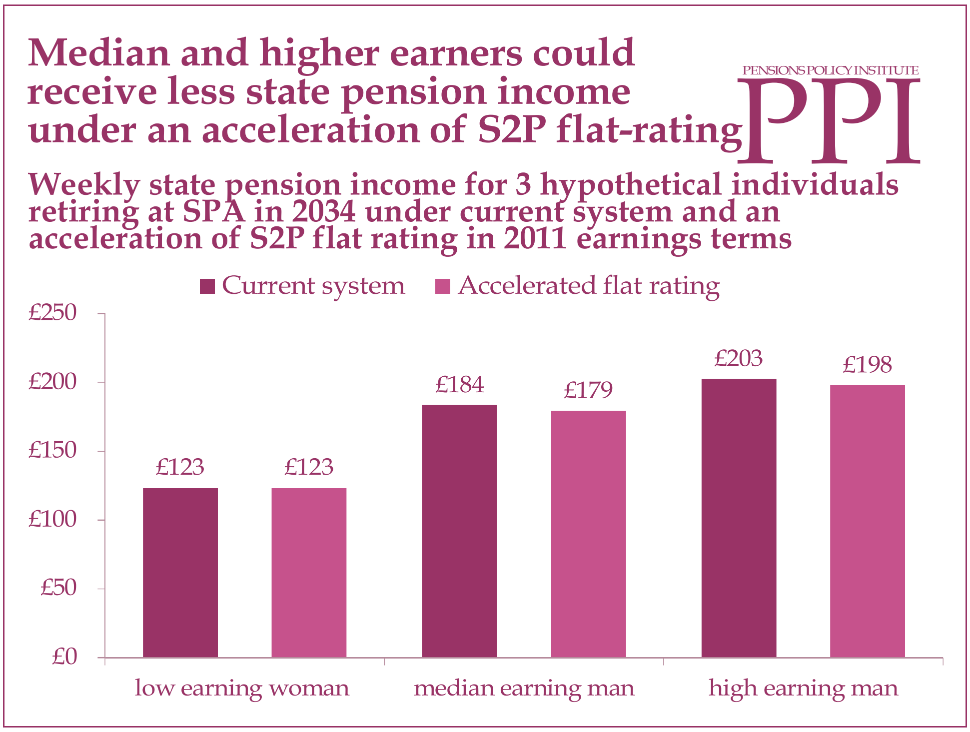
[35] PPI Distributional Model
[36] PPI Distributional Model

Under faster flat-rating, people who earned above the LET between 2013 and 2032 could lose some entitlement to state pension

The following analysis explores how the state pension income of the different hypothetical low, median and high earning individuals (from Chapter 1) would be affected by faster flat-rating (Chart 13).

Under faster flat-rating, median to higher earners are more likely to lose some entitlement to state pensions than low to very low earners who would have accrued mostly flat-rate S2P because of their income level.

Chart 13[37]



The individuals in Chart 13 accrued up to £5 per week less S2P entitlement per week (2011 earnings terms) as a result of accelerating S2P flat-rating. The high earner sees the largest reduction in S2P as he was earning above the flat-rate S2P level in every year that he was working. The low and median earning individuals lose smaller amounts as they were earning below the flat-rate level in some years between 2013 and 2030.

Some people, such as the self-employed, may not be affected by faster flat-rating

People would experience a range of outcomes from faster flat-rating, which would depend on how many years of S2P they qualified for, if any. A self-employed person, for example, who worked from age 16 in 2020 till age 68 in 2072 would only accrue entitlement to a BSP of £120 a week (in 2011 earnings terms), as the self-employed do not accrue S2P

[37] PPI Individual Model

entitlement and pay lower NICs. Therefore, a self-employed individual would be unaffected by this reform (during the years he spends in self-employment).

Accelerating S2P flat-rating has little impact on the income distribution of pensioner household incomes

Faster flat-rating flat-rating has little impact on the distribution of pensioner household incomes by 2055, as changes to pension income are relatively small and not all pensioner households are affected (Chart 14).

Chart 14[38]

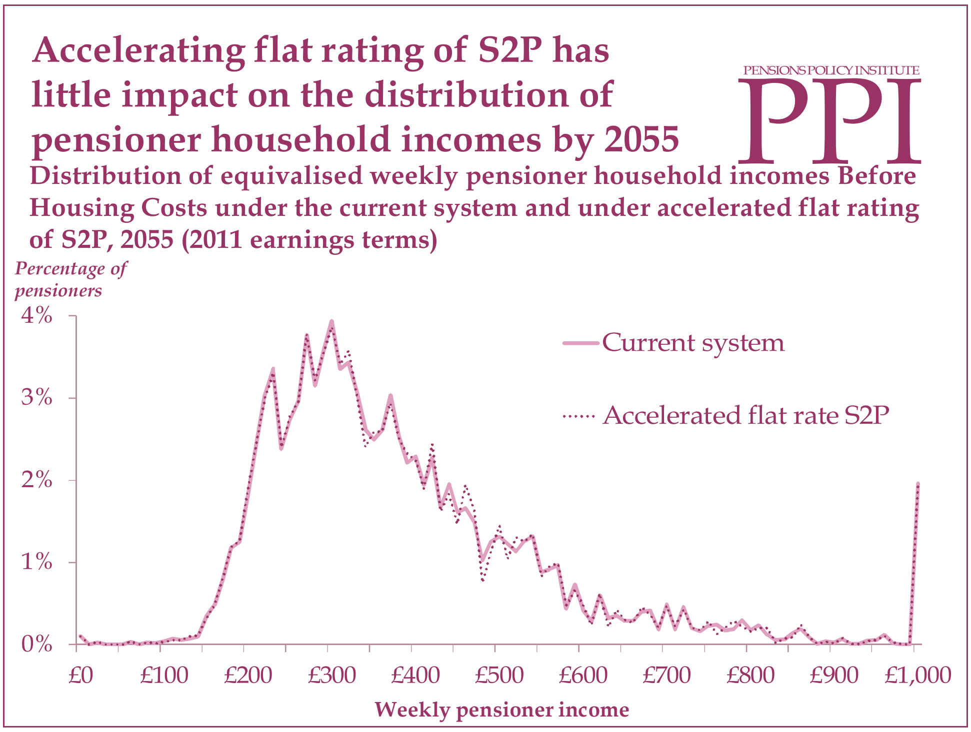


Chart 14 shows the distribution of household incomes of pensioners in 2055 under the current system and under the accelerated flat-rate S2P system. In this Chart income is calculated at a household level, includes all income in the household (including that of non-pensioners) and is shown on a Before Housing Costs (BHC) basis – that is, before any expenditure on rent or other housing costs has been deducted.

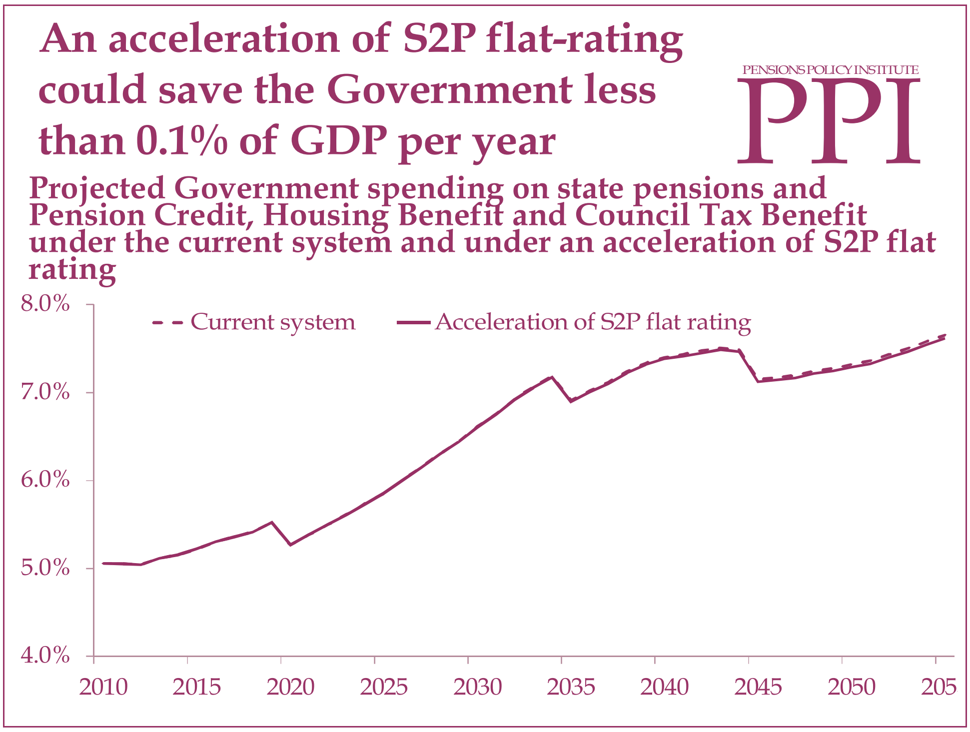
The income used in Chart 14 is also equivalised – that is adjusted so that the income of single pensioners can be compared with pension couples. This is because smaller households need less income to achieve a particular standard of living. This adjustment is done by using a method called equivalisation, which implies multiplying each household net income by a factor that is related to the size of the household.

[38] PPI Distributional Model

Faster flat-rating (in the absence of any other policy changes) would reduce Government spending on state pensions
The following analysis explores what Government spending might be under faster flat-rating (Chart 15). The analysis assumes:

- The Upper Accruals Point is reduced from 2013 so that it meets Lower Earning Threshold by 2020

Chart 15[39]



There would be little change in Government expenditure as a result of faster flat-rating as suggested in the Green Paper. Although many individuals would receive lower S2P as a result of the change, the amount by which S2P is reduced is relatively small relative and so has little impact on total Government expenditure on the state pension and means-tested benefits. The impact is also reduced as S2P is only increased each year in line with the CPI. By 2055 the saving that the Government makes from faster flat-rating could amount to £0.6bn per year, or less than 0.1% of GDP (Table 13).

