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An evaluation of the White Paper state pension reform proposals

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A PPI Discussion Paper

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Introduction

The Government published its proposals for reform of the state pension system in May 2006[1]. The proposals are largely based on the preferred approach of the Pensions Commission[2], though there are some differences in the detail of the proposals and the timetable for implementation.

Earlier this year the PPI published a detailed analysis[3] of the Pensions Commission's proposals for state pension reform, comparing the proposals against alternative reform options in the context of the Government's tests for state pension reform.

This was based on three different methods of quantitative analysis, using the PPI suite of economic models:
- How much do state pension reforms cost?
- How do reforms benefit poorer or better off pensioners?
- How do state pension reforms change eligibility for Pension Credit?

This report answers these questions for the White Paper proposals, and also examines:
- How do state pension reforms interact with Personal Accounts?

The analysis in this report compares the outcomes of the White Paper proposals to those from a continuation of the current system and from three alternative reform options. These additional options involve moving from the current two-tier pension system to a simpler single-tier system over various timescales, and are analysed as they represent the consensus solution suggested by pensions experts[4] and the broad construct proposed by the Pensions Commission[5]. It is only by comparing a range of options in detail and on a consistent basis that the relative strengths and weaknesses of different approaches become apparent.

Chapter 1 outlines the reform options that are modelled. Chapter 2 contains projections of the costs of the reform options. Chapter 3 considers the impact of reforms on the distribution of pensioners' incomes. Chapter 4 contains projections of the number of people who may be eligible for Pension Credit under the proposals, and Chapter 5 considers the interaction with Personal Accounts.

A separate modelling paper, containing more detail about the models and assumptions used in this paper, is available from the PPI website.

[1] DWP (2006 WP)
[2] Pensions Commission (2005)
[3] Curry and Steventon (2006)
[4] PPI (2006 SaSPS)
[5] Pensions Commission (2005)

Summary of conclusions

This paper gives a wider analysis of the White Paper state pension reform proposals than the White Paper itself provides. In particular, it identifies shortcomings and uncertainties in the reforms which are not shown in the White Paper. The key points from the analysis in this paper are:

- There is no net cost to Government from the reforms in the short-term, properly taking into account the partial abolition of contracting-out. From 2030 the White Paper proposals have an annual net cost to Government of around 0.1% of GDP.
- The White Paper proposals are described as providing a state pension of £135 a week from BSP and State Second Pension (S2P) combined. But because of a long transition, gaps in coverage, and the continued price indexation of S2P, the majority of people over state pension age may not have as much as £135 a week from the state even by 2050.
- Some of the poorest pensioners will not gain significantly from the White Paper state reforms. When the proposals are introduced gains are concentrated on pensioners with the highest incomes. Overall, the impact on the distribution of pensioner incomes is small.
- Future eligibility for Pension Credit is uncertain. Between one-third and two-thirds of pensioner households might still be eligible for Pension Credit in 2050, with a rise in the number eligible from around 4 million today to up to 6 million. Government estimates are at the bottom of this range.

Even a very successful Personal Account scheme will not significantly reduce the numbers of people eligible for Pension Credit. But, conversely, a potentially high level of eligibility to Pension Credit in future threatens the success of Personal Accounts. The White Paper reforms do not provide the certainty of a solid state pension foundation for Personal Accounts, which means that UK policy is different from other countries with national savings schemes.

This paper also compares the White Paper reform proposals with alternative simple single pension options which, for similar costs, have a better (more progressive) distributional outcome and reduce reliance on means-testing further.

The White Paper did not include full evaluation of alternative state pension reform models or of ways in which a better state pension foundation could interact with a Personal Account-type auto-enrolment scheme. Such evidence-based assessments should be made in more detail to help develop consensus on future policy.

Chapter 1: Reform options

This chapter describes the reform options analysed in this paper, and sets out the assumptions and definitions used in the analysis.

