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A Foundation Pension: A PPI evaluation of NAPF proposals

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NAPF

Securing the future of pensions

The analysis in this paper was completed in March 2010, before the General Election and the formation of the Coalition Government. The spending projections under the current system refer to the system that was legislated for by the Labour Government. The report, however, highlights a number of policy areas where the Coalition Government has announced new policies and, where possible, gives an indication of the likely impact of these polices on these proposals. Overall, the costs of the proposals in the report remain broadly the same after considering the impact of the Coalition Government's proposals. This is explained in more detail in the text of this report.

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A Foundation Pensions: A PPI evaluation of NAPF proposals

Introduction

The National Association of Pension Funds has proposed reform of the state pension into a simple 'Foundation Pension'. The NAPF believes this would have significant advantages over the current system, which has been characterised as overly complicated by many pensions commentators.

The role of the PPI is not to make policy recommendations, but to provide an independent evidence base to allow policy makers to assess alternative policies. This report provides an independent, evidence-based assessment of the NAPF proposals.

The Foundation Pension, as proposed by the NAPF, is a flat-rate benefit given to everyone of pension age, regardless of income or wealth, on a simplified contributory basis. This structure has been proposed to avoid the disincentives to save inherent in the means-tested environment, and aims to reduce pensioner poverty.

This report considers three possible levels of a Foundation Pension and provides estimates of the financial costs of each and analyses ways of making the system more affordable in the UK. The three possible levels of Foundation Pension, to be introduced in 2017, that are considered are:

- Foundation Pension at the Guarantee Credit level (£7,066 in 2010 earnings terms)
- Foundation Pension at £8,000 (in 2010 earnings terms)
- Foundation Pension at £10,000 (in 2010 earnings terms)

Chapter one describes how the Foundation Pension works and what the benefits of this approach might be.

Chapter two uses hypothetical case studies to explore how individuals of different income levels could be affected by the reforms to state pension.

Chapter three gives an overview of the financial costs of each Foundation Pension level.

Chapter four looks at the implications of increasing the State Pension Age (SPA) and increasing National Insurance contributions as a way meeting the cost of the Foundation Pension, and how these changes might affect individuals.

Chapter five examines the Foundation Pension introduced at £8,000 in 2010 earnings terms in more detail, looking at how the change could impact on the provision of means-tested benefits.

Chapter six examines the transition to the Foundation Pension.

Summary of Conclusions

The Foundation Pension is a simple, single pension payable from state pension age.

The current pension system in the UK was regarded by the Pensions Commission in 2005 as 'the most complex in the world'. The Foundation Pension is a single pension combining the current Basic State Pension and State Second Pension, payable to every individual over state pension age if they have accumulated at least 30 years of National Insurance contributions. This means that it is more likely that people will be able to understand what they will receive from the state pension. Once the Foundation Pension has been introduced, individuals would no longer accrue S2P entitlement, or the contracted-out equivalent. Guarantee and Savings Credit would be needed by fewer people, depending on the level of the Foundation Pension. NAPF has proposed introducing a Foundation Pension worth £8,000 a year (in 2010 earnings terms) in 2017.

The Foundation Pension provides more equal outcomes to everyone, especially women and carers

In the past few years, the current state pension system has been reformed to make the state pension system fairer to everyone. In the past many women or carers failed to qualify for a full Basic State Pension due to taking time out of the labour market for caring responsibilities. Changes in the Pensions Act 2007 will make it easier for carers and women to qualify for a full Basic State Pension.

Despite recent reforms to the current state pension system, women, carers and people in a low income group are still likely to get less from the state pension than others because of the different qualification criteria and indexation policies for S2P and BSP. The Foundation Pension is wholly based on the broader qualification criteria for BSP and so more people would be eligible for the full Foundation Pension.

The Foundation Pension could help to reduce pensioner poverty

Pension Credit has been an effective tool in reducing pensioner poverty; however, there is some debate as to whether the Guarantee Credit level is high enough. Pensioners are also required to 'claim' Pension Credit and currently around 20% of pensioners who are eligible for Pension Credit do not claim it.

Introducing the Foundation Pension in 2017 at £8,000 per year (in 2010 earnings terms) could see pensioners in the lowest 25% of the income distribution improve their income by 27% by 2030 compared to the current system. The Foundation Pension at £8,000 per year could take around 2 million pensioners out of means-testing by 2050. Under the current system, by 2050 around 45% of pensioner households could be eligible for pension credit. Under the Foundation Pension system at £8,000 (in 2010 earnings terms) this could reduce to 25%.

The Foundation Pension would increase state spending and may require other changes in policy to help offset the costs involved

The analysis in this paper was completed in March 2010, before the General Election and the introduction of the Coalition Government. Therefore, the spending projections under the current system refer to the system that was set in place by the Labour Government. Overall, the costs of the proposals in the report remain broadly the same after considering the impact of the Coalition Government's proposed changes.

Any pension system that provides a more generous benefit to pensioners will be more expensive to provide. For this report we have assumed that the Foundation Pension would be introduced overnight in 2017 at £8,000 per year, in 2010 earnings terms. This could cost an extra £25bn per year in 2017 (in 2010 earnings terms) compared to the current state pension system. This is approximately 1.5% of GDP. By 2050, the extra cost of introducing a Foundation Pension in 2017 at £8,000 per year in 2010 earnings terms could be £17bn per year (in 2010 earnings terms) or 0.9% of GDP.

If the Foundation Pension was introduced at the Guarantee Credit level, this could cost an extra £17bn per year in 2017 (1.0% of GDP), or an extra £45bn per year in 2017 (2.7% of GDP) if it was introduced at £10,000 per year.

The NAPF has proposed a number of different funding options to bridge the gap between the projected level of spending under the current state pension system and the projected level of spending under the Foundation Pension system. These options include:

- Increasing the State Pension Age
- Increasing National Insurance contributions for employers and employees
- Extra revenue from Contracted-Out Rebates from the removal of contracting-out of S2P.

Summary Table: Overall additional Government Expenditure from introducing a Foundation Pension at £8,000 (2010 earnings terms) allowing for different funding options, £ bn (2010 earnings terms), and % GDP

	2017	2030	2050
Additional cost of introducing a Foundation Pension at £8,000 (2010 earnings terms)	£25bn (1.5% GDP)	£21bn (1.2% GDP)	£17bn (0.9%GDP)
FP and faster increases in SPA, reaching 70 by 2046	£25bn (1.5% GDP)	£13bn (0.8% GDP)	£3bn (0.2% GDP)
FP and 1% increase in NI for employers and employees	£14bn (0.8% GDP)	£9bn (0.5% GDP)	£4bn (0.2% GDP)
FP and extra revenue from contracting-out	£17bn (1.0% GDP)	£16bn (0.9% GDP)	£13bn (0.7% GDP)
FP and faster increases in SPA AND 1% increase in NI for employers and employees AND extra revenue from contracting-out	£6bn (0.3% GDP)	-£5bn (-0.3% GDP)	-£17bn (-0.9% GDP)

The SPA is currently legislated to increase from 65 to 68 for men and women between 2024 and 2046. If the rate of increase of SPA were to double, i.e. the SPA reaches 70 by 2046, the cost to the Government of introducing the Foundation Pension at £8,000 per year in 2010 earnings terms in 2030 would be an extra £14bn (0.8% GDP), rather than an extra £21bn (1.2% GDP) without the change. By 2050 the additional cost of introducing the Foundation Pension would be an extra £3bn (0.2% GDP), rather than an extra £17bn (0.9% GDP) without the change.

The National Insurance contributions for employers and employees could be increased to help offset the higher state spending on the Foundation Pension. The following scenarios have been proposed by the NAPF:

- Increase the NI contribution rate between the Primary Threshold (PT) and the Upper Earnings Limit (UEL) from 11% to 12% for employees, and increase the contribution rate above the UEL from 1% to 2% for employees; or
- Increase the contribution rate from 12.8% to 13.8% for employers.

If both employee and employer contributions were increased by 1% in 2017, to coincide with the introduction of the Foundation Pension at £8,000 per year, and the additional revenue was used to fund the introduction of the Foundation Pension, the additional cost of the Foundation Pension could be reduced to an extra £14bn (0.8% GDP) in 2017 rather than £25bn (1.5% GDP) without the change, £9bn (0.5% GDP) in 2030 and £4bn (0.2%) in 2050.

The introduction of a Foundation Pension would result in the end of the State Second Pension (S2P) and therefore, the ability to contract-out of S2P. By then, contracting-out for DC schemes will already have ended and if current trends continue relatively few DB schemes would be contracted-out in the private sector. However this still provides a small amount of extra revenue (£8bn, 0.5% of GDP in 2017) as all employers and employees would need to pay the full level of National Insurance contributions.

If the State Pension Age, National Insurance Contribution and contracting-out changes are all introduced alongside a Foundation Pension, the additional extra cost in 2017 would be reduced to £6bn (0.3% of GDP). By 2030 there would be a net saving compared to the current system of £3bn (0.2% GDP), and by 2050 a net saving of £14bn (0.7% GDP).

The transition to the Foundation Pension is a complicated process

The transition to a Foundation Pension is complex, mainly due to the interaction with contracted-out pensions, though it is not necessarily any more complicated than the current system. The transition to a Foundation Pension could take a long time, although by 2031, 95% of pensioners could be receiving a state pension at the Foundation Pension level. However, it would take much longer for the remaining contracted-out pensions to cease payment.

Chapter one: what is a Foundation Pension and how would it work?

The National Association of Pension Funds has proposed reform of the state pension into a simple 'Foundation Pension'. This chapter describes the concept of a Foundation Pension and looks at how it might work and what the benefits of this approach might be.

The state pension reform option considered in this report is the introduction of combining the reformed Basic State Pension (BSP) and the reformed Second State Pension (S2P) (referred to as a 'Foundation Pension'), which would be flat-rate and would provide a pension of:

- The Guarantee Credit level (£7,060 per year in 2010);
- The level of a 'full' BSP and S2P once the Labour Government reform package has been fully implemented in 2050, (approximately 25% of average earnings or £8,000 in 2010 earnings terms); or
- Around £10,000 in 2010 earnings terms

The Foundation Pension (FP) would be:

- Paid on an individual basis to every individual over State Pension Age.[1]
- Qualification for the FP would be based on the same qualification criteria as the reformed BSP[2] i.e. individuals who have at least 30 years NI contributions would receive a full FP.
- Those who do not have 30 years NI contributions would receive a proportion of the FP in line with the amount of NI contribution years that they have accumulated.
- Future accrual to S2P and contracting-out would stop after the Foundation pension is introduced in 2017. However, people who have already accrued rights to SERPS/S2P would still retain their previous entitlements.
- The FP would be paid to people whose BSP and S2P[3] was lower than the new FP level, in the form of a top-up. Any individual who had a BSP and S2P entitlement of more than the FP level would continue to receive BSP and S2P.
- FP would be increased each year in line with earnings, so would increase relative to BSP and S2P in payment, and over time increase above the maximum possible combined BSP and S2P.
- Once the FP level is above the maximum possible combined BSP and S2P everyone receives the FP.
- The FP would be introduced 'overnight' in 2017.
- Once the FP is introduced there would be no future accrual of S2P, and no further contracting-out.

[1] Increasing as legislated in the Pensions Act 2008
[2] The aim is to get near universal coverage. The costing in this paper assumes that almost everyone is entitled to receive the Foundation Pension.
[3] S2P here also includes entitlement to other earnings related state pensions such as SERPS and Graduated Retirement Pension

- The S2P entitlement used to compare against the FP level would be gross S2P – that is before any deduction for contracting-out has been made. This ensures equal treatment for people who have been contracted-out of SERPS and S2P and those who remained contracted-in.

Chart 1[4]

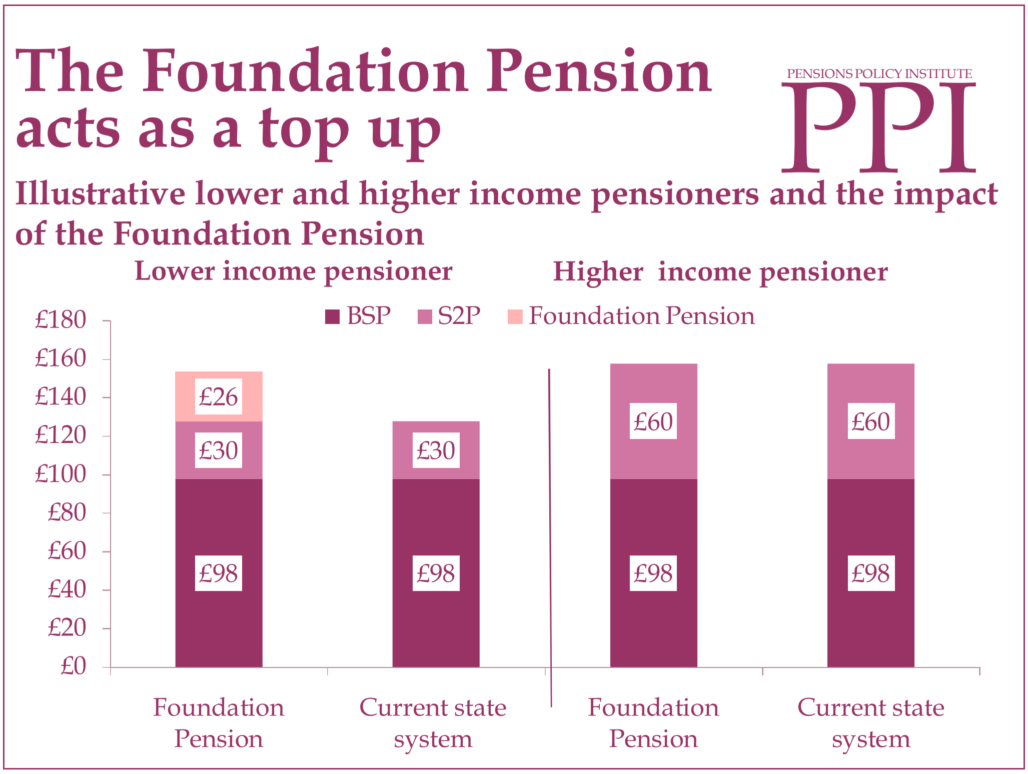


Chart 1 demonstrates how the Foundation Pension would work for an individual whose state pension income is below the proposed Foundation Pension level of £154 per week. The lower income pensioner in this illustration would receive £128 per week under the current system so would receive an extra £26 per week to bring them up to the Foundation Pension level.