[39] PPI Aggregate Model

Table 13:[40] Government expenditure on state pensions under the current system and with accelerated flat-rating of S2P, % GDP and £ billion (2011 earnings terms)

	2016	2020	2030	2040	2055
Current system	5.3% £84bn	5.3% £84.2bn	6.6% £105.9bn	7.4% £119.4bn	7.7% £125.2bn
Accelerated flat-rate S2P	5.3% £84bn	5.3% £84.2bn	6.6% £105.8bn	7.4% £119.1bn	7.6% £124.6bn
Difference	-	-	-£0.1bn - less than 0.1%	-£0.3bn - less than 0.1%	-£0.6bn - less than 0.1%

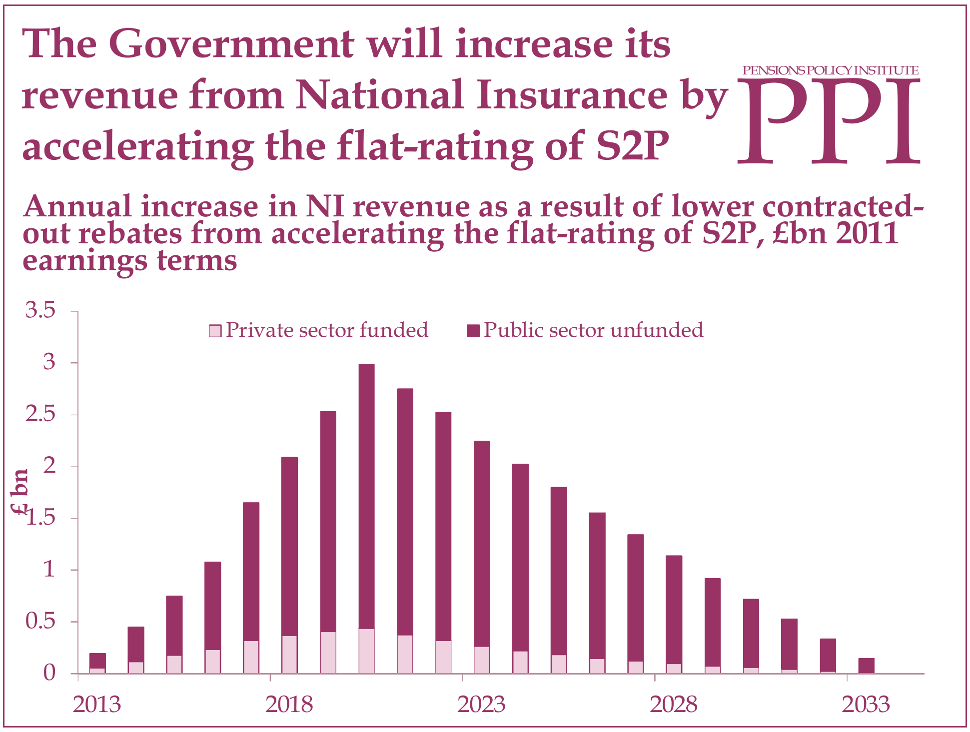
Accelerating S2P flat-rating will increase NI revenue

As well as reducing Government expenditure in the long run, accelerating S2P flat-rating will also increase the amount of National Insurance revenue received by the Government, as a result of reducing the amount of contracted-out rebate.

This is because the contracted-out rebate is calculated on earnings above the Lower Earnings Limit and below the Upper Accruals Point (UAP). As in the accelerated flat-rating option the UAP is reduced compared to the current system, the contracted-out rebate is calculated on a smaller band of earnings between 2013 and 2033. In 2020 this could increase the Government revenue from National Insurance by almost £3bn (2011 earnings terms), with £2.5bn from public sector pension schemes and £0.5bn from funded schemes (Chart 16).

[40] PPI Models

Chart 16[41]



The additional revenue from increased National Insurance contributions would improve Government finances. The impact on the Government finances of the additional revenue from public sector pension schemes would depend on whether HMT increased Departmental spending limits to offset the higher NI contributions. If spending limits were left unchanged, then all the higher NI revenues would accrue to the Government.

Faster flat-rating may have secondary effects on DB schemes

Maintaining contracting out would allow DB scheme sponsors to keep paying lower National Insurance (NI) rates on behalf of their employees, though NI rates would be higher, compared to under current policy, from 2013 as a result of the move towards flat-rate accrual of S2P by the mid-2030s under current policy.

The increased NICs would increase the cost to employers of offering a contracted-out DB scheme. This increase in costs may impact on the decisions made by employers with private sector DB schemes who are considering their scheme's future.

Faster flat-rating is unlikely to have a significant effect on the levels of entitlement to Pension Credit and other means-tested benefits

Faster flat-rating is likely to impact mainly median to higher earners, many of whom may not be eligible for means-tested benefits in the future.

[41] PPI Aggregate Model

Therefore, faster flat-rating will not impact substantially on eligibility for means-tested benefits (Table 14).

Table 14:[42] Proportion of pensioner households eligible for Pension Credit or for any of the means-tested benefits: Pension Credit, Housing Benefit or Council Tax Benefit, under the current system and accelerated S2P flat-rating

Year	Pension Credit		Any means-tested benefits	
	Current	Accelerated S2P flat-rating	Current	Accelerated S2P flat-rating
2010	45%	45%	60%	60%
2020	40%	40%	50%	50%
2030	40%	40%	50%	50%
2040	40%	40%	50%	50%
2050	35%	35%	45%	45%

Although PPI estimates show that there may be very small increases in the proportion of pensioner households eligible for means-tested benefits under a system of accelerated flat-rating of S2P compared to current policy, they are not significant enough to affect the rounded estimates of eligibility.

Faster flat-rating would see people receiving a fully flat-rate benefit from S2P sometime around 2072

The transition to a fully flat-rate S2P benefit for all pensioners would be slow. The Government has been clear that all entitlement to S2P already accrued under the current system will be honoured in full. As a result many people retiring after 2020 would receive some of their S2P under the current rules and some under the new rules. It would not be until people who started working in or after 2020 reached SPA, around 2072, that everyone would start to receive a fully flat-rate S2P benefit.

Faster flat-rating could involve other changes to the state pension system.

The Government has suggested that if they choose to proceed with the proposal of faster flat-rating then they could take further steps to reduce differences between the two tiers of the state pension system.[43] The Green Paper gives some suggestions for how this might be accomplished:

- Aligning the crediting arrangements for BSP and S2P more closely, for example this could mean extending S2P credits to people who were not previously entitled such as people in receipt of Job Seekers Allowance and/or introducing a maximum, flat-rate, S2P which people with 30 qualifying years would be entitled to.
- Allowing the self-employed to accrue S2P entitlement, and

[42] PPI Distributional Model

[43] DWP (2011) p. 27

- Uprating both BSP and S2P by the same value, for example, by the greater of the yearly rise in earnings, the Consumer Price Index or 2.5% (the 'triple-lock').

A two-tier pension system which included the above changes may start to resemble the second proposal, a single-tier pension, though each tier would be administered separately and the overall transition may take longer than under the second proposal (which would see the abolition of accrual of S2P entitlement from around 2016.) The Government estimates that if the above changes were introduced alongside faster flat-rating then, eventually, a full two-tier state pension may be worth between £135 and £145 (in 2010 values).[44] This would look very similar to the single-tier option, but would retain contracting-out and two separate state pensions.

The above changes could increase the costs of the state pension for the Government. Though the Government would save some money by faster flat-rating, they may need to generate further income to ensure that extending entitlement and uprating both tiers by the same value remains cost neutral. This could be accomplished through adjustments to the system, for example by reducing the value of S2P and/or by raising NICs.

Conclusions

The first proposal in the Green Paper is to bring forward the flat-rating of S2P that is already scheduled to occur by around 2030, so that people begin to accrue S2P on a flat-rate basis from 2020. No pensioners gain extra state pension income from this reform proposal. Implementing the proposal could reduce the incomes of pensioners who earned above £14,400 (2011 earnings terms) and accrued S2P entitlement between 2013 and 2030. These pensioners could receive less from their additional state pension income than they would have received under current legislation.

In 2034, no pensioners gain any state pension income as a result of faster flat-rating and around 5.3 million pensioners could receive a lower income from state and private pensions at an average loss of around £0.50 per week. Individuals who earn above £40,040 a year (frozen in nominal terms) between 2013 and 2033 could lose up to £4 a week in S2P benefit. By 2020, up to 12 million individuals could accrue less S2P each year as a result of faster flat-rating, losing an average of £0.34 per week S2P entitlement (2011 earnings terms).

Faster flat-rating is likely to mostly impact people with little to no breaks in their work history, many of whom may not be eligible for means-tested benefits in the future. Therefore, faster flat-rating may not impact substantially on eligibility for means-tested benefits.

Faster flat-rating would marginally reduce Government spending on state pensions, by less than 0.1% of GDP in 2055, £0.6 bn per year (2011

[44] DWP (2011) p. 27

earnings terms). However the Government would also receive an increase in revenue from NICs between 2013 and 2033, peaking at £3bn a year in 2020.

Faster flat-rating could therefore impact upon DB schemes, as employers of contracted-out DB schemes would have to pay higher National Insurance contributions than under current policy, although not as high as they would have to pay under the single-tier option explored in the next chapter.

The Government has suggested that if they choose to proceed with the proposal of faster flat-rating then they could take further steps to reduce differences between the two tiers of the state pension system, for example, allowing the self-employed to accrue S2P entitlement, and uprating both BSP and S2P by the same value.

A two-tier pension system which included the above changes may start to resemble the second proposal, a single-tier pension, though each tier would be administered separately and the overall transition may take longer than under the second proposal.

Chapter four: the implications of introducing a single-tier pension

This chapter explores the implications of introducing a single-tier pension for individual's income in retirement, for Government expenditure and for the wider impact on private pensions.

The Government has proposed to implement a single-tier pension of around £140 per week

The second policy option set out in the Green Paper[45] is the introduction of a single-tier state pension worth (at full entitlement) £140 per week in 2010 terms. The level of £140 per week was chosen to be just above the maximum Guarantee Credit level in order to ensure that people with a full state pension would not lose out on saving because of eligibility for Pension Credit. The single-tier pension would require more changes to the current state pension system than would be involved in faster flat-rating.