What are the reform options?
As well as comparing the White Paper reforms to the current system, the analysis in this paper also compares proposals against alternative reform options.

These comparisons are important because other reform options may, for similar costs, have a better (more progressive) distributional outcome, and / or reduce reliance on means-testing further. Even if these options are ruled out for other reasons (such as political principle, or fears of administrative difficulty) it gives valuable perspective to compare the impact of the White Paper proposals against what other reforms could achieve. Detailed analysis of a range of options makes the rationale for policy decisions more transparent, so should promote consensus.

The analysis in this paper covers the following options (see Box 1 for a detailed description of each option):

1. The current system
2. The White Paper proposals
3. A long transition to a single pension
4. A medium transition to a single pension
5. A short transition to a single pension

Options 3, 4 and 5 are used as they result in a simpler pension system than the White Paper proposals, are closer to the consensus solution suggested by pensions experts[6] and the broad construct for state pension reform proposed by the Pensions Commission[7], and are feasible to implement[8].

All of the single pension options are based on more inclusive qualification criteria than in the current system. This could be the improved contributory principle in the White Paper proposals for the Basic State Pension (and in particular the reduction in the required number of qualifying years for a full pension to 30), or could use a residency test. Both get to near-universal coverage, which is, as the White Paper accepts[9], the main objective.

[6] PPI (2006 SaSPS)
[7] Pensions Commission (2005) page 18 - ***PAYG pension provision should, after a transition phase become flat-rate***, … e***nsuring that all people are kept out of poverty in retirement*** … ***making the system as non-means-tested as possible***
[8] The options are similar to options 6, 7 and 8 in Curry and Steventon (2006). See page 6 and Appendix 3 of Curry and Steventon (2006) for further details.
[9] DWP (2006 WP) page 125, paragraph 3.74, and PPI Briefing Note Number 32 (2006)

In theory it would be possible to have a single pension without wider coverage, but this is not explored as it would remove simplicity and certainty, two of the key advantages of a single pension system.

Box 1: The reform options[10]

1. The current system: Existing uprating conventions continue. In particular the Basic State Pension (BSP) increases in line with prices (so declines to £60 a week in today's earnings, 11% of National Average Earnings (NAE), by 2025 and £35 a week, 6% of NAE, by 2050) and the Guarantee Credit (GC) increases in line with earnings (£114 a week in today's earnings, 21% of NAE).

2. The White Paper proposals: Including uprating BSP in line with earnings from 2012[11] (£75 a week, 14% of NAE), increasing state pension age to 66 by 2026, 67 by 2036 and 68 by 2046, making it easier to qualify for BSP and State Second Pension (S2P), S2P gradually becoming flat-rate, and making Savings Credit (SC) less generous from 2008. Contracting-out for Defined Contribution (DC) arrangements abolished from 2012.

3. A long transition to a single pension: From 2010 accruals to BSP and S2P are replaced with accruals to a new single pension that builds up over a 40 year period to reach the GC level (£114 a week for a single person, 21% of NAE, £87 a week for each partner in a couple, 16% of NAE), is uprated in line with average earnings, and is near-universal (either through residency or an improved contribution system). SC is gradually reduced, and is removed completely by the end of the 40 year transition period. State pension age increases as in the White Paper proposals. Contracting-out for Defined Benefit (DB) and DC arrangements abolished from 2010. All BSP and S2P accrued before 2010 is paid in full.

4. A medium transition to a single pension: From 2010 the BSP is increased from its current level by more than earnings growth until it reaches the GC level (£114 a week for a single person, 21% of NAE, £87 a week for each partner in a couple, 16% of NAE) by 2030, is uprated in line with average earnings, and is near-universal (either through residency or an improved contribution system). SC is gradually reduced, and is removed completely by the end of the 20 year transition period. State pension age increases as in the White Paper proposals. From 2010 accruals to S2P are stopped, and contracting-out for DC and DB arrangements abolished. All S2P already accrued is paid in full.