The higher income pensioner receives £158 per week under the current system which is more than the £154 per week Foundation Pension, so continues to receive this amount and does not get a Foundation Pension top-up.

The Foundation Pension could be simpler and easier to understand than the current system

One reason given for introducing a Foundation Pension is simplicity. The current contributory system is defined by over 30 parameters[5], and with Pension Credit, this is over 100. In contrast, the Foundation Pension is much simpler and can be defined by just three – the level of benefit, the number of years of National Insurance contributions, and the state pension age.

[4] PPI Modelling
[5] Examples of the parameters defining the current contributory system include: the level of four basic state pensions (A-D); earnings level is needed for S2P; as well as three accrual rates for different slices of earnings

Much of the simplification from introducing a Foundation Pension comes from having just one state pension and ending contracting-out of the State Second Pension. This means that the administration of state benefits and occupational pensions (following the ending of contracting-out) becomes simpler and more efficient.

Box 1: The Foundation Pension could be easier to administer[6]

A Foundation Pension that does not include contracting-out would be easier and cheaper to administer than the current system which includes means-tested benefits and contracting-out.

- The reduction in Pension Credit payments would be one source of savings to administration costs. Calculating eligibility for and paying means-tested benefits is expensive. The annual cost of administering a means-tested benefit for 1 year has been estimated as being 10 times more expensive than paying a contributory state pension.
- Ending contracting-out would also mean that the Government systems which administer the contracting-out could be discontinued, potentially making large cost savings.

Given the lack of data to quantify the savings to administration costs which would be possible with a Foundation Pension, none have been taken into account in calculating cost estimates.

It would potentially be easier under a Foundation Pension than under the current system for individuals to know how much income they can expect from the state, and to know whether or not they might benefit from private saving, because:

- Individuals would find it easier to calculate the single pension level, and would not need to work out their S2P entitlement and then add it to their BSP entitlement.
- Individuals would be less likely to be eligible for means-tested benefits in retirement.

A further simplification arising from the Foundation pension is that all working age individuals can qualify, irrespective of their working status, e.g. the self-employed. Currently, different groups can qualify for different parts of the state pension.

More people would qualify for a full pension

In the past few years, the current state pension system has been reformed to make the state pension system fairer to everyone. Home Responsibilities Protection (HRP) was introduced in 1978, but after the Pensions Act 2007 it was replaced with parents and carers credits and now constitutes a contribution to a qualifying year for the BSP. Protection can be given for those complete tax years where an individual is caring for children or a disabled person.

[6] As reported in evidence by the Department for Work and Pensions reproduced in the House of Commons Committee of Public Accounts (2003)

Changes in the Pensions Act 2007 also mean that from April 2010 both men and women will only need 30 qualifying years of National Insurance contributions to be eligible for the full Basic State Pension (reduced from 44 for men and 39 for women). The Pensions Act also abolishes the 25% minimum contribution threshold, meaning that people reaching SPA after April 2010 will receive a proportion of the BSP for every contributing year. Previously individuals with less than 25% of the required contributions did not receive any BSP.

Despite recent reforms to the current state pension system, women, carers and people in a low income group are still likely to get less from the state pension than others because of the different qualification criteria and indexation policies for S2P and BSP. The Foundation Pension is wholly based on the broader qualification criteria for BSP and so more people would be eligible for the full pension.

A Foundation Pension would especially benefit those who do not currently qualify for S2P

The introduction of a Foundation Pension would potentially be of great benefit to certain groups who currently build up low state pension entitlements. One of these groups is the self-employed.

The self-employed pay lower National Insurance contributions than employees but only build up entitlement to the BSP, not S2P (and previously SERPS).

However, under the Foundation Pension, people who had been self-employed would receive the same state pension as those who had been employed because entitlement for the entire state pension is the same as for the current BSP.

Other groups who currently do not qualify for S2P in any particular year would be affected in a similar way, including:

- Individuals who care for children older than age 12
- Individuals caring for those with disabilities, but caring less than 20 hours per week
- Individuals working but earning less than the lower earnings limit.

Currently approximately 25% of the working age population do not qualify for S2P in any single year[7].

[7] PPI (2008)

Women who paid reduced-rate National Insurance contributions would not benefit under a Foundation Pension

One group who would not be affected would be those women who had opted to pay reduced-rate National Insurance contributions. As eligibility to the Foundation Pension is based on the same qualification criteria as for the BSP, and women paying reduced-rate NI contributions do not accrue qualifying years for BSP, they would also not accrue qualifying years for the Foundation Pension. This group could be included in a Foundation Pension if the credit system were to be widened.

Box 2: Is the Foundation Pension fair to all?

The change in qualification conditions implicit in the Foundation Pension has implications for the perceived fairness of the new system. However, fairness is often a subjective concept.

While some may see a simplified system that gives a flat-rate amount to all those who contribute (in the broad sense of qualification to the current BSP) as a good thing, others would see the fact that the self-employed receive the same benefit as employees, but make a smaller total National Insurance contribution, as unfair. Adjusting NI contributions for the self-employed could overcome this, but could raise wider issues about the balance of the NI system.

The concept of the contributory state pension system has already been diluted by the reforms in the 2007 Pensions Act which reduced the number of qualifying years needed and extended the qualification for positive credits to BSP and S2P. In this light, the Foundation Pension could be seen as a continuation along the same path.

However, it is likely that introducing a Foundation Pension would at least raise further questions about the level of National Insurance contributions currently paid by the Self-Employed.

Conclusion

The Foundation Pension would be a flat-rate pension, linked to National Insurance contributions, and paid on an individual basis to every individual over State Pension Age and could provide a pension of £8,000 per year when introduced in 2017. As a result of the introduction of the Foundation Pension, no individual receives less than they have already accrued from the Basic State Pension and State Second Pension.

The next chapter looks at how the Foundation Pension may affect particular types of individuals.

Chapter two: how would a Foundation Pension affect individuals?

This chapter uses hypothetical case studies to explore how individuals' and couples' income may be affected by the introduction of the Foundation Pension. For the purposes of modelling the hypothetical individuals and couples, we have assumed that the Foundation Pension would be introduced at the £8,000 per year level in 2010 earnings terms.

Uses and limitations of hypothetical case study analysis

Hypothetical case studies are a useful way of looking at the income that certain individuals may receive; however, they should not be used as a prediction for how any particular income group will fare in the future. Each hypothetical individual has a specific life and working history, and the experiences of an individual in the future may be very different from those modelled here. In particular, the examples modelled in this chapter have good contribution records to both BSP and S2P, and in many cases with private saving. As Chapter one explains, individuals who would not qualify for S2P may be more likely to benefit from the Foundation Pension.

The assumptions used in these case studies reflect expectations of the implementation of the Foundation Pension. However, the state and private pensions landscape may experience changes in the future that are not accounted for here.

How much income do pensioners need?

Measurements of income needs in retirement can be based on basic need assessments or desired income levels[8]. For many people in retirement, satisfaction from income is related to whether they are able to achieve the same, or a similar standard of living to the one which they experienced during their working life.[9]

Box 3: Some pensioners can replicate working-life living standards with a 'desired replacement rate' of income in retirement

The majority of people feel that in order to be satisfied with their level of income in retirement, their income will need to provide them with a standard of living similar to the standard they experienced in their working life. Most pensioners can achieve a similar standard of living with an income in retirement of between 50% and 80% of their (gross) working life income.[10]

[8] PPI (2009)
[9] Pensions Commission (2004)
[10] Pensions Commission (2004)

Each individual's income during their life course can be compared to the desired replacement rates suggested by the Pensions Commission (Table 1). This is a usual way of analysing the adequacy of state and private pensions for each individual.

Table 1: Desired replacement rates for hypothetical individuals

Individual	Income in working life per week	Percentile of earnings[11]	Replacement rate	Replacement income per week
Low-earning woman	£300	30th	70%	£210
Median-earning man	£460	50th	67%	£310
High-earning man	£1,115	90th	50%	£558

Low earners retiring in 2020 are likely to receive more income from the Foundation Pension than under the current system

Under the Foundation Pension system, many low earners could receive more money from state pensions.

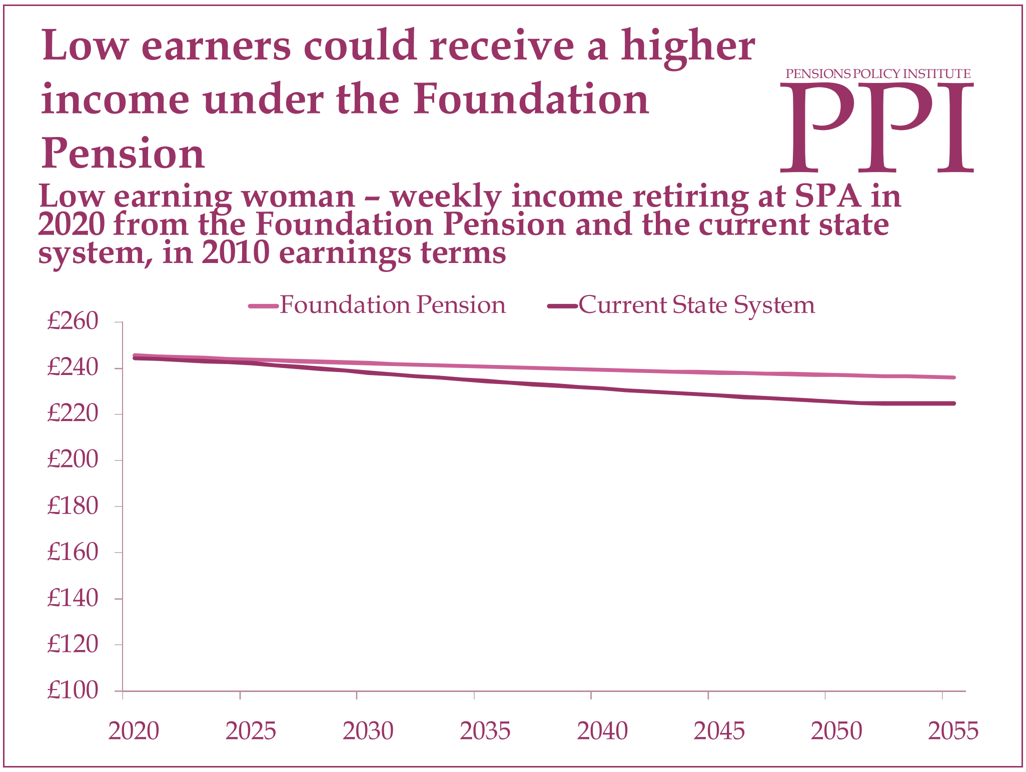
Individual 1: a low-earning woman age 65 in 2020

- She starts working full time from age 18 in 1973
- She works until age 65 in 2020 earning low age-specific earnings for women
- She has no private pension saving
- She is a tenant with no housing wealth and receives Housing Benefit in retirement

This low-earning woman's weekly income in working life, at the point of retirement is £300[12] per week in 2010 earnings terms. She would need a gross weekly income of £210 per week to meet her 70% replacement rate.

[11] Labour Force Survey 2007 data
[12] 30th percentile, age-specific earnings, PPI calculations based on Labour Force Survey (2008)

Chart 2[13]



If it is assumed that she retires with no private pension or other savings, she could receive a gross weekly income from Foundation Pension and state benefits of around £245 in 2010 earnings terms, compared to the £244 in 2010 earnings terms she would receive under the current reforms. Of this, she receives around £66 per week in 2010 earnings terms from Housing Benefit, £14 per week from Council Tax Benefit and some benefit in the form of Savings Credit.

By 2050 she could receive around £237 per week from the Foundation Pension and means-tested benefits. She could receive around £225 per week from the current state system, so later in retirement a low earner could be better off under the Foundation Pension.