Under a single-tier pension:

- The self-employed would build up entitlement in the same way as employed people, and would probably have to pay higher NICs as a result,
- Those in receipt of JSA would build up entitlement in the same way as carers and people on disability related benefits,
- People could have to build up a maximum of 30 years entitlement through National Insurance contributions or credits to receive the full rate of the single-tier pension,
- People would need to have made a minimum of 7 years of contributions to be entitled to any portion of the single-tier pension,[46]
- All entitlement would be based on individual contribution records regardless of whether the individual was married, widowed or divorced,
- The entire single-tier pension would be increased yearly by the greater of earnings, CPI or 2.5%, the triple-lock,
- Savings Credit would be abolished for those reaching SPA after the introduction of the single-tier pension, although it would be retained for those already over SPA when the single-tier was introduced,
- S2P would be discontinued for future accruals and people would no longer be able to contract-out. Individuals and employers whose pension schemes had been contracted-out prior to the implementation of the single-tier pension would need to start paying higher NICs. The Government would honour any S2P already accrued prior to the implementation of the new system.

[45] DWP (2011)
[46] This would reduce costs under the single-tier pension system

Not all the details of how the single-tier pension would work have been announced

Although the Government has proposed a single-tier state pension, there are still a large number of important details that were not covered in the Green Paper, for example:

- The exact mechanism for paying existing BSP and S2P entitlements that are in excess of the single-tier level
- How inherited rights (for any already built up in S2P) would work
- Exactly how contracted-out rights would be accounted for.

Although every effort has been made to replicate the Government's intention when considering this policy, the analysis in this chapter is therefore based on a specific set of assumptions about the way in which a single-tier system could work which may not turn out to be correct if the single-tier pension is progressed further. The analysis should therefore be viewed as a broad guide as to the type of outcomes that could be seen under a single-tier system, rather than a definitive projection. In particular, cost estimates and estimates of income distributions and future benefit entitlement could be very sensitive to final policy details.

Only new pensioners would be eligible for the single-tier state pension

The Green Paper has indicated that people already over SPA when the policy is introduced would not be eligible for the new single-tier state pension. This might create some disparity for outcomes between pensioners of different ages, as older pensioners without additional state pension entitlement may be more likely to be eligible for Pension Credit.

There are a number of different groups who may be particularly likely to gain from a single-tier pension:

- **People with low entitlement to S2P/SERPS** – often **women and carers** who have taken time out of the labour market, particularly if they took time out before 2002. And **lifelong low earners** – for example, people who earn below the Lower Earnings Limit (£5,304 in 2011) in one or more multiple jobs and don't qualify for S2P or BSP.
- **Self-employed -** who have not been entitled to accrue SERPs/ S2P entitlements – but who currently pay lower National Insurance Contributions as a result.
- **Unemployed –** currently those who claim Job Seekers Allowance earn credits for the Basic State Pension but not for SERPs/ S2P.
- **Pensioners who would have been entitled to but would have failed to claim Pension Credit –** between 27% and 38% of pensioners who were entitled to Pension Credit did not claim it in 2008/09.[47]
- **Future generations of older pensioners retiring after 2016 –** because the single-tier pension will be indexed to the higher of earnings, prices or 2.5% (the "triple-lock") it will maintain its value in real terms better than current entitlements to SERPs/S2P which are

[47] DWP (2010a) Table 1.5.1

indexed to CPI. This means that older pensioners are likely to receive a higher state pension income under the single-tier proposal than under the current system.

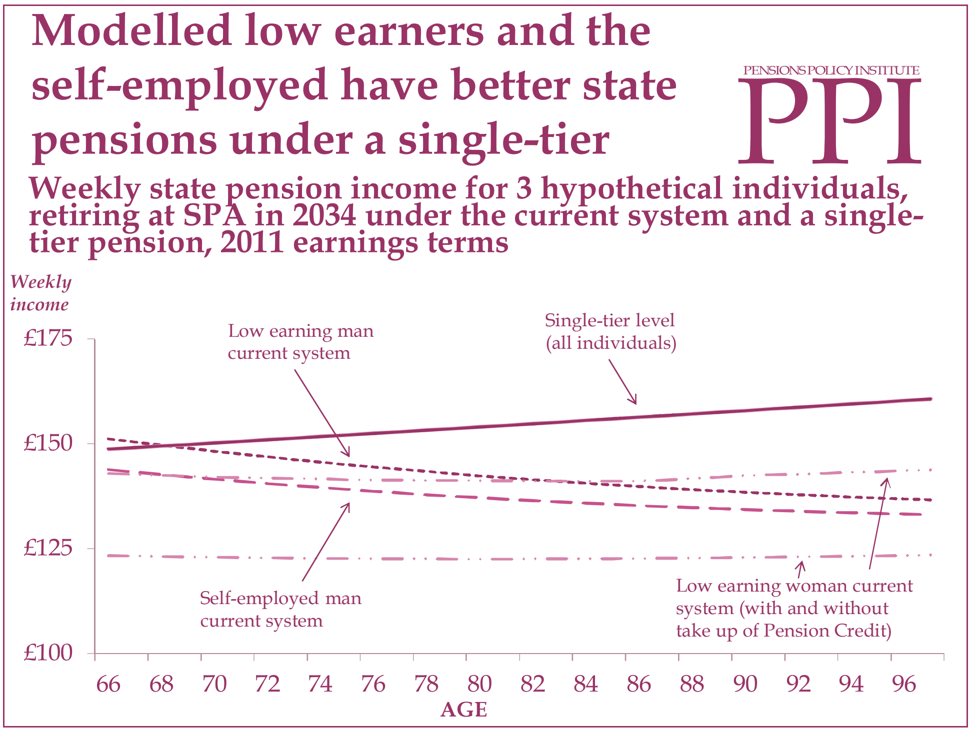
Low earners, the self-employed and older pensioners are more likely to benefit from a single-tier pension than higher earners.
People who are not currently likely to accrue substantial amounts of S2P entitlement for example, lower earners and the self-employed, are more likely to receive a higher income from the single-tier pension during retirement than they would have under the current state pension system. The following analysis explores how the state pension income of the different hypothetical individuals (from Chapter 1) would be affected by the introduction of a single-tier pension.

The self-employed are not entitled to build-up rights to S2P/ SERPs but as a result they currently pay lower National Insurance contributions than employees. The self-employed will gain higher state pension entitlements as a result of the introduction of a single-tier pension, however, the Government may also ask the self-employed to pay higher National Insurance contributions in the future in return.

People with incomplete NIC records may be better-off in the single-tier system than under the current system (Chart 17). NIC records could be incomplete due to periods of unemployment or self-employment, earning in more than one job but with each paying below the Lower Earnings Limit, or people whose caring is not recognised by the credits system (such as caring for children aged over 12, or for less than 20 hours a week).

The low earning female individual would have been entitled to Savings Credit under the current system. Even if she had claimed Savings Credit, she would still have initially been entitled to a higher state pension in the single-tier system, though some people who would have been eligible for Savings Credit could be worse off under a single-tier pension (Chart 17).

Chart 17[48]



The single-tier system is good for older pensioners

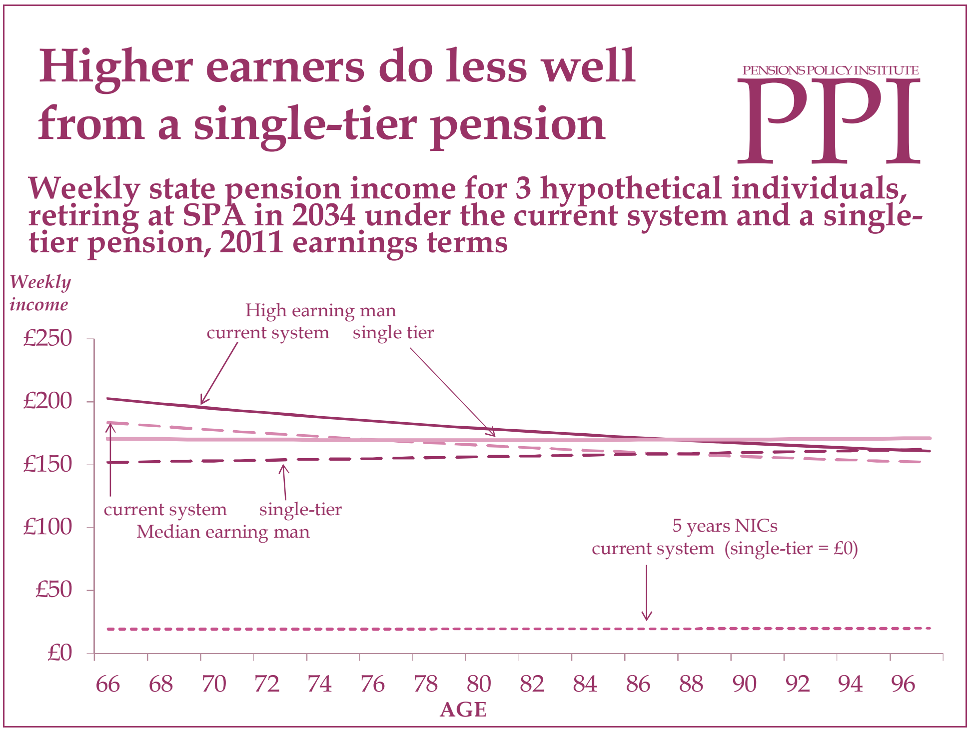
Most of the low earning individuals or individuals with incomplete work history cases have a higher state pension at the point of retirement under the single-tier pension. The indexation of the single-tier pension to the triple-lock (compared to BSP indexed with the triple-lock and S2P with CPI in the current system) means that the single-tier becomes more generous than the current system later in retirement.

People with little to no breaks in work history would initially receive less income from the state pension under a single-tier system, but do better at older ages

Individuals who would have built up high entitlements to S2P under the current system would initially receive a lower state pension under the single-tier option (Chart 18). Higher earners and those who would have accrued more than approximately 30 years of S2P entitlement are likely to receive less income during retirement from their state pension under the single-tier than under the current system.

[48] PPI Individual Model

Chart 18[49]



An individual who has very low levels of state pension entitlement (less than 7 qualifying years) would receive a significantly lower level of state pension under the single-tier system, as a result of the new minimum qualifying years requirement (Chart 18). They would not receive any single-tier pension, whereas under the current system they would be entitled to 5/30ths of the full BSP. Under a single-tier pension, people who would have been eligible for Savings Credit (under the current system) may also lose out.