5. A short transition to a single pension: From 2010 the BSP and S2P are combined together into a single pension at the GC level (£114 a week for a single person, 21% of NAE, £87 a week for each partner in a couple, 16% of NAE), which is uprated in line with average earnings and is near-universal (either through residency or an improved contribution system). No new SC awards are made from 2010 (but existing awards continue to be paid). State pension age increases as in the White Paper proposals. From 2010 accruals to S2P are stopped, and contracting-out for DC and DB arrangements abolished. Each individual receives the higher of the new pension, or the amount he or she accrues before 2010 in the current system, using the 'offset' transition[12].

[10] Options 4, 5 and 6 are similar to those modelled in earlier PPI work. See Curry and Steventon (2006).
[11] This is the earliest date that earnings uprating of BSP would be introduced, and is subject to it being 'affordable'. See DWP (2006 WP) page 17 paragraph 37.
[12] See Curry and Steventon (2006) page 36 for a detailed description of the offset transition

Personal Accounts

The Government has also proposed that a new system of Personal Accounts be introduced from 2012. Although many details are yet to be finalised, the basic framework would be:

- Auto-enrolment for all employees aged over 22 and earning more than £5,000 a year to a Personal Account (or an equivalent), with the opportunity to opt-out.
- Low charges, aiming for a 0.3% of assets annual management charge.
- Minimum contribution of 4% from the individual which will be matched by a minimum[13] 1% contribution from the Government and a compulsory 3% employer contribution[14].

This paper analyses different scenarios for Personal Accounts, to illustrate how sensitive the costs and distributional impacts of the alternative reform options are to different levels of success of Personal Accounts. For the first part of this paper comparing state pension reform options, analysis uses:

- A central scenario, based on the central case estimated by the Government of around one-third[15] of eligible employees opting-out of Personal Accounts or an approved employer scheme alternative.

For analysis of the White Paper reform proposals in Chapter 5 there is also:

- An optimistic opt-out scenario of 20% of eligible employees opting-out of Personal Accounts or an approved employer scheme alternative, in line with the top-range estimate made by the Government[16].
- A pessimistic opt-out scenario of 75% of eligible employees opting-out of Personal Accounts, or an approved employer scheme alternative, in line with the estimates made by the New Zealand Government of the proportion of eligible employees who will remain opted-in to the KiwiSaver[17].
- A 'levelling-down' scenario, based on the level of opt-out as in the central scenario but in which contributions made by employers who already offer pension schemes are 'levelled down' towards the minimum Personal Account contribution level[18].

[13] As this is provided through the current system of pension tax relief, the Government contribution would be higher for individuals who pay higher rate tax

[14] All amounts as a percentage of earnings between £5,035 and £33,540 in today's earnings terms

[15] DWP (2006 WP RIA) paragraph 2.50

[16] DWP (2006 WP RIA) paragraph 2.54

[17] See O'Connell (2006 NPSS) for a detailed discussion of the differences between KiwiSaver and the original proposals for the National Pensions Savings Scheme

[18] See Chapter 5 for further details

Quantitative testing

The quantitative testing in this paper is carried out using the PPI's economic models[19]. The models have been designed to allow different types of analysis under different pensions systems:

- The Aggregate Model projects long-term Government expenditure on pensions and contracted-out rebates, and income from the private pensions system. This shows how much reforms would cost relative to alternatives.
- The Individual Model projects future state and private pension income for hypothetical individuals. This can show how pension reforms affect different examples of individuals at different points in time.
- The Distributional Model projects forward the distribution of pensioner incomes consistently with the Aggregate Model. This highlights how progressive reforms are for the pensioner population as a whole, relative to the alternatives.