In this scenario she would exceed her desired replacement rate of £210 per week throughout her retirement in both options. Foundation Pension and state benefits increase in line with earnings, so she will have a higher income under the Foundation Pension system.

Median earners retiring in 2020 do not gain immediately from the Foundation Pension but gain eventually

Some median earners may not receive more income from the Foundation Pension than they would under the current state system until much later into retirement.

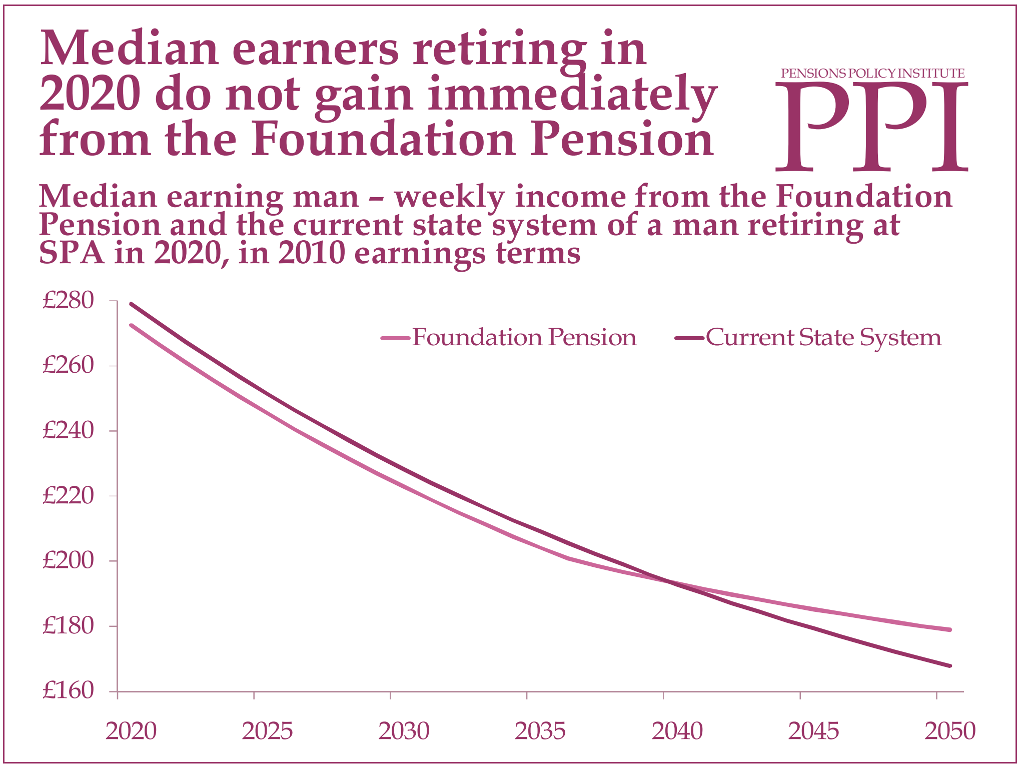
[13] PPI Modelling

Individual 2: a median earning man age 65 in 2020

- He works full time from age 21 in 1976
- He works until age 65 in 2020 earning median age-specific earnings for men
- Between the ages of 30 and 65 he and his employer contribute 8% of earnings into a DC occupational pension scheme
- He buys a level annuity at retirement
- He reaches SPA with about £8,000 in savings[14]

This median-earning man's weekly income in working life, at the point of retirement is £460[15] per week in 2010 earnings terms. He would need a gross weekly income of around £310 per week to meet his 67% replacement rate.

Chart 3[16]



If it is assumed that he retires with a private pension from 8% contributions, throughout his working life, buying a level annuity, and £8,000 of other savings, he could receive a gross weekly income from state pension of around £176 in 2010 earnings terms and a weekly income from private pension and savings of around £96 in 2010 earnings terms. In this scenario his total income of £272 per week would not exceed his desired replacement rate of £310 per week.

[14] Based on 50th percentile of savings for pensioners calculated by PPI (data from Family Resources Survey 06/07 in DWP(2008)) inflated by earnings
[15] 50th percentile, age-specific earnings, PPI calculations based on Labour Force Survey (2008)
[16] PPI Modelling

At the start of retirement, he receives slightly more (£183 per week in 2010 earnings terms) under the current system. However, the Foundation Pension level increases in line with earnings and State Second Pension increases in line with prices. This means that the Foundation Pension level will exceed his entitlement in 2040 at age 85. At this point he will receive the Foundation Pension of £154 per week in 2010 earnings terms. By 2050, at age 95, he will receive £11 per week more from the Foundation Pension than he would from the current system.

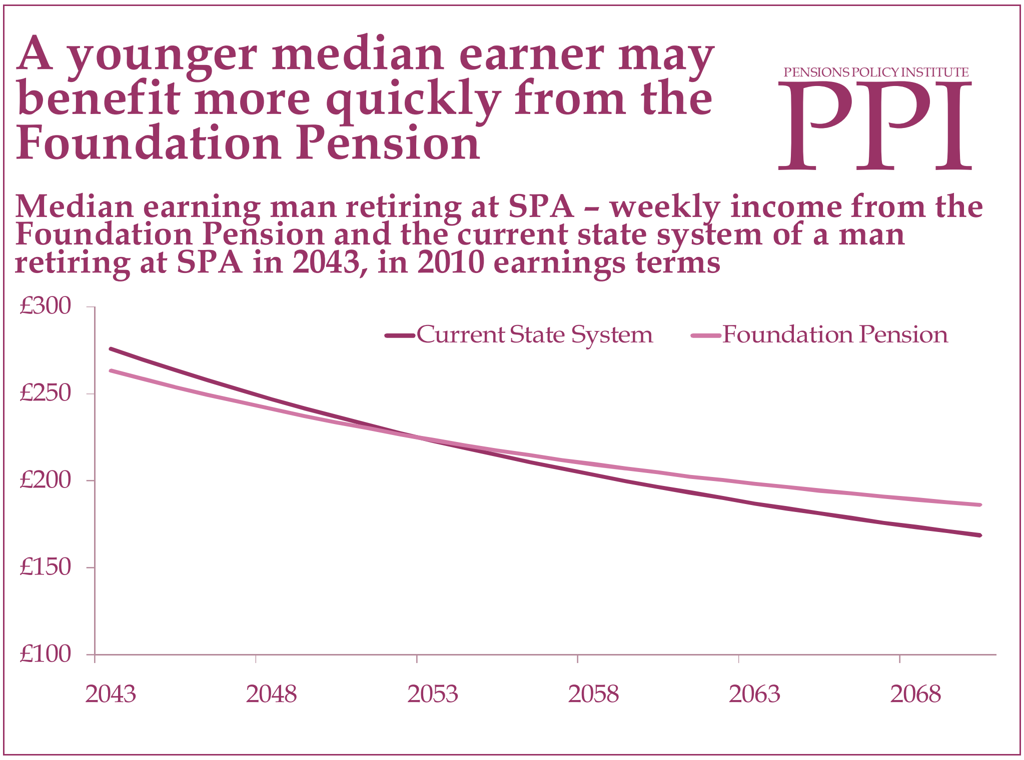
The private pension income from the level annuity continues to be eroded away in earnings terms, so by 2050 he will receive only £24 per week in 2010 earnings terms.

In 2050, he is well below his desired replacement rate of £310 per week under both systems.

In the future, median earners could receive more from the Foundation Pension than under the current system

This median-earning man has the same characteristics as Individual 2, except that he retires 23 years later, in 2043. His weekly income in working life, at the point of retirement is £460[17] per week in 2010 earnings terms. He would need a gross weekly income of around £310 per week to meet his 67% replacement rate.

Chart 4[18]



[17] 50th percentile, age-specific earnings, PPI calculations based on Labour Force Survey (2008)
[18] PPI Modelling

A younger median earner could receive less from the State Pension than a median earner retiring in 2020[19]. This younger median earner could receive £276 per week from the current state system. Therefore, a younger median earner could benefit from the introduction of the Foundation Pension more quickly than a median earner retiring in 2020. A median earner retiring in 2020 may have to wait 20 years before the Foundation Pension exceeds the benefit they could receive from the current state pension system; however, a median earner retiring in 2043 may only have to wait 10 years (Chart 4).

Some individuals would receive less from the Foundation Pension than they would from the current system if it had continued
Although no individual would receive less from the Foundation Pension than they would from their rights accrued in the BSP and SERP/S2P (and contracted-out equivalent) before 2017, some individuals could receive less from the Foundation Pension than they would if the current system had continued.

These would be individuals who would have spent part of their working life beyond 2017 earning above the earnings level at which S2P accrues at a flat rate. However, even in the current system the earnings above the flat-rate earnings level is decreasing year-on-year, and from approximately 2030, all S2P accruals will be flat rate.

Only those earning above the flat-rate S2P accrual rate between 2017 and 2030 would receive more under the current system. The maximum amount above the Foundation Pension that any individual could have received had the current system continued is £45 a week (£2,300 a year).

However, gains above the Foundation Pension would be eroded over time, as the Foundation Pension is increased in line with average earnings growth, whereas S2P in payment is increased in line with price growth.

Some high earners could lose out under a Foundation Pension because they would forfeit the opportunity to gain further S2P accruals
Some high earners may lose out on the opportunity to accrue future benefits as a result of the introduction of the Foundation Pension. People who retire after the introduction of the Foundation Pension lose the ability to accrue extra state pension from S2P after 2017. However, the value of the accrued S2P reduces quite quickly in earnings terms, so after 20 years of retirement these pensioners could become better off under the Foundation Pension.

Importantly, pensioners are not losing anything that they have already earned; instead, they are losing the ability to accrue further S2P benefits.

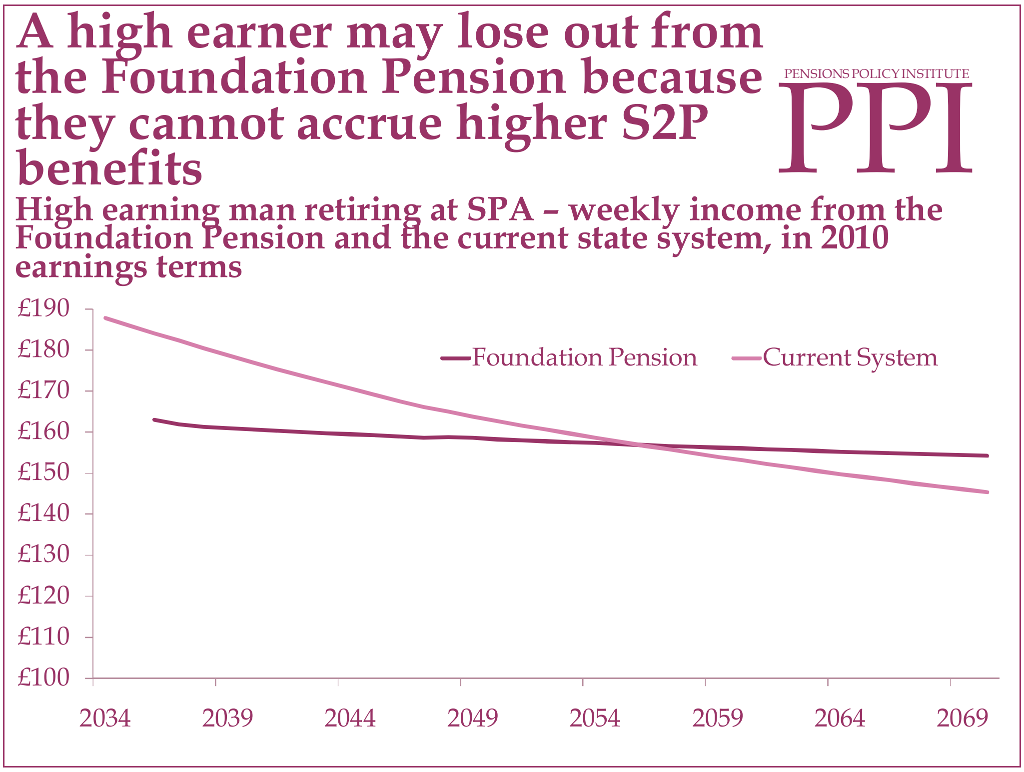
[19] This is as a result of S2P becoming more flat-rate by 2030

Individual 3: a high earning man age 66 in 2034

- He works full time from age 22 in 1989
- He works until age 66 in 2034 earning 90th percentile age-specific earnings for men under the current system
- Under the Foundation pension system he works until age 68 in 2036

This high-earning man's weekly income in working life, at the point of retirement is £1,115[20] per week in 2010 earnings terms.

Chart 5[21]



Under the Foundation Pension system, this high-earning man would retire in 2036, at age 68. At this point he would receive £162 per week, in 2010 earnings terms. This is made up of:

- £156 per week in state pension
- £6 per week in savings credit

Under the current state pension system, this individual would reach State Pension Age in 2034, at age 66. If he retires at State Pension Age and claims his state pension he would receive £186 per week, in 2010 earnings terms, and by 2036 this would be reduced to £183 per week.