Around 6.8 million pensioners could receive higher state and private pension income and around 5.2 million pensioners could receive lower state and private pension income under a single-tier pension in 2034

Under a single-tier pension, around 2 million single pensioners and 2.4 million pensioner couples could receive higher state and private pension income in 2034 under a single-tier pension, at an average gain of £11pw more (singles) and £28pw more (couples) (Table 15). Under a single-tier pension, around 3 million single pensioners and 1.1 million pensioner couples would receive lower state and private pension income in 2034, at an average loss of £15pw less (singles) and £24pw less (couples) (Table 15).

[49] PPI Individual Model

This report estimates the number of pensioners who 'gain' or 'lose' in terms of household income as a result of the reforms. The Government has made a commitment that no individual will lose state pension rights that they have already built up. The gains and losses shown in this report reflect the different amounts that pensioners might build up in future under the alternative reforms compared to how much they would build up if the current system continues.

Table 15:[50] Number of gainers and losers under a single-tier pension compared to the current system in 2034 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)

2034	Couples	Singles	Total pensioners
number of pensioners who gain **average gain**	2.4 million pensioner couples £28 a week (2011 earnings terms)	2 million single pensioners £11 a week (2011 earnings terms)	6.8 million pensioners £23 a week (2011 earnings terms)
number of pensioners who lose **average loss**	1.1 million pensioner couples - £24 a week (2011 earnings terms)	3 million single pensioners - £15 a week (2011 earnings terms)	5.2 million pensioners - £18 a week (2011 earnings terms)

In 2055, around 11 million pensioners could receive higher state and private pension income and around 5 million pensioners could receive lower state and private pension income under a single-tier pension

In 2055, around 3.5 million single pensioners and 3.8 million pensioner couples would receive higher state and private pension income under a single-tier pension, at an average gain of £10pw more (singles) and £30pw more (couples) (Table 16). In 2055, around 3.4 million single pensioners and 0.8 million pensioner couples would receive lower state and private pension income under a single-tier pension, at an average loss of £15pw less (singles) and £24pw less (couples) (Table 16).

[50] PPI Distributional Model, income changes include the change in private pension income arising from the ending of contracting-out. It has been assumed that all DB schemes (including public sector pension schemes) reduce the level of contributions and benefits to offset the higher required NI contribution.

Table 16:[51] **Number of gainers and losers under a single-tier pension compared to the current system in 2055 and average gain/loss (change in net income including state and private pensions, 2011 earnings terms)**

2055	**Couples**	**Singles**	**Total pensioners**
number of pensioners who gain **average gain**	3.8 million pensioner couples £30 a week (2011 earnings terms)	3.5 million single pensioners £10 a week (2011 earnings terms)	11 million pensioners £24 a week (2011 earnings terms)
number of pensioners who lose **average loss**	0.8 million pensioner couples - £24 a week (2011 earnings terms)	3.4 million single pensioners - £15 a week (2011 earnings terms)	5 million pensioners - £17 a week (2011 earnings terms)

Introducing a single-tier pension would significantly reduce the number of pensioners in low income households

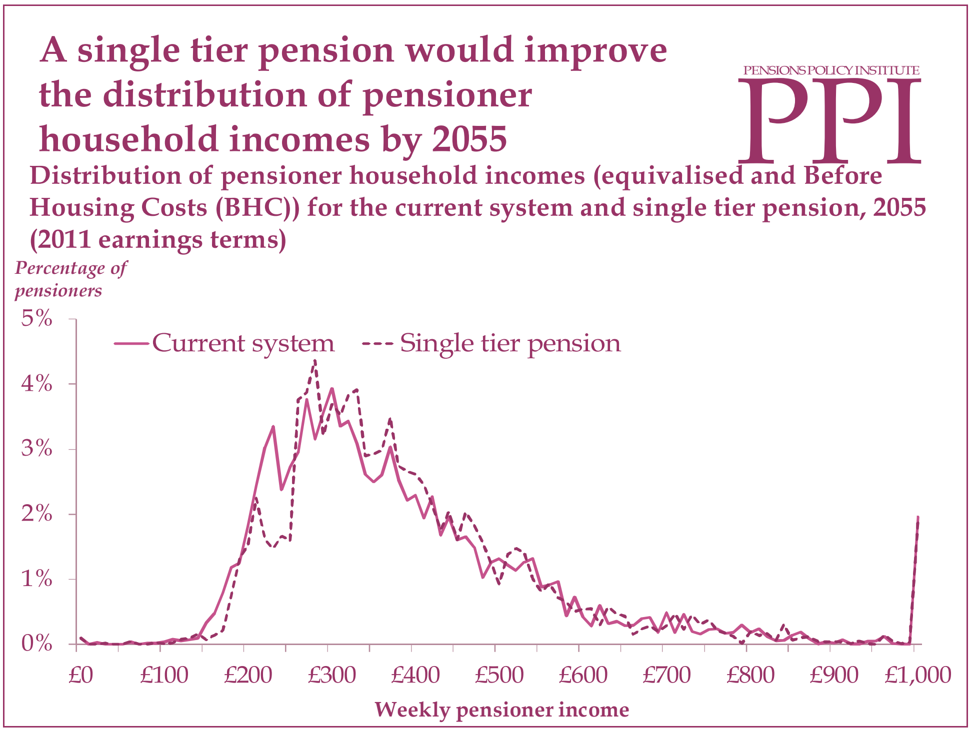
Introducing a single-tier pension would significantly reduce the number of pensioners in low income households, as the vast majority would qualify for a full single-tier pension, individuals are less reliant on having to claim means-tested benefits and because older pensioners would be better protected against on erosion of their incomes by inflation due to the triple-lock.

Chart 19 shows the distribution of household incomes of pensioners in 2055 under the current system and the single-tier pension system. In this Chart income is calculated at a household level, includes all income in the household (including that of non-pensioners) and is shown on a Before Housing Costs (BHC) basis – that is, before any expenditure on rent or other housing costs has been deducted.

The income used in Chart 19 is also equivalised – that is adjusted so that the income of single pensioners can be compared with pension couples. This is because smaller households need less income to achieve a particular standard of living. This adjustment is done by using a method called equivalisation, which implies multiplying each household net income by a factor that is related to the size of the household.

[51] PPI Distributional Model

Chart 19[52]



Introducing a single-tier pension is likely to increase the state pension income of those who had incomplete work histories during working life, but initially reduce those who would have accumulated more than 30 years of S2P. However, although these individuals may initially have received a lower pension income than under the current system, the fact that all state pension income would be increased by the triple-lock means that at very old ages the individuals may see higher state pension incomes than under the current system.

In addition, as the single-tier pension is paid automatically there are no issues of low income arising from non-take up of means-tested benefits.

As a result, fewer pensioner households have low incomes under a single-tier system than under the current system.

Introducing a single-tier pension could be broadly cost neutral

The following analysis explores what Government spending might be under a single-tier pension (Chart 20). The analysis assumes:

- The single-tier pension is introduced for people reaching SPA after April 2016. (This would be the first possible month, assuming a May 2015 General Election.)
- The value of a full single-tier pension is £140 in 2010 earnings terms, increasing in line with earnings until introduction in 2016. From 2016 onwards, the single-tier pension is assumed to increase in line with

[52] PPI Distributional Model, assumes that all DB schemes reduce the level of benefits in line with the loss of the contracted-out rebate.

the greater of the rise in earnings, CPI or 2.5% (the 'triple-lock' assumed to be 4.76%).

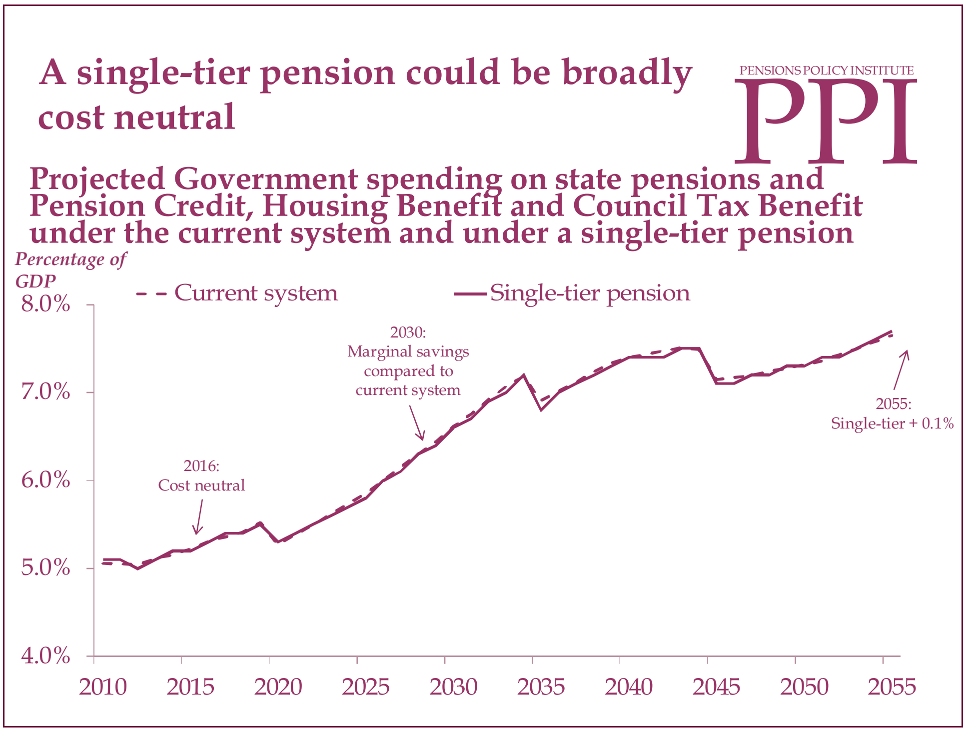
- Any state pension income up to £140 per week is increased yearly by 4.76% from 2016, and any excess over £140 is increased by the rise in the CPI.
- The amount of money that a contracted-out individual's state pension is reduced by is equivalent to the contracted-out deduction.
- Savings Credit is abolished for new pensioners from 2016 – however it continues as expected (not frozen after 2014) for people who reached SPA before 2016.
- Housing Benefit and Council Tax Benefit personal allowances are capped at the maximum Guarantee Credit level.
- All DB schemes (including public sector pension schemes) reduce the level of contributions and benefits to offset the higher required NI contributions.