The quantitative analysis in this paper will focus on:

- The costs of reform options, estimated using the Aggregate Model (Chapter 2). The definition of spending used in this paper includes spending on <u>all</u> pensions rather than just spending on pensions paid to people of state pension age and older, and therefore includes the cost of contracted-out rebates (see Box 2).
- The distributional impact on the pensioner population as a whole, estimated using the Distributional Model (Chapter 3). A full distributional analysis gives a more comprehensive evaluation of the impact of reform options than considering specific individuals[20].
- The number of pensioner benefit units eligible for Pension Credit, estimated using the Distributional Model (Chapter 4 and Chapter 5). Such estimates are very uncertain, because they depend on projections of the growth and distribution of a range of different income sources, including state pensions, private pensions, other savings and earnings. A potential range of outcomes is shown rather than a single point estimate.

[19] See Steventon (2005) and Curry (2003) for further details of the PPI's three economic models

[20] This is described in more detail in Curry and Steventon (2005) Box 5

Box 2: State pension costs

In this paper, 'cost' or 'state expenditure on pensions' means the annual cost to the public purse of paying Basic State Pension, SERPS / S2P, Pension Credit, other pension benefits such as Winter Fuel Allowances, and contracted-out rebates.

Increasing the generosity of the state pension could lead to savings in other forms of state expenditure on older people. The cost estimates in this paper include allowances for:

- Reductions in the cost of means-tested benefits: Pension Credit, Housing Benefit and Council Tax Benefit.
- Changes in the amount of income tax paid by older people.

The estimates also include an allowance for increases in the cost of Incapacity Benefit that result from an increase in state pension age. The costings assume that the amount of private income people have in retirement is not affected by the reforms, other than as described for the different scenarios for the outcome of Personal Accounts.

This approach is broadly comparable to that used by the Government[21] with one significant difference. Government cost estimates do not include expenditure on contracted-out rebates, although the changes to contracting-out White Paper proposals are acknowledged as having an impact on Government revenue[22].

It is important to allow for spending on contracted-out rebates, as changes in spending on contracted-out rebates now can have an impact on future spending on pension benefits. For example, not paying contracted-out rebates today would increase the amount of S2P that would need to be paid in future. Spending more on contracting-out could reduce the amount spent on S2P in future if more people contract-out, and reduce spending on Pension Credit if people receive higher contracted-out pensions.

Both sides of the equation – the paying of contracted-out rebates in the short term and the paying of S2P benefits in the long term - need to be taken into account. Otherwise it would in theory be possible to reduce the cost of the state pension system to zero in future by completely pre-funding all pensions, seemingly with no change in spending today.

To make comparisons with Government projections easier, Table 1 in Chapter 2 shows the cost of contracting-out separately from other costs.

[21] DWP (2006 WP)
[22] For example DWP (2006 WP) page 24, notes to Figure 9

Chapter 2: How much does reform cost?

This chapter compares the projected cost of alternative reform options.

There is no net cost to Government from the reforms in the short-term, properly taking into account the partial abolition of contracting-out. From 2030 the White Paper proposals have an annual net cost to Government of around 0.1% of GDP. For the same cost or less, the UK could move to a simple near-universal single pension system.

The White Paper proposals have no initial net cost to Government

If the White Paper state pension proposals are implemented as planned, then net Government spending on pensions will not be higher than it would have been had the current system remained in place until after 2030, and even then the additional cost will be small (Table 1).

As Box 2 explains, changes in expenditure[23] on contracted-out rebates need to be accounted for when considering the impact of reform on Government finances. In the first year that the White Paper reforms would be implemented (2012), the proposed abolition of contracting-out into Defined Contribution (DC) arrangements will result in an increase in Government revenue of £4 billion (Table 1). This has not been factored into the Government projections of spending on pensions[24], even though the resulting higher future spending on S2P has been counted.

The increased revenue from abolishing contracting-out for DC arrangements more than covers the projected costs of state pension reform until state pension age is increased. After 2030 the cost of the reforms is only 0.1% of GDP up to 2050.