[20] 90th percentile, age-specific earnings, PPI calculations based on Labour Force Survey (2008)
[21] PPI Modelling

In 2060, after around 25 years of retirement, he would receive £154 per week from the Foundation Pension. At this point the Foundation Pension level would have overtaken what he would have been entitled to from the current state system, in earnings terms. Under the current system, in 2060 he would receive £149 per week in 2010 earnings terms.

A couple consisting of a low-earning woman and a median-earning man retiring in 2020 could benefit from the Foundation Pension

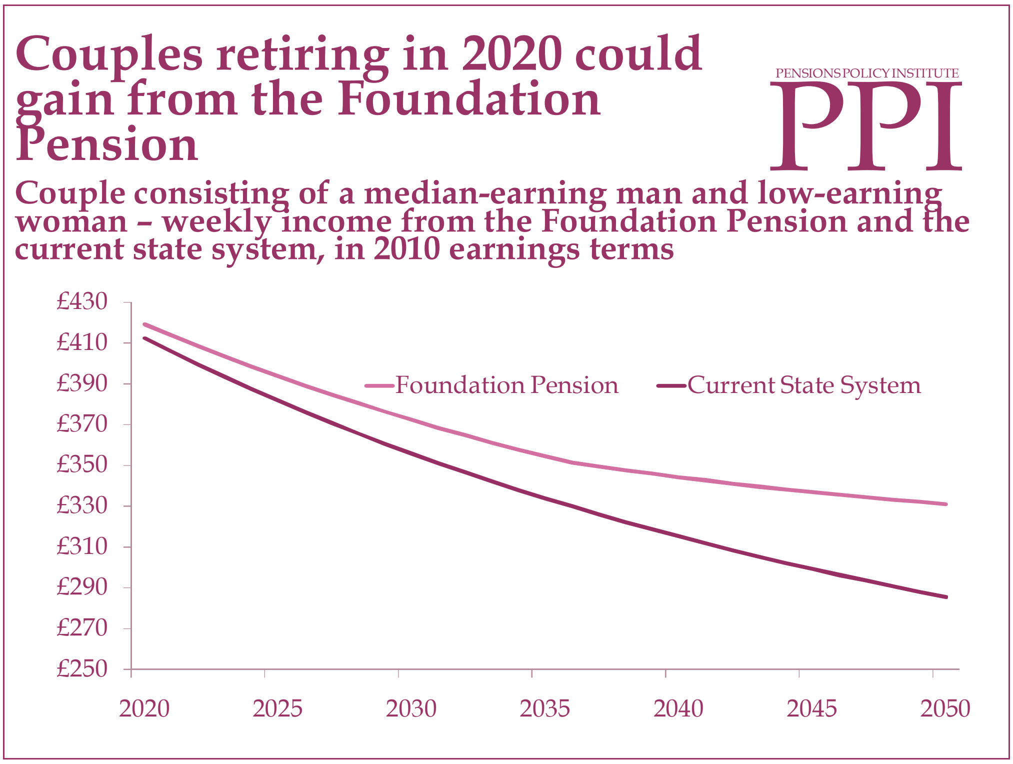
Under the Foundation Pension, the weekly income of a couple could increase. This is more likely to be the case if there is a low-earner in the couple. The Foundation Pension is paid on an individual basis; however, a low-earner may not receive means-tested benefits such as Housing Benefit and Council-Tax Benefit as a result of being in this couple. As the Foundation Pension is higher for a couple, they are less likely to receive means-tested benefits even though they are a low and median-earner.

Couple 1: a low-earning woman age 65 in 2020 and a median earning man age 65 in 2020[22]

- She starts working full time from age 18 in 1973
- She works until age 65 in 2020 earning low age-specific earnings for women
- She has no private pension saving
- He works full time from age 21 in 1976
- He works until age 65 in 2020 earning median age-specific earnings for men
- Between the ages of 30 and 65 he and his employer contribute 8% of earnings into a DC occupational pension scheme
- He buys a level annuity at retirement

[22] In this scenario we didn't include any savings he might have accumulated in his working life

Chart 6[23]



It is assumed that this couple is made up of a low-earning woman and a median earning man. They both retire in 2020 at age 65. The median-earning man has a private pension from 8% contributions throughout his working life and has purchased a level annuity. The low-earning woman has no private pension.

At the start of retirement, in 2020, the couple are entitled to £419 per week, in 2010 earning terms, from the Foundation Pension. This is made up of:

- £176 per week from the state pension for the median-earning man
- £154 per week from the state pension for the low-earning woman
- £89 per week in private pension

From the current system the couple would be entitled to £412 per week in 2010 earnings terms. This is made up of:

- £183 per week from the state pension for the median-earning man
- £140 per week from the state pension for the low-earning woman
- £89 per week in private pension

Chart 6 shows that the couple's combined income is higher throughout their retirement under the Foundation Pension system, and in particular towards the end of their retirement.

[23] PPI Modelling

The Foundation Pension could increase pensioner incomes across the income distribution

Hypothetical case studies are a useful way of looking at the income that certain individuals may receive; however, they should not be used as a prediction for how any particular income group will fare in the future. In particular, many individuals may have partial contribution or savings records.

Another way of illustrating the impact of introducing the Foundation Pension on individual pensioners and pensioner couples is to look at how pensioners in different parts of the income distribution would be affected.

Currently, the average amount of BSP received for all persons is £75.33 per week and the average State Second Pension received for all persons is £28.71 per week, including contracted-out deductions[24]. The average pensioner would need to claim around £29 per week in Guarantee Credit to bring them up to the current Guarantee Credit level of £133 per week.

Under the Foundation Pension, the average pensioner could receive £154 per week, in 2010 earnings terms, which is an increase of up to £1,100 per year extra in state pension as a result of the Foundation Pension.

Low and medium income single pensioners could benefit the most from the Foundation Pension[25]

Based on the pension income distribution for single pensioners, low and medium income pensioners could benefit the most from the introduction of the Foundation Pension.

Table 2: The income of single pensioners at different percentile points of the pensioner income distribution in 2010

	Low income (25th percentile)[26]	**Median**	**High income (75th percentile)**
State Pension Income	£92	£123	£164
Total Income	£170	£228	£309

Currently, a low income single pensioner receives around £170 per week in the form of total pension income. A median income single pensioner receives around £228 per week and a high income pensioner receives around £309 per week in total pension income (Table 2).

[24] Information provided by the DWP from a 5% sample of administrative records taken March 2008

[25] The PPI Distributional Model is used to analyse the income distributions of pensioners. Pensioner couples have not been modelled her (see Appendix 2 for explanation)

[26] The pensioner who has a higher income than a quarter of all single pensioners and a lower income than three-quarters of all single pensioners

Chart 7[27]

Low and medium income pensioners could benefit more from the Foundation Pension

Change in income for single pensioners in different parts of the income distribution from the introduction of the Foundation Pension, in 2010 earnings terms

	Current state pension system			Foundation Pension		
Total Income	25th percentile	median	75th percentile	25th percentile	median	75th percentile
2017	£166	£227	£320	+30%	+15%	+9%
2030	£163	£215	£295	+27%	+15%	+6%
2050	£149	£192	£253	+30%	+21%	+12%

By 2030, a low income pensioner (the 25th percentile) could receive £163 per week in total pension income (in 2010 earnings terms) under the current state system. A low income pensioner could benefit significantly from the introduction of the Foundation Pension and could be 27% better off in their total income.

The benefit of the Foundation Pension to low income pensioners could be even greater by 2050. A low income pensioner could receive £149 per week in total pension income (in 2010 earnings terms) under the current system. Under the Foundation Pension, a low income pensioner could get 30% extra in total income.

The Foundation Pension advantage could be lower for high income pensioners (the 75th percentile) in the future; however, their income could still be higher under the Foundation Pension system than under the current system.

By 2030, the total pension income for a high income pensioner under the current system could be £295 per week (in 2010 earnings terms). The total pension income of a high earner under the Foundation Pension could increase by 6% compared to the current state system.

[27] PPI Modelling

The current state system could become much less generous, in earnings terms, for high income pensioners by 2050. The total pension income for a high earner could be £253 per week (in 2010 earnings terms). Under the Foundation Pension, total pension income could be 12% higher for a high earning pensioner.

Conclusion

The introduction of the Foundation Pension could benefit many low-median income pensioners, and many pensioner couples, including those who do not currently qualify for S2P. However, some high earning individuals could be better off under the current system.

Low-median income individuals and couples stand to gain the most from the introduction of the Foundation Pension. In particular, most individuals and couples could be considerably better off in later retirement under the Foundation Pension than under the current system. By 2050, low income pensioners could receive 30% more in total pension income under the Foundation Pension than under the current state system. Median earners could receive 21% more in total pension income.

Chapter three: how much would introducing a Foundation Pension cost?

This chapter analyses three proposed possible levels of the Foundation Pension and gives an overview of the financial costs of each Foundation Pension level.

As discussed in Chapter one, the state pension reform option considered in this report is the introduction of combining the reformed Basic State Pension (BSP) and the reformed Second State Pension (S2P) (referred to as a 'Foundation Pension'), which would be flat-rate and would provide a pension of:

- The Pension Guarantee Credit level (£7,060 per year in 2010); or
- The level of a 'full' BSP and S2P once the Labour Government reform package has been fully implemented in 2050, (approximately 25% of average earnings or £8,000 in 2010 earnings terms); or
- Around £10,000 in 2010 earnings terms.

Spending on state pensions under the current reform system is expected to increase in the future. Currently, BSP, SERPS and S2P are all increased with price inflation; however, the recent Labour Government committed to increase BSP in line with earnings inflation in 2012 or by the end of the next parliament and the new Coalition Government has announced its intention to bring this forward to 2011.

Changes in the Pensions Act 2007 make qualification for BSP easier, which is also expected to increase spending on state pensions. Both men and women reaching SPA from April 2010 will only need 30 qualifying years of National Insurance Credits to be eligible for the full BSP. The Pensions Act also abolishes the 25% minimum contribution rule, meaning that people reaching SPA after April 2010 will receive a proportion of the full BSP for every contributing year.

This is represented by an increase in total spending on state pensions and related benefits from 4.9% of GDP in 2010 to 6.6% of GDP in 2050 (Table 3).

Table 3: Costs of State Pensions and related benefits under current reforms and the costs of introducing Foundation Pension at £8,000 in 2010 earnings terms (the level of a 'full' BSP and S2P in 2050) in 2017 (£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
Spending on State Pensions and related benefits	77	89	93	111	122	123
% GDP	4.9%	5.5%	5.7%	6.5%	6.9%	6.6%
Extra spending on State Pensions and related benefits after the introduction of the Foundation Pension	0	+25	+23	+21	+20	+17
Extra Spending as a % GDP	+0%	+1.5%	+1.4%	+1.2%	+1.1%	+0.9%

Costs of pension reform

The introduction of the Foundation Pension would increase costs by raising the level of the state pension. This would be offset by:

- Including the value of contracted-out benefits in the calculation of the Foundation Pension.
- Lower entitlements to means-tested benefits (Pension Credit, Housing Benefit and Council Tax Benefit).
- An increase in the amount of National Insurance contributions collected as contracting-out is ended.

Introducing the Foundation Pension at a level of £8,000 (in 2010 earnings terms) in 2017 could result in an immediate increase in state spending on pensions of £25bn (in 2010 earnings terms), or 1.5% of GDP compared to the projections based on the current system (Chart 8 and Table 3).

By 2050, the extra cost of the Foundation Pension could be £17bn (in 2010 earnings terms), or 0.9% of GDP.

Box 4: Potential changes to pension policy as a result of the General Election 2010

Date of introduction: The cost of introducing the Foundation Pension in 2017 (Table 3) assumes that the Basic State Pension will be re-linked to earnings growth inflation in 2012.As a result of the General Election 2010, the Coalition Government has committed to re-link BSP to earnings inflation in 2011. However, there will be little impact on the overall cost of the Foundation Pension as a result of this policy.

Indexation: The Coalition Government has proposed a 'triple-lock' guarantee so that BSP is increased by the higher of earnings inflation, price inflation or 2.5%. The impact of this change on the relative additional cost of the Foundation Pension will depend on the actual uprating figure used in 2011. Calculations by the DWP earlier this year[28] and used in the Liberal Democratic Party's manifesto[29] assumed that this new measure would not result in an extra cost as it would lead to BSP being increased by 2.5%, the same as under the previous uprating policy. The same assumption (BSP uprating of 2.5% in 2011) has been used in this report in the calculation of the costs of the current system and of the Foundation Pension. The Coalition Government's proposals on indexation are therefore unlikely to materially alter the cost of the Foundation Pension as set out in this report.