Introducing a single-tier pension would lead to the ending of contracting-out for Defined Benefit (DB) pension schemes. It is necessary, in order to analyse the impact of the single-tier pension, to model how employers who run DB schemes could respond to the subsequent increase in their National Insurance Contributions.

In reality, employers are likely to respond in different ways. Some might choose to absorb the extra NI costs, and leave their pension scheme unchanged. Some might change the contributions to, and benefits from, their scheme to offset the higher NI contributions. Others may take the opportunity to change their pension provision arrangements altogether, perhaps moving to Defined Contribution provision.

The analysis in this report assumes that the sponsors of DB schemes (including those in the public sector) adjust the contributions to, and benefits from, DB schemes to exactly offset the extra NI contributions they would have to pay. This leads to lower long-term private pension incomes for DB scheme members, offset by the changes in their state pension arrangements. This is a more pessimistic assumption than assuming that all employers keep schemes as they are, but not as pessimistic as assuming that all employers change arrangements completely.

Chart 20[53]



Introducing a single-tier pension would be broadly cost neutral with differences between expenditure on the current system and the single-tier differing by less than 0.1% of GDP from year to year. A single-tier pension could:

- Be broadly cost neutral from 2016 to 2050
- Cost less than current system by less than 0.1% between 2019 and around 2050.
- Cost more than current system by about 0.1% by 2055 (Table 17).

Table 17:[54] **Government expenditure on state pensions under the current system and with a single-tier pension, % GDP and £ billion (2011 earnings terms)**

	2016	2020	2030	2040	2055
Current system	5.3% £84bn	5.3% £84bn	6.6% £106bn	7.4% £119bn	7.7% £125bn
Single-tier pension	5.3% £84bn	5.3% £84bn	6.6% £105bn	7.4% £119bn	7.7% £126bn
Difference	-	-	- £1bn - less than 0.1%	-	+ 0.1% + £1bn

[53] PPI Aggregate Model
[54] PPI Models

Introducing a single-tier pension means that the Government would:

- Pay out more in BSP but save on additional state pension and means-tested benefits, most substantially Savings Credit.

Introducing a single-tier pension could reduce the levels of entitlement to Pension Credit

Introducing a single-tier pension could significantly reduce eligibility for Pension Credit, with eligibility falling from 45% of pensioner households in 2010 to 5% of pensioner households by 2050 (Table 18). The reduction is initially gradual as only new pensioners are eligible for the single-tier pension.

Table 18:[55] Proportion of pensioner households and number of pensioners eligible for Pension Credit, under the current system and single-tier pension

	Proportion of pensioner households		Number of pensioners (millions)	
Year	**Current system**	**Single-tier pension**	**Current system**	**Single-tier pension**
2010	45%	45%	4.5	4.5
2020	40%	35%	4.1	3.7
2030	40%	20%	4.9	2.6
2040	40%	10%	5.1	1.4
2050	35%	5%	4.4	0.8

Introducing a single-tier pension could substantially reduce entitlement to Pension Credit because the full rate of the single-tier pension is intended to remain above the income level below which people are eligible for the Guarantee Credit element of Pension Credit.

The single-tier proposal also involves abolishing Savings Credit for pensioners reaching SPA after the introduction of the single-tier pension. Pensioners reaching SPA after the introduction of the single-tier would no longer be eligible for Savings Credit, though people over SPA when the single-tier is introduced would still be eligible for Savings Credit if their income is low enough. After the introduction of the single-tier pension, Savings Credit would slowly be phased out as more pensioners entered under the new system, less pensioners were retired under the old system, and expenditure on Savings Credit would reduce over time.

If fewer pensioners are eligible for Pension Credit, this indicates that:

- More pensioners have income above the Government's assessment of the minimum income a pensioner needs, and that
- Fewer pensioners with savings are likely to have poor incentives to save.

[55] PPI Distributional Model, all figures rounded to nearest 5% and 0.1 million

However, there are other means-tested benefits other than Pension Credit. Currently around 60% of pensioner households are eligible for one or more of Pension Credit, Housing Benefit or Council Tax Benefit. If the Government proceeds with the proposal to introduce a single-tier state pension then the proportion of pensioner households eligible for any means-tested benefit could reduce to around 35% by 2050, compared to 45% under the current system (Table 19).

Table 19:[56] Proportion of pensioner households eligible for Pension Credit or for any of the means-tested benefits: Pension Credit, Housing Benefit or Council Tax Benefit, under the current system and single-tier pension

Year	Housing Benefit		Council Tax Benefit		Pension Credit		Any means-tested benefit	
	Current	Single-tier	Current	Single-tier	Current	Single-tier	Current	Single-tier
2010	20%	20%	50%	50%	45%	45%	60%	60%
2020	20%	20%	45%	45%	40%	35%	50%	50%
2030	20%	20%	45%	40%	40%	20%	50%	45%
2040	15%	15%	40%	35%	40%	10%	50%	40%
2050	15%	15%	35%	35%	35%	5%	45%	35%

It is not yet clear how means-tested benefits might be structured under a single-tier state pension

Under a single-tier pension, the Savings Credit element of Pension Credit would be abolished for future pensioners because most pensioners could expect to retire with a State Pension above the level of the Guarantee Credit. Abolishing Savings Credit would also assist with overall cost savings. However, people who reach SPA before the introduction of the single-tier, and who consequently received state pension under the two-tier system, would still be eligible for Savings Credit.

This could cause complications for the following reasons:

- It would require the administration of two differently structured means-tested benefit systems side-by-side.
- The point at which eligibility for Housing Benefit (HB) and Council Tax Benefit (CTB) starts to taper away is currently set at the maximum level of Guarantee Credit and Savings Credit. If Savings Credit is abolished, this could mean that the level of income at which eligibility for HB and CTB begins to taper is lowered to the maximum level of Guarantee Credit (£137.35 for a single pensioner in 2011/2012). This could result in some people receiving less support from HB and CTB than they would have received under the current system.

[56] PPI Distributional Model, all figures rounded to nearest 5%

There may be implications for Government expenditure on unfunded public sector pension schemes if a single-tier pension is introduced
The ending of S2P and contracting out would lead to a single NI rate, and there would be an immediate increase in Government revenue due to the removal of the NIC's rebate.

In 2016 PPI projects that ending contracting-out into DB pension schemes could increase the amount of NI collected by the Government by around £6bn[57] (2011 earnings terms). Of this £6bn, £5bn is in respect of public sector pension schemes (including the funded LGPS), and £1bn is in respect of private sector pension schemes.

Ending S2P and contracting out could therefore increase Government revenue because employers and individuals who were previously in contracted-out DB pension schemes would start paying full rate NICs.

However, the majority of this will be in public sector pension schemes and so could represent a transfer from one part of Government (including Local Government) to another. The overall impact on the Government finances will depend on how Departmental Budgets are changed to reflect the increased level of NI contributions that both employers and employees would pay, or how the pension schemes are changed to reflect the fact that they would be contracted-in rather than contracted-out.

In the unfunded public sector schemes, the Government could choose to:

- Allow Departments and employees to reduce scheme benefits, and therefore contributions to pension schemes, to offset the loss of the contracting-out rebate, or
- Increase the Departmental spending limits to reflect the higher NI costs. In which case the net impact on the Government finances through the unfunded public sector schemes could be less than the full level of the contracted-out rebate.
- However, the Government may decide not to change any budget allocations but to allow the burden of the extra NI costs to fall onto Departments and Local Authorities (who would need to absorb the extra costs within existing spending arrangements) and individuals. If this were the case, Government revenues could increase by the full amount.

Government revenues would in any case increase by £1bn, in respect of the removal of the contracted-out rebate for funded private sector DB schemes.

[57] PPI Aggregate Model

There may be secondary impacts on private sector DB schemes if a single-tier pension is introduced
Ending S2P and contracting out would also impact on private sector DB schemes as both employers and individuals in contracted-out DB schemes would have to pay full rate NI contributions. In 2016, this could amount to an increase in combined employer and employee NICs of around £1bn from private sector schemes.

Private sector DB schemes who wished to make up for the increased costs might choose to:

- *Absorb the costs* without reducing the value of their pension scheme
- *Reduce the generosity of the scheme*, for example by increasing the level of contributions that employees pay or reducing the yearly accrual rate for employees, for example from 1/60th to 1/80th.
- *Close the scheme or parts of the scheme*, for example closing the scheme to new members or closing the scheme for future accruals

Changes to private sector DB schemes may not always be straightforward to implement as they often require approval from scheme trustees. Some schemes linked to former-Nationalised industries may not be able to change benefit levels without Government legislation. Some schemes may choose to close to new members, or wind up instead of trying to find a way to cope with increased costs, however many schemes are experiencing funding difficulties and may have already intended to close or wind up.

Individual members of DB schemes may be impacted by the introduction of a single-tier pension
Individuals and employers in private sector DB schemes currently pay lower NICs to the Government in return for schemes taking on responsibility for paying an equivalent of S2P to the employee. Employees in DB pension schemes will need to pay higher NICs under a single-tier pension. However the impact that the introduction of the single-tier pension has on their level of pension contributions and their pension income will depend on how their employers react to the removal of contracting out.

If an employer chose to reduce the benefits of an existing DB scheme in such a way as to exactly offset the impact of removing contracting-out (by, for example, reducing the accrual rate), then;

- Employee/employer contributions would be lower than under the current system.
- Employee/employer NICs would be higher (by the amount of the contracted-out rebate) than under the current system as they would now pay full NICs.
- The change in the overall level of pension built-up in that year depends on how much the individual earns.

Lower earning individuals could see their pension contributions falling by more than their NI contributions increase (especially if pension contributions are payable across all earnings), and so see a net increase in their take home pay.

Higher earnings individuals could see their pension contributions falling by less than their NI contributions increase, and so see a net fall in their take home pay.

In 2016 PPI projects that ending contracting-out into to DB pension schemes could increase the amount of NI collected by the Government by around £6bn[58] (2011 earnings terms). Of this £6bn, £5bn is in respect of public sector pension schemes (including the funded LGPS), and £1bn is in respect of private sector pension schemes.