[23] In accounting terms, contracting-out is revenue forgone rather than expenditure. However, the revenue forgone can be treated as a cost as they equate to the same thing when considering the overall impact on net Government finances.
[24] DWP (2006WP) page 24

Table 1[25]: Projected increase in Government spending, additional Government revenue from changes to contracting-out, and net change in finances from alternative reform options, compared to projected state expenditure on pensions under the current pensions system

	Projected spending under the current system	Extra cost on top of the current system			
		White Paper	Long transition to a single pension	Medium transition to single pension	Short transition to a single pension
In £ billion, 2006/7 prices					
		Increase in Government spending			
2012	83	1	-6	5	12
2020	95	5	-10	10	10
2030	130	10	-10	35	15
2040	165	15	-10	40	20
2050	205	15	-*	35	20
		Additional revenue from abolishing contracting out[26]			
2012		4	11	11	11
2020		5	10	10	10
2030		10	10	10	10
2040		10	15	15	15
2050		10	15	15	15
		Net change in Government finances			
2012		-3	-17	-6	1
2020		-*	-20	0	*
2030		*	-20	20	5
2040		10	-20	25	10
2050		10	-15	20	5
As a percentage of GDP					
		Net change in Government finances			
2012	5.4%	-0.2%	-1.1%	-0.4%	0.0%
2020	5.2%	0.0%	-1.0%	0.1%	0.1%
2030	5.9%	0.1%	-1.0%	1.0%	0.2%
2040	6.3%	0.1%	-1.0%	0.8%	0.2%
2050	6.3%	0.1%	-0.6%	0.5%	-0.1%

It is possible for a £ billion cost to be a %GDP saving compared to the current system, as raising state pension age leads to a higher GDP.

[25] PPI estimates using the Aggregate and Distributional Models. See Steventon (2005) for a technical description of the models. Figures in £ billion are rounded to the nearest £1 billion for 2012 and to the nearest £5 billion for the later years. * represents less than £2.5 billion. See the separate PPI modelling paper for a comparison with Government estimates of the current system and White Paper proposals.
[26] This analysis uses more conservative (i.e. lower) estimates of the future cost of contracting-out based on the GAD assumptions for the setting of contracting-out rebates than are estimated if the rebates are generated using the underlying assumptions in the Aggregate Model. This is to allow for a more direct comparison with Government estimates. For the White Paper option contracting-out is abolished only for DC schemes. For the other reform options all contracting-out is abolished.

Single pension options could cost less

A move to a simpler, single pension system could be achieved with a better overall impact on Government finances than the White Paper reforms (Table 1). The cost, in terms of the net change in Government finances:

- Of a short transition to a single pension is broadly the same as the White Paper reforms, both in 2012 and in later years.
- Of the long and medium transitions to a single pension cost less than the White Paper reforms until 2020.
- Of the long transition to a single pension costs less than the current system to 2050 and beyond.

This appears to contradict assertions made by the Government and the Pensions Commission that a single pension, sometimes called a 'Citizen's Pension' is not affordable[27]. This is because:

- There is no one model of a single pension. The Government and the Pensions Commission considered a more expensive version of the single pension than is considered in this paper, where a single person receives a higher pension than each partner in a couple (Box 1).
- Different transition paths to a single pension are also considered in this paper. These have different costs.
- Government and Pensions Commission estimates do not take into account the extra revenue generated by abolishing contracting-out.

For the short transition to a single pension, the higher additional spending from moving overnight to a higher flat-rate pension is more than covered by the additional revenue from abolishing contracting-out for both DC and DB arrangements.

In the long and medium transitions to a single pension, the Government's financial position is improved further in the short term as the additional revenue from abolishing contracting-out is higher than the additional spending on state pensions. The impact of abolishing contracting-out gets smaller in the future, as the cost of contracting-out is projected to decline[28].

Therefore a move to some form of single pension is affordable, and could even be afforded at lower cost than the White Paper reforms if the additional revenue collected from the abolition of contracting-out is retained within the pension system.

[27] See for example DWP (2006 WP) pages 117 - 118 Box 3a

[28] Due to the earnings band that contracting-out applies to becoming smaller relative to average earnings each year

Chapter 3: Who benefits from reform?