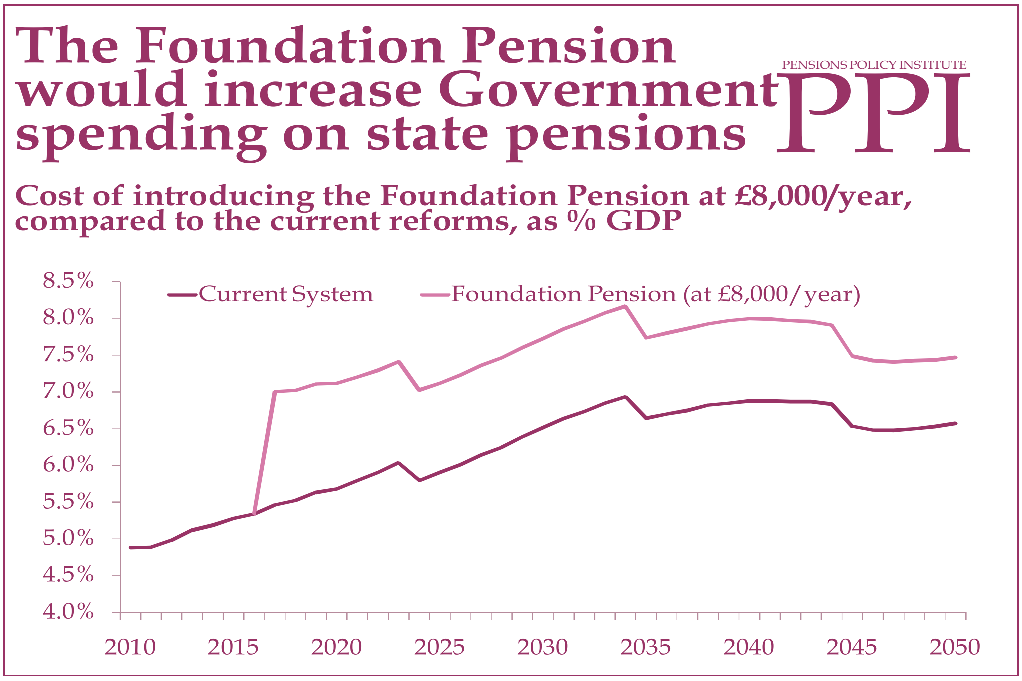
State Pension Age: The Coalition Government has also said it will review the timing of the proposed changes to the State Pension Age for both men and women. What these changes will be remains uncertain. Any additional or earlier increase in SPA will reduce the cost of the Foundation Pension as well as the costs of the current system. It is likely that the additional cost of introducing a Foundation Pension after a change in SPA would the similar, and potentially slightly lower, than those shown in this chapter.

The degree to which the cost of the Foundation Pension would differ from these estimates will depend on the precise proposals put forward by the Coalition Government. Chapter 4 shows the impact of introducing a higher SPA than those already proposed. PPI Briefing Notes 54 and 56 give more information about the potential impacts of bringing forward the first planned increases in SPA above 65.

By introducing the Foundation Pension at a level of £8,000 (in 2010 earnings terms) in 2017, spending on means-tested benefits falls by around £6bn (from around £14bn to around £8bn) per year (in 2010 earnings terms)[30]. The amount of means-tested benefits paid in the form of Guarantee Credit falls to almost zero from the introduction of the Foundation Pension at the Guarantee Credit level. However, it is not exactly zero because some pensioners with a severe disability or those who are carers are entitled to an additional amount above the Guarantee Credit level.

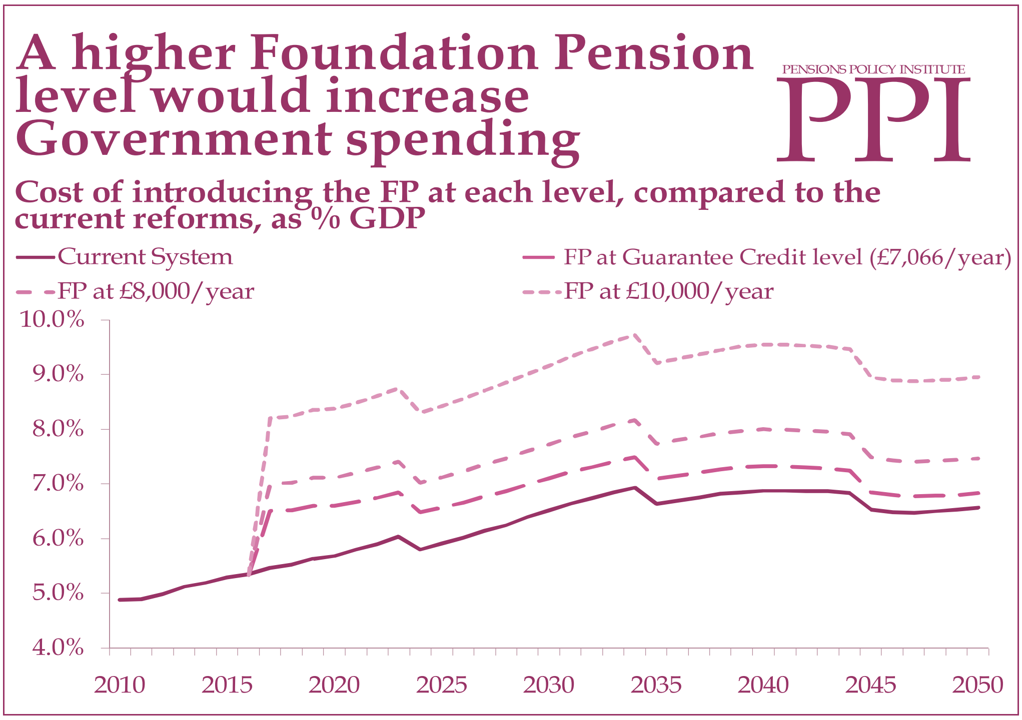
[28] Hansard: 13th Jan 2010, Column WA162
[29] Liberal Democrats manifesto (2010) page 101
[30] Full tables of costs of the current system and the Foundation pension are in Appendix 1

Chart 8[31]



The costs of introducing a Foundation pension relate to the level that it is set at. Chart 9 shows Government expenditure on state pensions at three different levels of the Foundation Pension compared to the current system.

Chart 9[32]



[31] PPI Modelling
[32] PPI Modelling

Introducing the Foundation Pension at the Guarantee Credit level in 2017 could result in an immediate increase in state spending on pensions of £17bn (in 2010 earnings terms), or 1% of GDP compared to the projections based on the current system (table 3). This increase is due to the top-up to the Foundation Pension level required by those who fall below it under the current system. Under the current system, SERPS and S2P will continue to be increased in line with price inflation in the future; however, the Foundation Pension will be increased in line with earnings inflation, making it more expensive.

By 2050, the extra cost of the Foundation Pension could be £5bn (in 2010 earnings terms), or 0.2% of GDP.

Introducing the Foundation Pension at a level of £10,000 (in 2010 earnings terms) in 2017 could result in an immediate increase in state spending on pensions of £45bn (in 2010 earnings terms), or 2.7% of GDP compared to the projections based on the current system (table 4). By 2050, the extra cost of the Foundation Pension could be £45bn (in 2010 earnings terms), or 2.4% of GDP.

Introducing the Foundation pension at £10,000 per year (in 2010 earnings terms) could result in almost no spending in the form of Pension Credit. The maximum level of Pension Credit for an individual is £9,700 per year in 2010 which is below the level of the Foundation Pension. Therefore, individuals who were eligible for the higher rate of Pension Credit because of disability or through caring would now receive more from the Foundation Pension. This is assuming that they qualify for the Foundation Pension. There may be some cases where people do not qualify for the full Foundation Pension and would still receive Pension Credit.

The amount of Housing Benefit or Council-Tax Benefit that can be received is linked to rent and council tax levels, so higher income pensioners may still be entitled to these benefits. So, although spending on both Housing Benefit and Council Tax Benefit could fall dramatically if the Foundation Pension was introduced at £10,000 per year, spending on means-tested benefits of this form are unlikely to ever completely fall to zero, regardless of the level of the state pension.

Table 4: Summary of the extra spending on state pensions and related benefits from introducing the FP at each of the three scenarios (as % GDP)

	2010	2017	2020	2030	2040	2050
As % GDP						
Current Reforms	4.9%	5.5%	5.7%	6.5%	6.9%	6.6%
FP at the Guarantee Credit level	0%	+1.0%	+0.9%	+0.6%	+0.4%	+0.2%
FP at £8,000 (in 2010 earnings terms)	0%	+1.5%	+1.4%	+1.2%	+1.1%	+0.9%
FP at £10,000 (in 2010 earnings terms)	0%	+2.7%	+2.7%	+2.7%	+2.7%	+2.4%
£bn, in 2010 earnings terms						
Current Reforms	77	89	93	111	122	123
FP at the Guarantee Credit level	0	+17	+15	+10	+8	+5
FP at £8,000 (in 2010 earnings terms)	0	+25	+23	+21	+20	+17
FP at £10,000 (in 2010 earnings terms)	0	+45	+44	+45	+48	+45

Table 4 shows that the additional costs of introducing the Foundation Pension overnight in 2017 would be substantial: £17bn at the Guarantee Credit level, £25bn at a Foundation Pension of £8,000 and £45bn at a Foundation Pension of £10,000, in 2017.

The additional costs are driven by two effects. The majority of the increased costs come about from increasing the pensions of pensioners who have already retired in 2017. In addition, there is a smaller additional cost from improving the pensions of future pensioners, who are of working age in 2017, but will retire at some point in the future.

An alternative approach to introducing the Foundation Pension overnight in 2017 for all current and future pensioners would be to introduce the change for future pensioners only.

Table 5: Extra spending on state pensions of introducing the Foundation Pension to future pensioners only compared to the cost of new pensioners under the current system (£ bn in 2010 earnings terms)[33]

	2017	2018	2019	2020	2030	2040	2050
Cost of paying future pensioners under current system	4	9	13	17	60	96	113
Extra cost of introducing the Foundation Pension in 2017, to future pensioners only							
Guarantee Credit level	+1	+1	+1	+2	+6	+8	+5
£8,000/year level	+1	+2	+3	+4	+13	+19	+18
£10,000/year level	+3	+5	+7	+8	+21	+30	+33

The cost of introducing the Foundation Pension in 2017 could be reduced by introducing the Foundation Pension to future pensioners who retire from 2017. However, the cost could build up relatively quickly.

In 2017 the additional cost of introducing the Foundation Pension at £8,000 per year for future pensioners (that is, 65 year-old men and 63 year-old women[34]) could be £1bn, in 2010 earnings terms (Table 5). However, by 2030 (13 years after the introduction) the additional cost could be £13bn, in 2010 earnings terms. By 2030, men aged 66 to 78 and women aged 66 to 76 would be eligible to receive the Foundation Pension. In the long term; the costs would be similar to those in Table 4.

Introducing the Foundation Pension to new pensioners only would reduce the costs in the short term; however, there are other consequences to introducing the Foundation Pension solely to new pensioners:

- The Foundation Pension may be less fair to some individuals. Pensioners who retire in the years leading up to the introduction of the Foundation Pension will not be entitled to receive the Foundation Pension, whereas pensioners who retire after 2017 will.
- Pensioner poverty is currently more severe at older ages, so those that are more likely to need the Foundation Pension top-up will not be eligible to receive it
- There would still be a reliance on means-tested benefits, especially for pensioners of older ages.

Contracting-out would still come to an end even if the Foundation Pension was only introduced for new pensioners, as there would still be no future accruals of State Second Pension.

[33] The figures in Table 5 do not include Council Tax Benefit and Housing Benefit as it has not been possible to include them in this analysis. However, we do not think this will affect the overall trend of the extra costs of introducing the Foundation Pension in 2017 to future pensioners only.
[34] The SPA in 2017 is currently 65 for men and 63 for women.

Chapter four: how could the costs of introducing the Foundation Pension be met?

This chapter looks at the implications of increasing the State Pension Age (SPA) and increasing National Insurance contributions as a way of paying for the Foundation Pension.

Potential for savings
It might be possible to introduce other measures to raise revenue or to reduce costs to help offset the higher state spending on the FP. These include:

- Increasing NI contributions for employers and employees
- Increasing the State Pension Age

Increasing NI contributions for employers and employees
Two scenarios have been suggested by the NAPF for increasing NI contributions for employers and employees.

Scenario 1:

- Increase the NI contribution rate between the Primary Threshold (PT) and the Upper Earnings Limit (UEL) from 11% to 12% for employees, and increase the contribution rate from 12.8% to 13.8% for employers. This scenario holds employee contributions above the UEL at 1%.

Scenario 2:

- Increase the contribution rate above the UEL from 1% to 2% for employees on top of the other increases in scenario 1.

Table 6: Extra revenue from increasing National Insurance contributions in 2017 (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Current NI levels	107	116	119	123	128	131
Scenario 1	0 (0%)	+10 (0.6%)	+10 (0.6%)	+10 (0.6%)	+10 (0.6%)	+11 (0.6%)
Scenario 2	0 (0%)	+11 (0.7%)	+11 (0.7%)	+12 (0.7%)	+12 (0.7%)	+13 (0.7%)

Scenario 1 could generate £10bn per year in 2017 (in 2010 earnings terms) in revenue to the Government. Scenario 2 could generate a further £1bn per year in 2017 (in 2010 earnings terms) (table 6).

The extra revenue generated from increasing National Insurance contributions is expected to stay relatively stable over time, in earnings terms. This is because the amount of tax payable is directly related to an individual's earnings. However, the revenue generated from increasing National Insurance contributions for employees above the UEL is expected to rise slightly in the future. The UEL is held constant in nominal terms, so over time, more and more people will find themselves above the UEL, and having to pay the extra 1% in National Insurance contributions.