As a result employers and individuals in occupational DB schemes in both the public and private sectors would have to pay higher National Insurance rates. In 2016 this could mean that:

- Public sector employee NI contributions would increase by 1.4%, equivalent to an estimated increase of £1.4bn.
- Public sector employer NI contributions would increase by 3.4%, equivalent to an estimated increase of £3.4bn.
- Private sector employees in DB schemes' NI contributions would increase by 1.4%, equivalent to an estimated increase of £0.3bn.
- Private sector employers who offer DB schemes would see their NI contributions increase by 3.4%, equivalent to an estimated increase of £0.8bn.

The Government could chose to compensate for the impact on public sector employees and employers by altering public sector wages and Government Departmental spending limits but the impact on private sector DB schemes would be real.

Introducing a single-tier pension would create transitional issues for people over SPA, people with S2P entitlement or people who were contracted-out of S2P

Until the single-tier pension was fully phased in, meaning that no one still had entitlement under the two-tier system, there would be complexity surrounding the entitlement and administration of state pension for those who had already built up S2P and those who were contracted-out. Once a single-tier pension had been fully phased in, the state pension system would be less complex than the current, two-tier system.

The Government has proposed that, under the single-tier pension, those who had built up entitlement to S2P under the previous system would receive their full entitlement, even if it is above the full rate of the single-tier pension. This would result in a system where, until past entitlements

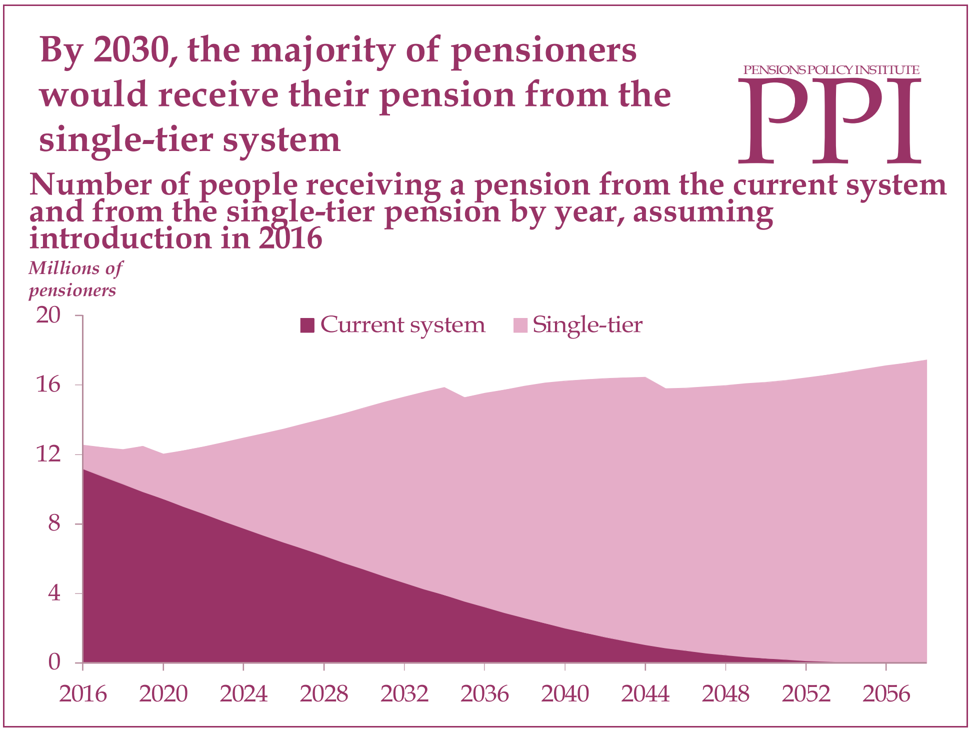
[58] PPI Aggregate Model

to S2P have declined, some pensioners would get a higher state pension than others. It is likely that the additional pension paid on top of the single-tier level would be uprated yearly in line with CPI, which is consistent with S2P uprating.

Similarly, the new system would need to take account of the rebates given to those who were contracted-out of S2P under the two-tier system. The Government proposes that people who had been contracted-out of S2P would receive a reduced single-tier pension (lower than the estimated £140 a week) to compensate for the NI rebates received and under the understanding that they would receive a private pension that would replace the S2P given up.

As more people reach SPA who are eligible for the single-tier pension the system will become easier to administer, and it will become more straightforward for people to work out what they are entitled to. It could take around 11 years for the majority, more than 50%, of pensioners to be receiving pensions under the single-tier pension system (Chart 21).

Chart 21[59]



[59] GAD UK 2008 based population projections

Conclusions
Introducing a single-tier pension would be broadly cost neutral with differences between expenditure on the current system and the single-tier differing by less than 0.1% of GDP from year to year. A single-tier pension could:

- Be broadly cost neutral
- Cost less than current system by less than 0.1% between 2019 and around 2050.
- Cost more than current system by about 0.1% by 2055.

Low earners, people with incomplete NI contribution histories such as the self-employed, unemployed and some carers, and older pensioners are more likely to benefit from a single-tier pension than higher earners. People who are entitled to but do not claim PC would also be better-off under the new single-tier pension as it would provide a higher state pension than they currently receive.

People with little to no breaks in their work history with full NI records who would have accrued higher state pension, through S2P, under the current system would receive less income from the state pension under a single-tier system, but could do better at older ages, if they live to a very old age.

Individuals with less than 7 years of NI contributions and individuals who would have qualified for Savings Credit could be worse off under a single-tier system.

Introducing a single-tier pension and removing Savings Credit for future pensioners could substantially reduce entitlement to Pension Credit in the future. By 2050 only 5% of pensioner households could be eligible for Pension Credit, compared to 35% under the current system.

Introducing a single-tier pension could significantly reduce the number of pensioners in low income households, as the vast majority would qualify for a full single-tier pension, individuals are less reliant on having to claim means-tested benefits and because older pensioners would be better protected from the effects of inflation by the triple-lock.

The ending of S2P and contracting out would lead to a single NI rate, and there would be an immediate increase in Government revenue due to the removal of the NIC's rebate. In 2016 PPI projects that contracted-out rebates to DB pension schemes could increase the amount of NI collected by the Government by £6bn. Of the £6bn, £5bn is in respect of unfunded public sector pension schemes and £1bn is in respect of private sector schemes.

Ending S2P and contracting out could therefore increase Government revenue because people who were previously contracted-out would start paying full rate NICs. However, the majority of this will be in public sector pension schemes and so could represent a transfer from one part of Government to another. The overall impact on the Government finances will depend on whether Departmental Budgets are changed to reflect the increased level of NI contributions that both employers and employees would pay, or how the pension schemes are changed to reflect the fact that they would be contracted-in rather than contracted-out.

Ending S2P and contracting out could also impact on private sector DB schemes as they will no longer receive the NI rebate. In 2016, this could amount to an increase in the cost of combined employer and employee NICs of £1bn. Private sector schemes could choose to reduce benefit levels, increase contributions or change provision entirely.

Employees in DB pension schemes will need to pay higher NICs under a single-tier pension. However the impact that the introduction of the single-tier pension has on their level of pension contributions and their pension income will depend on how their employers react to the removal of contracting out.

If employers adjust benefit levels and employee contributions to take account of the ending of contracting-out, lower earners are more likely to see take-home pay increase and high earners more likely to see take home pay fall. Many might see an initial state pension entitlement lower than in the current system, but more of their pension income would be indexed to the triple-lock rather than CPI.

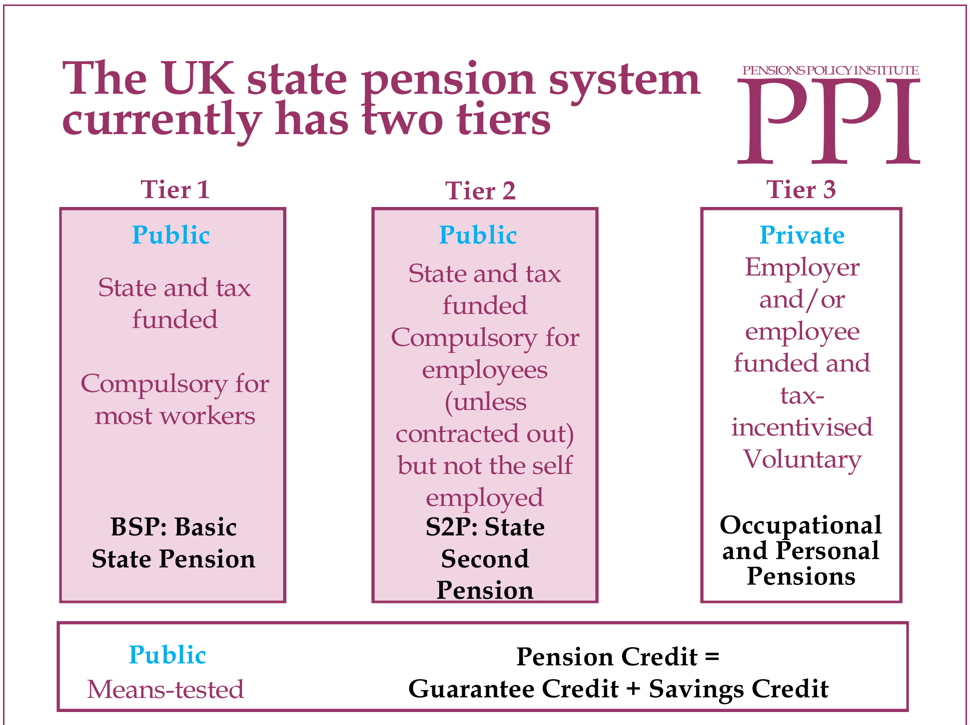
Appendix one: description of the current pension system

This appendix gives an overview of the UK's current pension system and introduces the Government's proposals for reform.

The current pension system

In its current form, the UK state and private pension system can be divided into three tiers (Chart A1). The Basic State Pension and Additional State Pensions, which make up the first two tiers, are managed and delivered by the state and are funded through National Insurance Contributions (NIC's) and general taxation. The third tier, private pensions, is funded by the employee and/or the employer and is supported by Government through tax relief.