Increasing the State Pension Age

Another cost savings scenario proposed by the NAPF is to increase the currently proposed level of State Pension Age up to age 70 by 2046.

The current SPA is age 60 for women and age 65 for men. Under the Labour Government's reforms, the SPA is already due to increase for women from 60 in 2010, reaching 65 by 2020. The Labour Government legislated for further increases in SPA for both men and women. The increases will happen in phases, the first phase being an increase in SPA from 65 to 66 between 2024 and 2026, the second increase from 66 to 67 between 2034 and 2036 and the last increase from 67 to 68 between 2044 and 2046.

Box 5: Impact of General Election 2010 reforms on costs of the Foundation Pension

The Coalition Government has proposed a review of the SPA changes, although they have said that the rise in the SPA from 65 to 66 will not be sooner than 2016 for men and 2020 for women.

In the scenario modelled below, the SPA for men and women increases to 66 between 2024 and 2026, to 67 between 2029 and 2031, to 68 between 2034 and 2036, to 69 between 2039 and 2041, and to 70 between 2044 and 2046. This is essentially doubling the rate of increase between 2024 and 2046 that is set out in the current legislation.

Table 7: Saving from increasing SPA to 70 by 2046 (doubling the rate of increase between 2024 and 2046 that is in the current reforms) (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Saving at £8,000/year Level	0 (0%)	0 (0%)	0 (0%)	+7 (0.4%)	+14 (0.8%)	+14 (0.7%)

Chart 10[35]

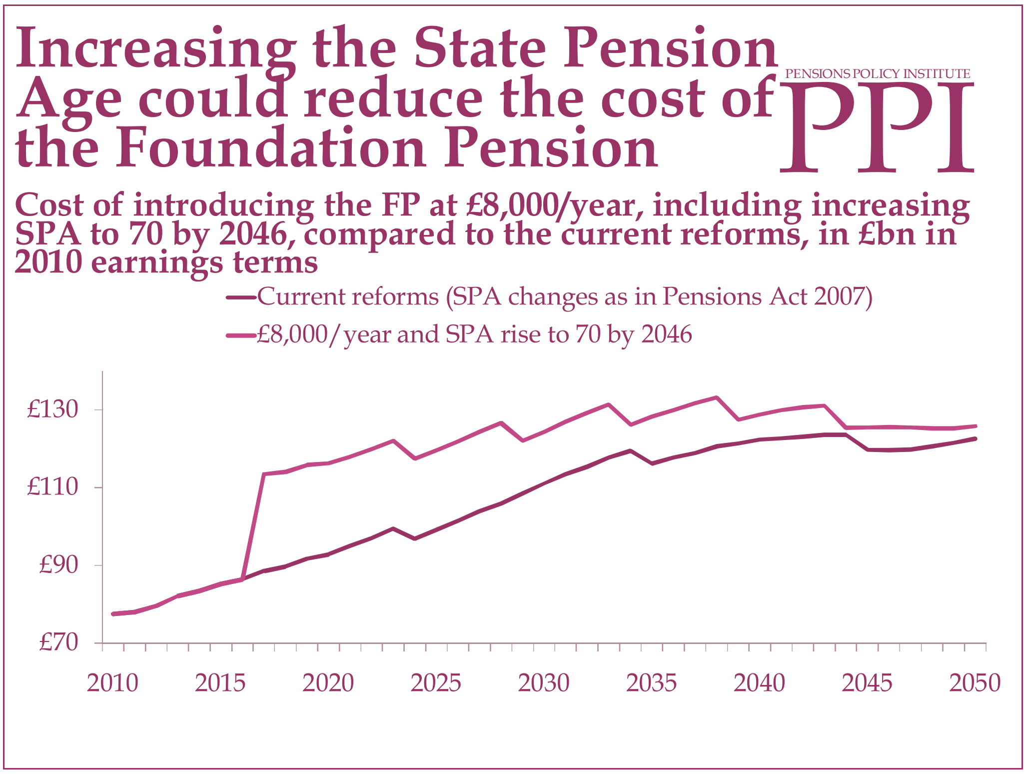


Chart 10 shows the total cost of introducing the Foundation Pension at £8,000, including the increase in SPA to 70 by 2046. The changes to SPA compared to the current reform scenario are unchanged until 2024, so the costs of introducing the Foundation Pension at each level between 2017 and 2024 are as discussed in Chapter 3. However, after 2024, the extra cost of introducing the Foundation pension at each level could significantly reduce, if the SPA is increased to 70 by 2046.

Increasing SPA has other implications other than reducing the cost of state pensions. Bringing forward the increase in SPA will affect individuals differently. Those affected by the reforms will need to change their work and savings patterns to adjust to the change in SPA. Currently, for men, there is a significant transition from full-time or part-time employment into 'inactivity' past age 59. Approximately 80% of men aged 55-59 are in employment, falling to 60% aged 60-64, and only 20% aged 65-69. In order to make an increase in SPA effective, attitudes towards working longer would need to change substantially.

However, there has been a trend of people working longer in the past 15 years. The economic activity rate for people at or over SPA fluctuated between 7.7% and 9.1% between 1994 and 2003. This rose to over 10% in 2008 and one estimate is that this figure could rise to 13% by 2020[36].

[35] PPI Modelling
[36] Future Foundation for Saga, September 2003

Bringing forward the planned increase in SPA will also impact expenditure on those below SPA.

The policy may mean:
- More income tax revenue from more people working
- More VAT revenue from increased consumer spending from people having a higher disposable income from working longer

However, there could be higher Government spending on:
- Unemployment benefits (including some on younger workers)
- Disability benefits

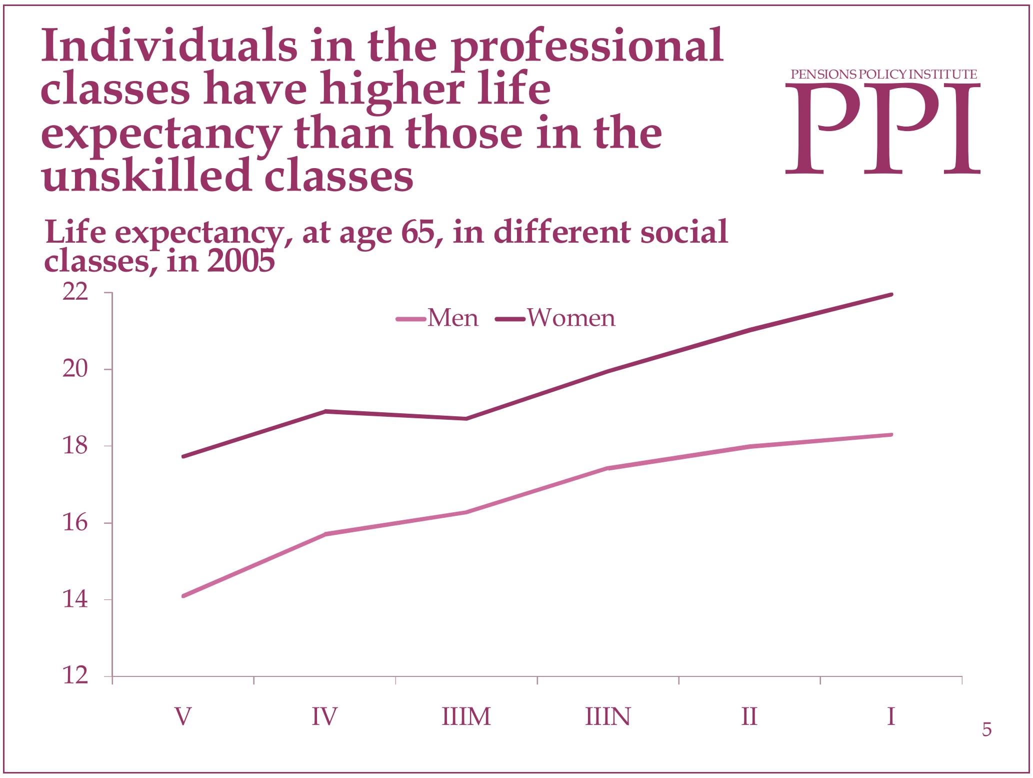
The reaction to an increase in SPA may depend on the lead-in time and how long people are given to adjust and change their working patterns. Currently approximately 80% of men aged 55-59 are in employment, falling to 60% aged 60-64, and only 20% aged 65-69. This shows that there is a large gap between the age at which people currently retire, and the pension age implied by the policy proposals. A longer lead-in time would give more chance for expectations and behaviour to change.

Evidence suggests that around 75% of people don't know what their SPA is[37], with almost all of these thinking that they will reach it sooner than they actually will. This highlights that many people have given very little thought to their retirement and suggests that an increase in the SPA could have little immediate effect on the behaviour of many people.

Any review of SPA would also need to consider the impact on different social classes. There is a clear difference in life expectancy between individuals in different social classes. The life expectancy difference between Class I (professional) and Class V (unskilled) at age 65 is around 5 years for men and around 4 years for women[38] (Chart 11).

[37] DWP (2009)
[38] ONS(2006) Trends in life expectancy by social class 1972—2006

Chart 11[39]



All other things being equal, increasing SPA will reduce the number of years people can expect to receive state pension so those in Class V see a larger proportional fall in the length of time they receive pensions than those in social Class I. If SPA increases more quickly than life expectancy for each social class, then future cohorts of people could receive their state pension for a shorter time than current cohorts do.

The proportion of people in Class V is now less than 5% of the population, and declining (expected to reach 3% in 2050). Therefore, differences in life expectancies between social classes should be used with caution. The majority of the population are in Class II, III or IV where differences in life expectancy are smaller. In addition, many more people are now capable of working after SPA than when the state pension system was designed.

However, projections of life expectancy are an average, and many people will not experience the benefits of longer living. For those people, an increase in SPA could be a big disadvantage.

[39] ONS(2006)

Increasing State Pension Age would change the impact of the Foundation Pension on Individuals

If SPA was increased as part of the package of reforms alongside the introduction of the Foundation Pension, individuals may receive more private pension as well as higher state pension income, assuming they work and save for longer before the new higher SPA.

Individual 4: a median earning man age 70 in 2046

- He works full time from age 22 in 1998
- He works until age 70 in 2046 earning median age-specific earnings for men
- Between the ages of 22 and 70 he and his employer contribute into a DC occupational pension scheme at the minimum 8% contribution level.
- He buys a level annuity

This median-earning man's weekly income in working life, at the point of retirement is £460[40] per week in 2010 earnings terms. He would need a gross weekly income of around £310 per week to meet his 67% replacement rate.
It is assumed that he varies his contribution rate during his working life as described above. He also buys a level annuity.

Under the Foundation Pension system, this median-earning man would retire in 2046, at age 70 (Chart 12). At this point he would receive £292 per week, in 2010 earnings terms, which is just under his desired replacement rate. This is made up of:

- £154 per week from Foundation Pension
- £138 per week from private pension

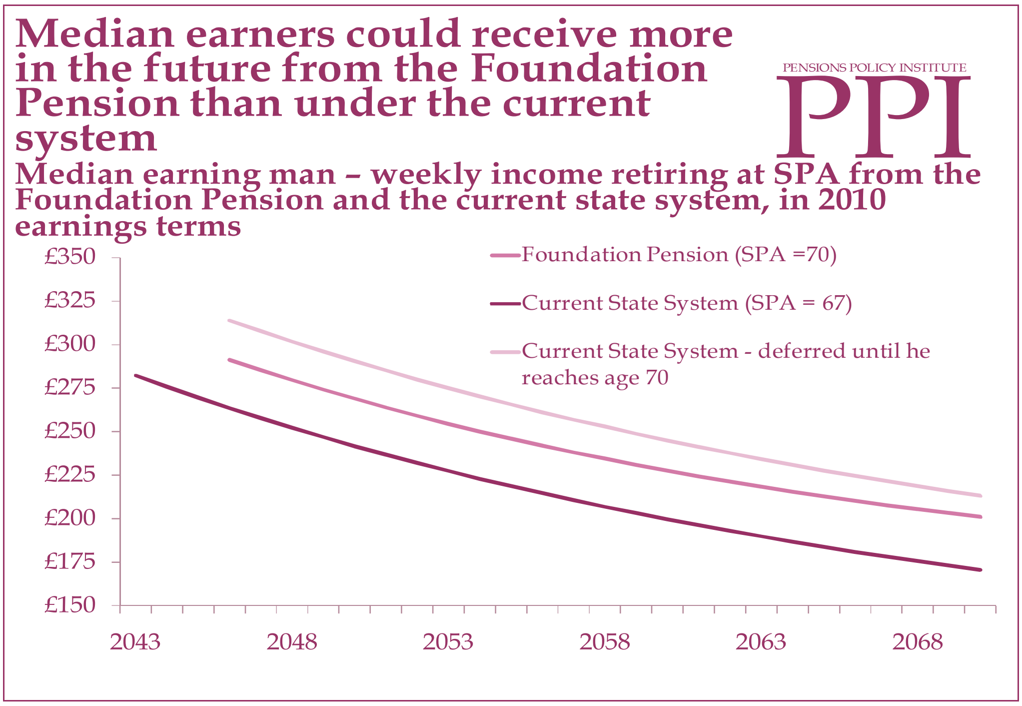
Under the current state pension system, this individual would reach SPA in 2043, at age 67, at which point he would receive £166 per week from state pension and £117 per week from private pension (in 2010 earnings terms). By 2046, he would receive £264 per week, in 2010 earnings terms, which is further below his desired replacement rate of £310 per week. This is made up of:

- £161 per week from state pension
- £102 per week is from private pension

This assumes that he takes his state pension at the current system State Pension Age of 67 (in 2043). However, if he deferred receiving his state pension until age 70 under the current system (with an SPA of 67), he could receive £211 per week from state pension and £138 per week from private pension.