Chart A1



The Basic State Pension is the first tier of the state pension

The Basic State Pension (BSP) makes up the first tier of the state pension. Since 2010, a minimum of 30 qualifying years of National Insurance Contributions (NICs) or NIC credits has been necessary in order to be entitled to a full BSP (a full BSP is £102.15 per week in 2011/12). Both individuals and their employers pay NICs. Before 2010 women needed 39 qualifying years of NICs and men needed 44 qualifying years to qualify for a full BSP.

Currently, not everyone qualifies for a full BSP. Over 95% of men and around 75% of women reaching SPA in 2010 qualified for a full BSP,[60] and, assuming the current state pension system remains the same, the Government projects that around 90% of men and women reaching SPA in 2050 would be eligible for a full BSP.[61]

From 2011, the BSP will be increased each year by the higher of the growth in earning, the Consumer Price Index (CPI), or 2.5%.

Pension Credit is the main means-tested benefit for pensioners
Pensioners with income and savings below a certain level may qualify for one or a number of means-tested benefits: mainly Pension Credit, Housing Benefit and Council Tax Benefit. Some pensioners may qualify for other disability related benefits or increases and many pensioners qualify for seasonal payments such as the Winter Fuel Allowance and the Christmas Bonus.

Pension Credit is the main means-tested benefit for pensioners and is intended to ensure that pensioners do not have to live on incomes below a 'guaranteed' minimum level. Pension Credit has two elements, Guarantee Credit (GC) and Savings Credit (SC). From 6 April 2011, GC tops pensioners' income up to £137.35 per week for single pensioners and £209.70 for couples. Savings Credit aims to ensure that those who have made some private provision for retirement will be better-off than those who have made no provision. From 6 April 2011 the maximum SC is set at £20.52 per week for singles and £27.09 for couples until 2014.

In 2008/09 between 32% and 37% of pensioners were entitled to claim Pension Credit;[62] this is between 3.6m and 4.2m pensioners.[63] However, between 27% and 38% of pensioners who were entitled to Pension Credit did not claim it in 2008/09.[64]

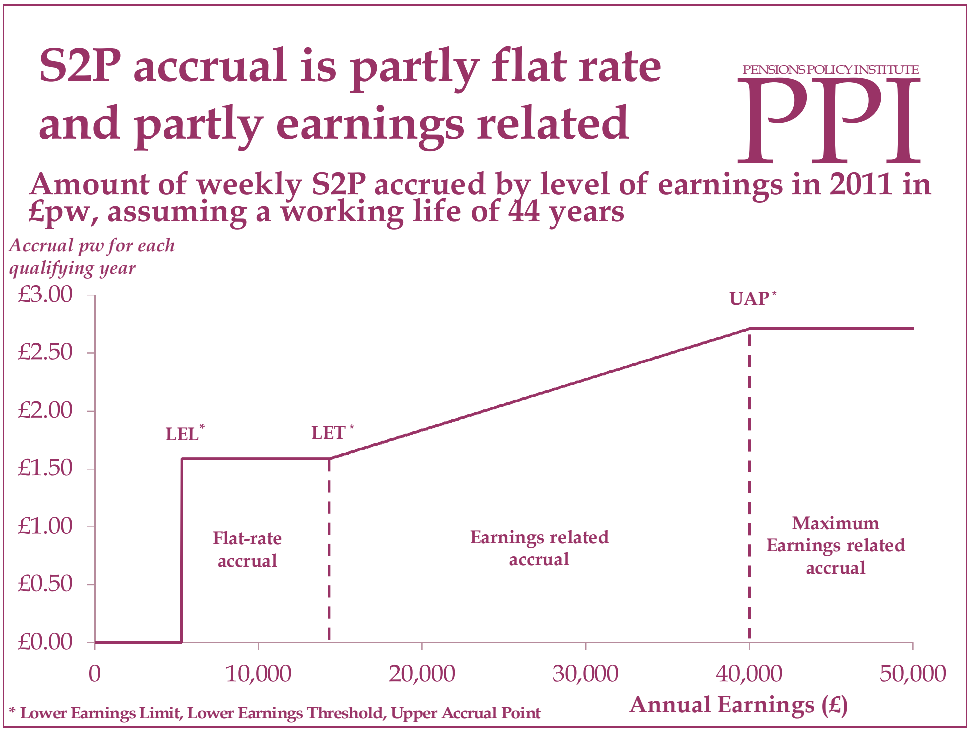
State Second Pension and its predecessors make up the second tier of the state pension
The second tier of the state pension is the Additional State Pension, which has existed in three different guises since its inception in 1961:
- The State Second Pension (S2P) since 2002,
- The State Earnings-related Pension Scheme (SERPS) from 1978 to 2002,
- The Graduated Retirement Benefit (GRB) from 1961 to 1975.

Many pensioners and working-age people will have built up entitlement to SERPS and/or GRB as well as S2P.

[60] DWP projections
[61] DWP projections
[62] DWP (2010a) Table 1.3.1
[63] Out of a total 11.3m pensioners in 2008/09, DWP (2010b)
[64] DWP (2010a) Table 1.5.1

Current S2P accrual is partly flat-rate and partly earnings-related
Employees with earnings above £5,304 (the Lower Earnings Limit, LEL) and up to £14,400 (the Lower Earnings Threshold, LET) currently accrue entitlement to S2P benefit of around £1.70 per week in 2011 earnings terms for each qualifying year of NIC's.[65] Employees with earnings between £14,400 and £40,040 (the Upper Accrual Point, UAP) accrue entitlement to further S2P benefit of up to around £1 per week for each qualifying year of NIC's (Chart A2).

Chart A2[66]



The maximum benefit that someone can receive from a combination of S2P, SERPS and GRB in 2011 is £159.52 per week, on top of a maximum basic state pension of £102.15, giving a maximum possible state pension for someone reaching SPA in 2011/12 of £261.67 per week in 2011. Though in order to receive the maximum state pension an individual would have need to earn above the Upper Earnings Level or Upper Accruals Point in every year since 1978. Once in payment, additional state pension payments are increased in each tax year by the rise in CPI.

Not all people in work or on benefits are eligible for S2P
The amount of S2P that people are entitled to at retirement depends on how many years they qualify for. People who are employed and earning above the LEL can gain entitlement for every year between the age of 16 and SPA. Certain individuals who are not working but are in receipt of benefits, such as disabled people and carers, can gain S2P credits which

[65] DWP (2011) set out the fixed level of S2P accrual at £1.60 per week in 2010 terms to the nearest 10p. This is £1.70 in 2011 earnings terms.
[66] Assuming a 44 year working life, S2P accrual rate varies based on an individual's age and SPA

accrue entitlement to the flat-rate S2P benefit of around £1.70 per week in 2011 earnings terms. However not everyone in receipt of benefits can accrue S2P credits. People in receipt of Job Seekers Allowance (JSA) currently receive BSP credits but not S2P credits. People who are self-employed are not eligible for S2P and do not make S2P contributions. Consequently, the self-employed pay lower NIC's.

In 2008/9, around 70% of the working-age population were accruing entitlement to S2P (or a contracted-out equivalent), either through earnings or credits.[67]

People saving in private and occupational pension schemes are able to 'contract-out' of paying S2P

It is possible for members of occupational, stakeholder and personal pension schemes to contract-out of S2P, though contracting out functions differently for different types of schemes.

In occupational DB schemes:

- The scheme itself is contracted-out of S2P and employers and employees automatically pay lower NICs. In 2011/2012 their NICs are reduced by 3.7% (employers) and 1.6% (employees) (Table A1)
- The amount of NIC rebate for occupational DB schemes is based on the expected cost of providing the equivalent of an S2P benefit through a private pension. The rebate is calculated based on a recommendation by the Government Actuary (GAD).
- The employer takes on a liability to guarantee that the benefits received from the pension scheme in retirement will be at least equal, on average, to the S2P benefit given up from the state.

In occupational DC schemes (contracting-out abolished from 2012):

- The employee is contracted-out of S2P and employers and employees automatically pay lower NICs. In 2011/2012 their NICs are reduced by 1.4% (employers) and 1.4% (employees)
- The employer must pay the equivalent of the contracted-out rebate into the pension scheme, but does not have a liability to pay out an equivalent of S2P benefits in retirement.
- The Government pays in age-related top ups at the end of each tax year.

In personal DC schemes (contracting-out abolished from 2012):

- The employee is contracted-out of S2P but both the employee and the employer pay the full rate of NICs.
- The Government pays a contracted-out rebate plus an age-related top up into the employee's designated pension scheme at the end of each tax year.

The amount of the contracted-out rebate is reviewed every 5 years. The current combined employer/employee rebate for DB schemes is 5.3% of

[67] FRS data 2008/9

earnings between the Lower Earnings Limit (LET) and the Upper Accrual Point (UAP), though employee NI contributions are made on earnings between the Primary threshold (PT) and Upper Earnings Limit (UEL). 5.3% is the total rebate for occupational DB schemes. It is made up of 3.7% for employers and 1.6% for employees (Table A1).

Table A1: National Insurance Contributions - 2011/12 Tax Year

	2011/12	Higher earners
Class 1: Employee NI Contributions		
Employees' NI Contributions	12% on earnings between £7,225 (PT) and £42,475 (UEL)	2% on earnings above £42,484
Married women's reduced rate	5.85% on earnings between £7,225 (PT) and £42,475 (UEL)	2% on earnings above £42,484
Employee's contracted-out rebate (DB)	1.6%	
Employee's contracted-out rebate (occupational DC)	1.4% + age-related top up	
Class 2: Self-employed		
Self-employed	Flat-rate of £2.50 a week = £130 a year	
Employer NI Contributions		
Employers' NI Contributions	13.8% on all earnings above £7,072	
Employers' contracted-out rebate, (occupational DB)	3.7%	
Employers' contracted-out rebate, (occupational DC)	1.4%	

The Government has announced that the 2012-2017 rebate for DB occupational pension schemes will be reduced to 4.8% (1.4% employee, 3.4% employer).[68, 69] The new rebate was chosen by the Secretary of State, and is the lowest of three possible rebates offered by a review of the Government Actuary's Department.[70] The chosen rebate is lower than the previous rebate and means that the contracted-out element of NICs will be lower for people between 2012 and 2017 than it is currently.