[40] 50th percentile, age-specific earnings, PPI calculations based on Labour Force Survey (2008)

Chart 12[41]



His private pension is lower than in the Foundation Pension scenario because he has had 3 years less contribution years and started receiving his level annuity in 2043.

In 2070, after around 25 years of retirement, he would receive £154 per week from the Foundation Pension. At this point the Foundation Pension level has overtaken what he would have been entitled to from the current state system, in earnings terms. Under the current system he would receive £136 per week in 2010 earnings terms.

The value of the private pension, in both scenarios drops significantly, in earnings terms. This is because he has purchased a level annuity. Although the value of the state pension is kept quite steady in earnings terms, by 2070 he will still fall considerably under his desired replacement rate because of the fall in value of his private pension.

So, the combined impact of retirement income of the move to a Foundation Pension and an increase in SPA depends on the impact in retirement behaviour.

- If this individual worked longer and took his pension later as a result of the changes, he would have a higher income throughout retirement with a Foundation Pension and a SPA of 70.
- However, if he had worked until age 70 under the current system – 3 years past SPA – his retirement income would have been higher than under the Foundation Pension.

[41] PPI Modelling

Contracting-Out

The introduction of a Foundation Pension would result in the end of the State Second Pension (S2P) and therefore, the ability to contract-out of S2P. This provides extra revenue as currently employers and employees pay reduced National Insurance contributions if their pension scheme is contracted-out of S2P. In the future all employers and employees would need to pay the full level of National Insurance contributions:

Table 8: Additional revenue from Contracted-Out Rebates (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Contracted-Out Rebates	0	+8	+7	+5	+4	+4
% GDP	0%	0.5%	0.4%	0.3%	0.2%	0.2%

The reforms in the Pensions Act 2007 mean that contracting-out will be abolished for Defined Contribution occupational schemes and personal pensions. The aim is to introduce this change in 2012, to coincide with the re-linking of the BSP with earnings growth. However, the removal of contracting-out would have implications for the remaining Defined Benefit (DB) schemes and members in 2017:

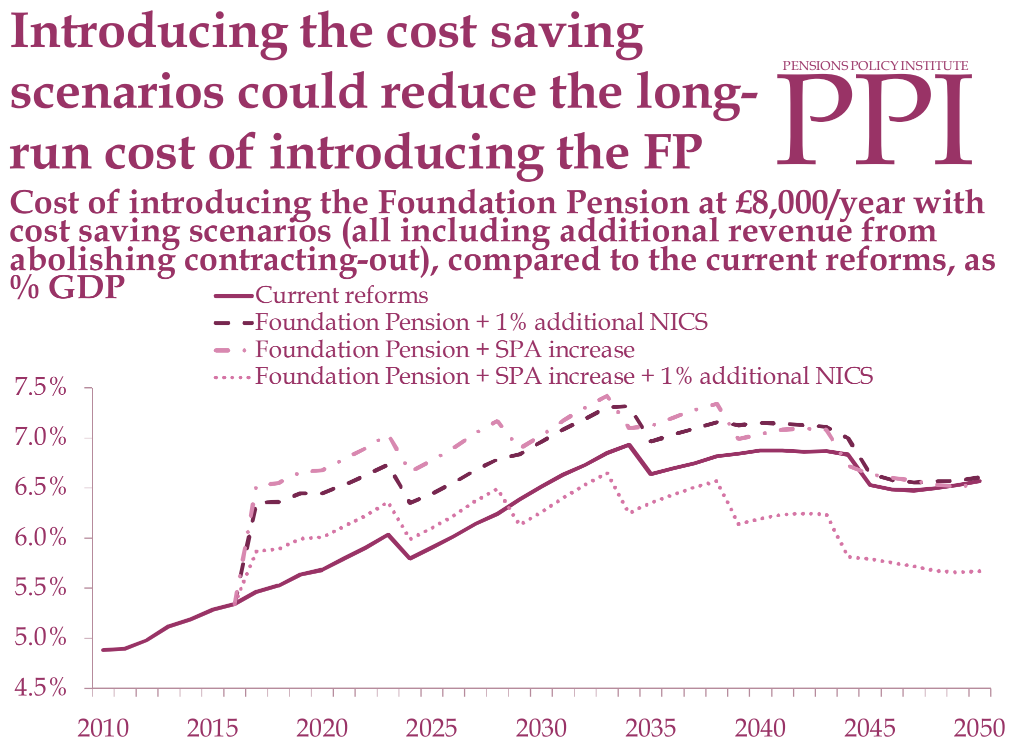
- Employers and employees pay higher National Insurance contributions
- Employees get a higher State Pension
- Employers have to decide what to do with their existing scheme:
  - Make higher contributions to make up the short-fall from the end of contracting-out
  - Reduce employee benefits
  - Integrate scheme to change i.e. only pay a benefit over the FP level
  - More substantial changes

The number of active members of private sector occupational DB pension schemes has fallen dramatically in the last 20 years. In 1991 there were more than 6 million active members of private sector DB schemes. This has fallen to 2.7 million in 2007. If current trends continue, then active membership in private sector DB schemes could fall to as little as 1.5 million active members in 2050. Pensions in the public sector are still predominantly contracted-out Defined Benefit schemes, and so the Government (as an employer) would need to consider whether the schemes would need to be redesigned. It should be recognised that ending contracting-out could put added pressure on the DB schemes that are still open.

Summary

Chart 13 compares the costs of the current state pension system to introducing a Foundation Pension at the £8,000 per year level, including increasing the SPA to 70 by 2050, increasing NI contributions by 1%, and the extra revenue from contracted-out rebates.

Chart 13[42]



Although introducing the Foundation Pension at £8,000 per year, in 2010 earnings terms could be more expensive than the current state system initially, by 2025 (8 years after the introduction of the Foundation Pension), if a wide-range of revenue raising policies are introduced, the cost of the Foundation Pension could be less than the current state system. However, it should be noted that there would be other social and economic implications of increasing National Insurance contributions and of ending contracting-out

[42] PPI Modelling

Chapter five: how could a Foundation Pension affect means-testing?

Pension Credit has been an effective tool in reducing pensioner poverty[43]; however, there is some debate as to whether the Guarantee Credit level is high enough. Pensioners are also required to 'claim' pension credit. Currently around 20% of pensioners who are eligible for Pension credit do not claim it. Under the Foundation Pension system there would be no need for an individual to claim the benefit. While there may be concerns with means-tested benefits, they are also a way for Government to focus scarce resources on the poorest pensioners.

This chapter examines the effect on eligibility for means-tested benefits of introducing the Foundation Pension at £8,000 per year in 2010 earnings terms.

The impact on means-tested benefits
Introducing a Foundation Pension could reduce the proportion of pensioners who are eligible for means-tested benefits.

Table 9: Eligibility for means-tested benefits under Current Reforms[44]

	2010	2017	2020	2030	2040	2050
Pension Credit	50%	45%	45%	45%	45%	45%
Housing Benefit	20%	20%	20%	20%	20%	20%
Council Tax benefit	45%	45%	40%	40%	40%	35%
Any means-tested benefit	60%	55%	55%	55%	55%	55%

Under the current state pension system, around 60% of pensioners are currently entitled to some form of means-tested benefit. By 2050, this could reduce to 55% of pensioners (table 9). The average entitlement of means-tested benefit in 2010 is £70 per week in 2010 earnings terms and could be around £62 per week in 2010 earnings terms by 2050. This is due to the re-linking of BSP to earnings inflation[45] and the changes in the Pensions Act 2007 which make qualification for BSP easier.

43 DWP (2006) Security in retirement: towards a new pension system
44 Figures are rounded to the nearest 5%. The PPI usually provides a range of figures for eligibility for means-tested benefits, but only the central scenario is shown here to facilitate comparisons with policy options. PPI (2007) PPI Projections of future eligibility for means-tested benefits.
45 BSP is assumed to be re-linked to earnings inflation in 2012 in this paper.

Table 10: Eligibility for means-tested benefits under a Foundation Pension set at £8,000 (in 2010 earnings terms) level

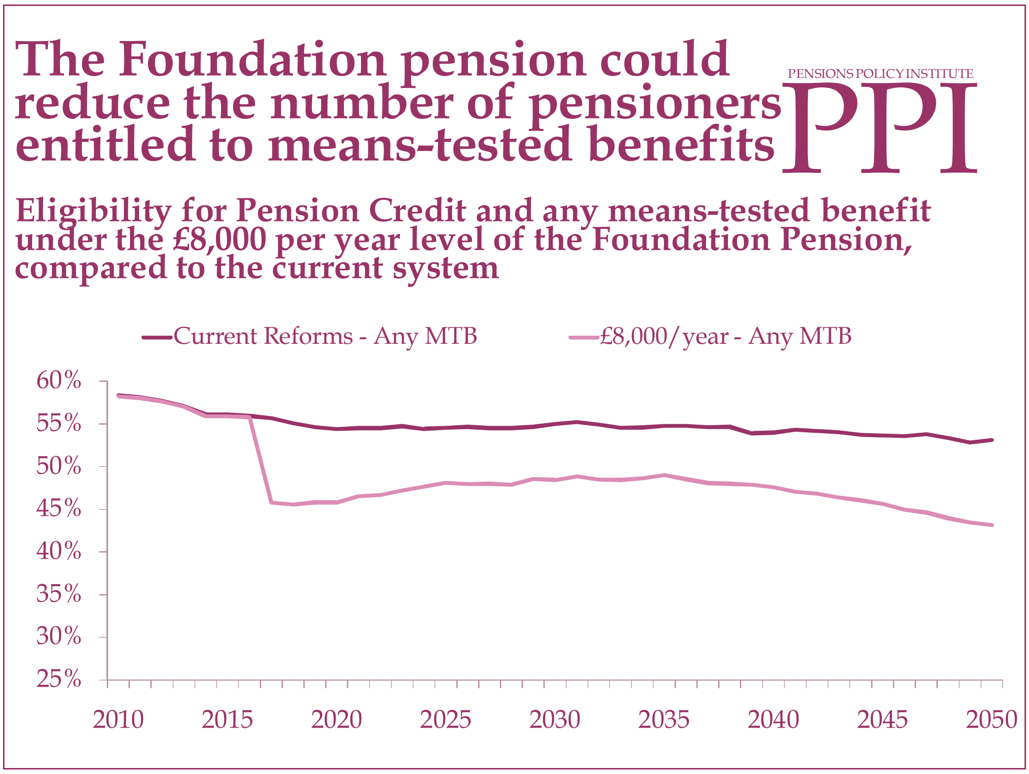
	2010	2017	2020	2030	2040	2050
Pension Credit	50%	30%	30%	30%	30%	25%
Housing Benefit	20%	20%	20%	20%	20%	20%
Council Tax Benefit	45%	35%	35%	35%	35%	30%
Any means-tested Benefit	60%	45%	45%	50%	50%	45%

Introducing the Foundation Pension at £8,000 per year in 2010 earnings terms could see eligibility for some form of means-tested benefit fall from 60% in 2010 to 45% by 2050 (Chart 14). This is mainly because eligibility for Pension Credit will be dramatically reduced. Under the current system, by 2050 around 45% of pensioner households could be eligible for pension credit. Under the Foundation Pension system at £8,000 (in 2010 earnings terms) this could reduce to 25%.

The Foundation Pension of £8,000 per year is equivalent to £154 per week. The Guarantee Credit level is set at £130 per week in 2009 earnings terms which is below the Foundation Pension. Therefore, very few people will receive Guarantee Credit after the introduction of the Foundation Pension. Only those who are not entitled to the full Foundation Pension, pensioners who are disabled or those who are carers will get some Guarantee Credit.

Despite the fall in the number of pensioners entitled to Guarantee Credit, there will still be pensioners who are entitled to Savings Credit. By 2050, 25% of pensioners could still be entitled to Savings Credit.

Chart 14[46]



Falls in means-testing could lead to an increase in savings[47]

It could be argued that a reduction in the impact of means-testing and simpler state pension system (that demonstrates the benefit of saving more clearly to individuals) would give better incentives to save. However it is difficult to quantify precisely how much of an impact a Foundation Pension may have on private pension saving levels.

No change in savings behaviour is assumed in this evaluation. However, if more people saved, and if contributions to private pensions were higher as a result of the introduction of a Foundation Pension, then this could result in:

- Higher private pension incomes, especially for low income pensioners (who are the target group for auto-enrolment),
- Further reductions in eligibility for means-tested benefits, and
- Consequently, lower Government spending on means-tested benefits

There would also be increased tax relief costs on the higher levels of private pension saving.