Fewer people are contracting out in the private sector as a result of DB scheme closures

The majority of contracting out is in to DB occupational pension schemes in both the public and private sector, though members of DC schemes

[68] HMT (2011) paragraph 2.54
[69] GAD (2011)
[70] GAD (2011)

have been allowed to contract-out of S2P. From 2012, contracting out into private DC pension schemes will be abolished, however under current legislation people in occupational pension schemes will still be able to contract-out after 2012. Contracting out in the private sector has been in decline as many private sector DB schemes are closing to new members, new accruals, or selling off their liabilities to third parties (Table A2).

Table A2:[71] **Distribution of active private sector DB schemes by status**

Percentage of schemes	2006	2007	2008	2009	2010
Open	43%	36%	31%	27%	18%
Closed to new members	44%	45%	50%	52%	58%
Closed to future accruals	12%	16%	17%	19%	21%
Winding up	1%	2%	2%	2%	2%

Active membership in private sector DB schemes has consequently been dropping. There were around 3.6m active members in private sector DB schemes in 2004. This dropped to around 2.4m active members in 2009. However DB scheme membership has grown in the public sector, where DB schemes are the dominant form of provision, from around 4.2m members in 1991 to around 5.4m members in 2009.[72]

Contracting-out in unfunded public sector schemes functions differently from in the private sector

The seven main public sector pension schemes have a combined active membership of a little under 5 million employees including the funded Local Government Pension Scheme (LGPS). Six of the seven main schemes are unfunded, meaning that there is no fund of assets to back the pension promises. Current pensions are paid out using the contributions in respect of current members, with the Government making up any difference. Only the Local Government Pension Scheme has a fund of assets invested to cover the pension promises.

Around 70% of public sector employees are in unfunded schemes.[73] Unfunded public sector pension scheme members receive a contracted-out rebate on their NICs as do members of funded schemes and private sector members of occupational pension schemes.

In the LGPS the schemes are funded rather than unfunded and are therefore treated in a similar way to private sector DB schemes. Overall, under the current system, the contracted-out rebates received in the public sector (including LGPS) is estimated to be worth £5bn in 2016 (2011 earnings terms).[74]

[71] Table reproduced from TPR, PPF (2010) Table 1.1
[72] ONS (2010)
[73] PPI (2010)
[74] PPI estimate from the PPI aggregate model

The third tier of the pension system is made up of private pensions
Tier 3 consists of private pensions and it includes all voluntary pension arrangements. This includes Defined Benefit (DB) and Defined Contribution (DC) occupational, stakeholder and personal pensions. In 2008 there were around 10m active members of private or occupational pension schemes in the private sector and around 5.4m active members of occupational pension schemes in the public sector (Chart A3).[75]

Chart A3[76]

Occupational pension membership in the private sector has been decreasing since a peak in the 1960's. Membership in private DC pension schemes is increasing in the private sector. From 2012, employers will be required to automatically enrol qualifying employees into private or occupational pension schemes. In the future there is likely to be greater private pension coverage in the private sector. Active membership in private DC pension schemes could grow to around 15 million by 2020 and around 17 million by 2050.[77]

[75] ONS (2009) table 2.1
[76] PPI estimates based upon ONS Occupational Pension Scheme Survey and ASHE workplace pension membership data. Change in membership between data points smoothed. Assumes that all members of stakeholder and personal pensions are employed in private sector.
[77] PPI (2009), PPI Aggregate Model

Conclusions

In its current form, the UK state and private pension system can be divided into three tiers. The Basic State Pension and Additional State Pensions, which make up the first two tiers, are managed and delivered by the state and are funded through National Insurance Contributions and general taxation.

Pensioners with income and savings below a certain level can also qualify for a number of means-tested benefits. The main means-tested benefit for pensioners is Pension Credit. In 2008/09 between 32% (3.6m) and 37% (4.2m) of pensioners were entitled to Pension Credit.

The third tier, private pensions, is funded by the employee and/or the employer and is supported by the Government through tax relief. In 2008 there were around 10m active members of private or occupational pension schemes in the private sector and around 5.4m active members of occupational pension schemes in the public sector.

Fewer people are contracting out in the private sector as a result of DB scheme closures. Active membership in private sector DB schemes has consequently been dropping. There were around 3.6m active members in private sector DB schemes in 2004. This dropped to around 2.4m active members in 2009. However DB scheme membership has grown in the public sector, where DB schemes are the dominant form of provision, from around 4.2m members in 1991 to around 5.4m members in 2009.[78]

Occupational pension membership in the private sector has been decreasing since a peak in the 1960s. In contrast, membership in DC private pension schemes is increasing in the private sector. Active membership in private DC pension schemes could grow to around 15 million by 2020 and around 17 million by 2050, following the introduction of auto-enrolment.

[78] ONS (2010)

Appendix two: modelling methods and assumptions

This appendix describes the assumptions and methodology used for the modelling in this report. The modelling uses the PPI's suite of economic models that were developed with funding from the Nuffield Foundation, comprising of:

- The Individual Model
- The Aggregate Model
- The Distributional Model

General assumptions

The PPI suite of models use a wide range of assumptions, covering economic assumptions (such as price inflation and earnings growth), pension assumptions (such as the level of opt out from auto-enrolment, the shift from Defined Benefit to Defined Contribution). The main assumptions used in this research are:

- Population projections in line with the ONS 2008-based principle projections.
- Short-term (to 2016) assumptions for earnings growth, CPI and RPI in line with the Office for Budget Responsibility projections for the 2011 Budget.[79]
- Long-term earnings growth of 4.5% in nominal terms.
- Long-term CPI inflation of 2%.
- Long-term RPI inflation of 2.87% (consistent with the CPI inflation).
- Long-term triple-lock indexation (the higher of earnings, CPI and 2.5%) of 4.76%.[80]
- Expected investment returns of 3.0% in excess of RPI, before charges corresponding to a mixed equity/bond fund.
- The proportion of employees who are active members of private sector DB schemes is assumed to fall by 80% between 2006 and 2035 and remain constant thereafter.

Policy assumptions

Further assumptions specific to the reform options being analysed are as follows:

Option 1

Accelerated flat-rating of State Second Pension accruals is achieved through lowering the Upper Accrual Point linearly from 2013 to merge with the Lower Earnings Threshold in 2020.

[79] OBR (2011)

[80] An analysis of a combined triple-lock index over a full economic cycle between 1993 and 2009 suggests that on average the triple-lock would have grown by around 0.26% more than average earnings over this period. It is therefore assumed that the triple-lock is equivalent to a nominal growth rate of 4.76%.

Option 2

The single-tier flat-rate pension is set at £140 per week in 2010 earnings terms and introduced to pensioners reaching SPA in or after 2016. Following introduction, the single-tier pension is uprated in-line with the triple-lock index. S2P accruals, and hence contracting-out, also cease from 2016.

Individuals reaching SPA in 2016 and beyond that have BSP and S2P/SERPs entitlement accrued before 2016 above the level of the single-tier are paid an excess amount to match their entitlement under current policy. This amount is calculated at SPA as single-tier entitlement minus total state pension entitlement under current policy and uprated in subsequent years in-line with CPI.

Contributions to Defined Benefit Schemes have been reduced to reflect the loss of the contracting-out rebate. This is also reflected by a corresponding reduction in benefits in payment to individuals that have contributed since the abolition of S2P.

Savings Credit is abolished for pensioners receiving the single-tier pension. In accordance with this, the threshold for receipt of Housing and Council Tax Benefit for pensioners is reduced by the maximum amount of Savings Credit that could otherwise have been received in that year.

Individual modelling

The PPI's individual model uses individual characteristics and working patterns to project retirement income from private pensions, state pensions and other benefits for hypothetical individuals. Detailed assumptions are made concerning:

- Individual characteristics, for example, age and whether they are earning or saving in each particular year.
- Past and future parameters to the pension system, for example, how the parameters for state pensions will change in future.

Descriptions of the assumptions made for each hypothetical individual used in this report are available in Chapter 1.

Aggregate modelling

The Aggregate Model projects long-term state expenditure on pensions and contracted-out rebates, aggregate income from the private pensions system and the annual fiscal cost of tax relief.

The starting point for this projection is a set of official projections of the future number of people in the UK by age and sex. This is broken down further by employment status using a projection of future employment rates, which are in turn based on an official projection of activity rates. Finally, an earnings distribution is superimposed, which is based on an anonymised 1% sample of National Insurance records supplied by the Department of Work and Pensions.

Based on this labour market projection, the model projects future state expenditure on SERPS, State Second Pension, and contracted-out rebates, as well as contributions to and income from private pensions. Future state expenditure on Basic State Pension is projected using data supplied by the Department for Work and Pensions.

Distributional modelling

The Distributional Model projects forward the distribution of incomes for people over State Pension Age. Types of income modelled include state and private pensions, earnings, income from investments and state means-tested benefits.

The Distributional Model is a static microsimulation model, similar to the Policy Simulation Model used within the Department of Work and Pensions. It uses a sample of around 8,000 UK pensioner units (either single pensioners, or couples), from the Pensioners' Incomes Series 2007/08 dataset.

Each year, the incomes of the individuals in the dataset are adjusted in line with the Aggregate Model to take account of future changes in income, after which the Distributional Model calculates income tax liability and entitlement to means-tested benefits. The individuals are reweighted to take account of future demographic changes, ensuring that projections from the Distributional Model are consistent with those from the Aggregate Model.

Household net equivalised incomes

In this report, where specified, the income distributions under different policy scenarios have been presented using household net equivalised incomes. In order to obtain these from Distributional Model pensioner unit incomes, firstly incomes for multi-pensioner unit households were added together. The Households Below Average Income 2007/08 dataset was used to derive net income from non-pensioners to be added to corresponding households. For future years, net income from non-pensioners is assumed to grow in-line with average earnings.

To recognise that households of different sizes require different incomes in order to achieve a particular standard of living, it is necessary to adjust net household incomes using a method called 'equivalisation'. This involves multiplying incomes by a scaling factor so that they are comparable to a standard household size, in this case, a couple with no children. The results in this project were calculated using the OECD equivalence scales.[81]

[81] For a more detailed description of the equivalisation methodology, see appendix 2 of DWP (2007)

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