[46] PPI Modelling
[47] PPI (2006) Are Personal Accounts suitable for all?

Chapter six: how complex is the transition to a Foundation Pension?

The transition to a Foundation Pension is complex, mainly due to the interaction with contracted-out pensions, though it is not necessarily any more complicated than the current system. The transition to a Foundation Pension could take a long time, although by 2031, 95% of pensioners could be receiving a state pension at the Foundation Pension level. However, it would take much longer for the remaining contracted-out pensions to cease payment.

Transition to a Foundation Pension is complex
Although the principle of the Foundation Pension is simple, the transition from the current system to the Foundation Pension is complex, as a result of needing to incorporate the complexities from the legacy of the current system.

In particular the need to incorporate contracted-out benefits in the calculation of the Foundation Pension would mean that during the transition period a large number of individuals would need to receive part of the Foundation Pension of £8,000 from a private pension and therefore receive less than the full level of the Foundation Pension directly from the state. The alternative (ignoring contracted-out pensions for the calculation of the Foundation Pension) would result in individuals receiving windfall gains as they would receive a full Foundation pension from the state as well as the value of their contracted-out contributions. Ignoring contracted-out pensions would also significantly increase the costs of introducing a Foundation Pension.

Communication of the Foundation Pension benefits will be important
The complexity of the transition to the Foundation Pension makes communication of the level of pension benefit to individuals important. In particular it would be important to manage expectations so people know how Foundation Pension entitlement will be calculated and what to expect.

If the pension benefits are not communicated adequately there could be a perception that the Foundation Pension is worse than the current system. For example, if:

- Individuals receive less than £8,000 directly from the state (as part of the individuals benefit comes from contracting-out);
- The amount of pension assumed to come from contracting-out is less than the amount actually received;

people could feel that they are not getting all that they are entitled to, or may be disappointed with what they receive. While this could be perceived as a weakness of a Foundation Pension, in both cases the situation is the same as in the current system, but the impact of contracting-out is more transparent.

Although the complications arising from transition reduce the simplicity of the Foundation Pension, compared to a situation in which every individual simply receives a flat-rate amount from the state, the system during the transition period is not necessarily any more complex than the current system.

The transition to a Foundation Pension would take many years
The transition to a Foundation Pension would take many years to complete, as:

- Individuals who are eligible for more than the Foundation Pension level because of their rights in BSP and SERPS/S2P (and contracted-out equivalents) accrued before 2017 in the current system, would continue to receive the higher amount.
- Contracted-out rights earned before 2017 would continue to be paid from private pensions.

At the introduction date of the Foundation Pension in 2017, 26% of single pensioner individuals could be entitled to receive more than the Foundation Pension level as a result of higher entitlement from BSP and SERPS/S2P accruals. By 2031 this figure could fall to below 5%. The Foundation Pension level of £8,000 is set as the approximate maximum amount of S2P and BSP that an individual could accrue by 2050, so the number of pensioners entitled to receive more than the Foundation Pension level should fall to close to zero by 2050.

The transition away from contracted-out rights would potentially be much longer. An individual age 18 who was in contracted-out employment in 2016 could in theory be receiving income from the contracted-out pension (and therefore less than the full amount of Foundation Pension from the state) until 2100 and beyond.

Appendix 1: Detailed tables of costs of alternative levels of Foundation Pension

Table A1: Costs of State Pensions and related benefits under current reforms (£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
BSP	49	56	59	71	78	76
SERPS/S2P	12	15	17	21	24	26
Other State Benefits	4	5	5	6	6	6
Guarantee Credit	5	5	4	4	4	4
Savings Credit	1	1	1	1	1	1
Housing Benefit	5	5	5	6	7	7
Council Tax Benefit	2	2	2	2	2	2
Spending on State Pensions and related benefits	77	89	93	111	122	123

Table A2: Costs of introducing FP at £7,060 in 2010 earnings terms (the Guarantee Credit level) in 2017 (£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
Total spending under current reforms	77	89	93	111	122	123
FP	0	+22	+19	+14	+12	+9
Other State Benefits	0	0	0	0	0	0
Guarantee Credit	0	-4	-4	-3	-4	-4
Savings Credit	0	0	0	0	1	1
Housing Benefit	0	-1	-1	0	0	-1
Council Tax Benefit	0	0	0	0	0	0
Extra spending on State Pensions and related benefits	0	+17	+15	+10	+8	+5
% GDP under current reforms	4.9%	5.5%	5.7%	6.5%	6.9%	6.6%
% GDP	4.9%	6.5%	6.6%	7.1%	7.3%	6.8%
Extra spending (% GDP)	0%	1%	0.9%	0.6%	0.4%	0.2%

Table A3: Costs of introducing FP at £8,000 in 2010 earnings terms (the level of a 'full' BSP and S2P in 2050) in 2017
(£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
Total spending under current reforms	77	89	93	111	122	123
FP	0	+31	+29	+26	+26	+24
Other State Benefits	0	0	0	0	0	0
Guarantee Credit	0	-4	-4	-4	-4	-4
Savings Credit	0	0	0	0	0	0
Housing Benefit	0	-1	-1	-1	-1	-2
Council Tax Benefit	0	-1	-1	-1	-1	-1
Extra spending on State Pensions and related benefits	0	+25	+23	+21	+20	+17
% GDP under current reforms	4.9%	5.5%	5.7%	6.5%	6.9%	6.6%
% GDP	4.9%	7.0%	7.1%	7.7%	8.0%	7.5%

Table A4: Costs of introducing FP at £10,000 in 2010 earnings terms in 2017
(£bn in 2010 earnings terms)

	2010	2017	2020	2030	2040	2050
Total spending under current reforms	77	89	93	111	122	123
FP	0	+53	+52	+55	+58	+55
Other State Benefits	0	0	0	0	0	0
Guarantee Credit	0	-5	-4	-4	-4	-4
Savings Credit	0	-1	-1	-1	-1	-1
Housing Benefit	0	-2	-2	-3	-3	-4
Council Tax Benefit	0	-1	-1	-1	-1	-1
Extra spending on State Pensions and related benefits	0	+45	+44	+45	+48	+45
% GDP under current reforms	4.9%	5.5%	5.7%	6.5%	6.9%	6.6%
% GDP	4.9%	8.2%	8.4%	9.2%	9.6%	9.0%

Table A5: Cost of alternative FP levels including increasing SPA to 70 by 2046 (doubling the rate of increase between 2024 and 2046 that is in the current reforms) (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Current Reforms (SPA changes in Pensions Act 2007)	77 (4.9%)	89 (5.5%)	93 (5.7%)	111 (6.5%)	122 (6.9%)	123 (6.6%)
Extra cost at Guarantee Credit Level	0 (0%)	+17 (1.0%)	+15 (0.9%)	+4 (0.2%)	-4 (-0.2%)	-7 (-0.4%)
Extra cost at £8,000/year Level	0 (0%)	+25 (1.5%)	+23 (1.4%)	+13 (0.8%)	+6 (0.4%)	+3 (0.2%)
Extra cost at £10,000/year Level	0 (0%)	+45 (2.7%)	+44 (2.7%)	+36 (2.1%)	+31 (1.8%)	+28 (1.5%)

Table A6: Scenario Table: Costs of introducing FP at the Guarantee Credit Level in 2017, increasing the level of SPA, 1% increase in NI contributions (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Total Spending above current reforms	0 (0%)	+17 (1.0%)	+15 (0.9%)	+4 (0.2%)	-4 (-0.2%)	-7 (-0.4%)
Savings from extra NI contributions	0 (0%)	-11 (-0.7%)	-11 (-0.7%)	-13 (-0.8%)	-15 (-0.9%)	-16 (-0.9%)
Savings from extra revenue from Contracted-Out Rebates	0 (0%)	-8 (-0.5%)	-7 (-0.4%)	-5 (-0.3%)	-4 (-0.2%)	-4 (-0.2%)
Total additional spending after allowing for NI and Contracted-out changes	0 (0%)	-1 (-0.1%)	-3 (-0.2%)	-14 (-0.8%)	-23 (-1.3%)	-27 (-1.5%)

Table A7: Scenario Table: Costs of introducing FP at £8,000 (in 2010 earnings terms) in 2017, increasing the level of SPA, 1% increase in NI contributions (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Total Spending above current reforms	0 (0%)	+25 (1.5%)	+23 (1.4%)	+13 (0.8%)	+6 (0.4%)	+3 (0.2%)
Savings from extra NI contributions	0 (0%)	-11 (-0.7%)	-11 (-0.7%)	-13 (-0.8%)	-15 (-0.9%)	-16 (-0.9%)
Savings from extra revenue from Contracted-Out Rebates	0 (0%)	-8 (-0.5%)	-7 (-0.4%)	-5 (-0.3%)	-4 (-0.2%)	-4 (-0.2%)
Total additional spending after allowing for NI and Contracted-out changes	0 (0%)	+6 (0.4%)	+5 (0.3%)	-5 (-0.3%)	-13 (-0.7%)	-17 (-0.9%)

Table A8: Scenario Table: Costs of introducing FP at £10,000 (in 2010 earnings terms) in 2017, increasing the level of SPA, 1% increase in NI contributions (£bn in 2010 earnings terms and as a % of GDP)

	2010	2017	2020	2030	2040	2050
Total Spending above current reforms	0 (0%)	+45 (2.7%)	+44 (2.7%)	+36 (2.1%)	+31 (1.8%)	+28 (1.5%)
Savings from extra NI contributions	0 (0%)	-11 (-0.7%)	-11 (-0.7%)	-13 (-0.8%)	-15 (-0.9%)	-16 (-0.9%)
Savings from extra revenue from Contracted-Out Rebates	0 (0%)	-8 (-0.5%)	-7 (-0.4%)	-5 (-0.3%)	-4 (-0.2%)	-4 (-0.2%)
Total additional spending after allowing for NI and Contracted-out changes	0 (0%)	+26 (1.6%)	+26 (1.6%)	+19 (1.1%)	+13 (0.7%)	+8 (0.5%)

Table A9: Summary: Reduction in those entitled to any means-tested benefit under the three FP scenarios

	2010	2017	2020	2030	2040	2050
Current Reforms	58%	56%	54%	55%	54%	53%
At the Guarantee Credit level	0%	-6%	-4%	-2%	0%	-2%
At £8,000 (in 2010 earnings terms) level	0%	-10%	-8%	-7%	-6%	-10%
At £10,000 (in 2010 earnings terms) level	0%	-22%	-22%	-22%	-23%	-26%

Appendix 2: The PPI Models

This appendix describes modelling assumptions used in this report. The modelling uses three models – the Individual Model, the Aggregate Model, and the Distributional Model – that were developed with a grant from the Nuffield Foundation.

Individual modelling
The modelling of the pension pot sizes of hypothetical individuals uses the PPI Individual Model.[48] Detailed assumptions have been made about the individuals' working and saving behaviours and these are described in the main report. Throughout, the modelling assumes:

- Future annual price inflation of 2.5%.
- Future annual earnings growth of 2% in excess of prices.
- Expected investment returns of 3.5% in excess of prices, before charges, corresponding to a mixed equity/bond fund.[49]
- Annual management charges of 0.5% of assets under management.

Aggregate modelling
The modelling of the aggregate size of pension funds uses the PPI Aggregate Model. Private pension funds are modelled using a stock/flow approach. The flows into each pension fund consist of contributions and investment returns, while the flows out of each pension fund are new pensions and tax-free lump sums. More detail about the modelling methodology is available on the PPI website.[50]

Distributional modelling
The Distributional Model allows the distributional impact of possible reforms to be analysed. The projected distribution of pensioner incomes from the model is also the starting point for estimates of the future cost of Pension Credit and revenue from income tax.

The Distributional Model projects forward the distribution of pensioner incomes:

1. A sample of people currently over state pension age is the starting point.
2. Incomes are uprated in line with Aggregate Model estimates.
3. Income tax liabilities are calculated for each member of the sample.
4. Pension Credit entitlements are calculated for each member of the sample.
5. A weight is attached to each member of the sample so that the balance between ages, gender and marital status matches long-term projections.

There are limitations to the modelling of pensioner couples with this modelling. The Distributional Model uses the Pensioners Income Series (PIS) as the income in the base year. The people in the PIS are identified as Benefit

[48] For more information on the Individual Model, see PPI (2003) *The Under-pensioned*
[49] This corresponds to assumed equity returns of 7.5% a year, assumed bond returns of 4.5% a year, and a portfolio of 55% equities and 45% bonds
[50] For more information on the Individual Model, see PPI (2005) *What will pensions cost in future?*

Units, which could be an individual or a couple. This means that income can only be projected for each Benefit Unit. However, the Foundation Pension is paid on an individual basis, which reduces the credibility of the Distributional Model when analysing the income of pensioner couples. Therefore, we have omitted any analysis of pensioner couples when looking at distributional effects for this paper.

Modelling of the Foundation Pension

The data from the Pensioner Incomes Series, used in the PPI Distributional Model, does not identify individual incomes within couples. Therefore, it was necessary to use an implied couples rate to calculate costs. As this approach is also used in calculating costs of the current system, we would not expect a significant impact on modelled additional costs of introducing a Foundation Pension.

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