This chapter compares the impact of alternative reform options on people over state pension age with low and high incomes.

The White Paper proposals aim to make the Basic State Pension (BSP) near-universal, and are described as providing a state pension of £135 a week from BSP and State Second Pension (S2P) combined. But because of a long transition, gaps in coverage, and the continued price indexation of S2P, the majority of people over state pension age may not have as much as £135 a week from the state even by 2050.

Some of the poorest pensioners will not gain significantly from the White Paper state reforms. When the proposals are introduced gains are concentrated on pensioners with the highest incomes. Overall, the impact on the distribution of pensioner incomes is small.

In contrast, single pension options can have better distributional outcomes, with a fast transition to a single pension being better for today's poorest pensioners.

Reforms aim to make the state pension near-universal

One of the key aims of the White Paper is to ***make the state pension fairer and more widely available***[29], and in particular to recognise the contribution of those with caring responsibilities, who are predominantly women.

The Government's preferred way of achieving this is to reform the contributory system (Chart 1), rather than introduce residency-based qualification to the state pension[30].

The Government prefers the contributory system as a matter of principle***: a belief that the contributory principle promotes personal responsibility and positively rewards people's contribution to society***[31]. Where the Government has put forward other reasons for preferring contributory over residency, evidence is mixed:

- ***Public support***[32]: Half of participants in National Pensions Day preferred a residency test, with one-third preferring contributory[33]. Other surveys show a preference for a system that 'gives back what you put in'[34], but this is not how the new contributory principle works[35].

[29] DWP (2006 WP) page 17
[30] Such as the residency basis for future accruals to BSP as proposed in Pensions Commission (2005)
[31] DWP (2006) page 125
[32] John Hutton MP in uncorrected oral evidence to the Work and Pensions Select Committee, 7 June 2006 Question 282
[33] Feedback from National Pensions Day 18 March 2006, DWP
[34] Kelly (2006)
[35] PPI Briefing Note Number 32 (2006)

Chart 1[36]

Summary of proposed changes to the state pension system

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	Current system	WP proposals
Qualifying years	44 years for men and 39 years for women for a full BSP.	30 qualifying years required for a full BSP.
Minimum contributions	At least one qualifying year for BSP must be through earnings, and entitlements of less than 25% of a full pension are not paid.	No minimum contribution conditions for BSP or S2P.
Credits for parents	Credits awarded until children turn 6 for S2P, and Home Responsibilities Protection (HRP) available for BSP until the child turns 16.	Weekly credits awarded until children turn 12 for BSP and S2P.
Credits for the provision of care for the sick or disabled	State Pension protected through Carer's Allowance in S2P or HRP in BSP where someone provides 35 or more hours weekly care.	Weekly credits available in BSP and S2P to those caring for 20 or more hours a week.

- ***Practical reasons, such as administrative complexity and the scope for fraud and abuse***[37]: Government stresses administrative difficulties with proving past residency, because there is no one database of residency records.
    - However, National Insurance records would provide past residency information for most people, and other sources of self-certification (such as GP / NHS records or passports) could be used for others. Future residency would be easier to record, for example by the addition of a postcode field in the National Insurance system.
    - To recognise any remaining difficulties, past residency could be subject to a more lenient test (say, 10 years) compared to a longer test for future accrual (which could be on the same 30-year basis as proposed in the new contributory system, and therefore be no more likely to be open to fraud and abuse, or give rise to excessive amounts of benefit exported overseas[38]).

[36] Based on DWP (2006 WP RIA) page 116
[37] DWP (2006 WP) page 126
[38] Both concerns are raised in DWP (2006 WP) page 126 referring to short qualification period

- ***Better outcomes more quickly for women pensioners***[39]: It is the reduction in the number of qualifying years needed to qualify for a full BSP to 30 that improves outcomes quickly, rather than reforms to the system of credits for carers. There is no practical reason why the 30-year rule could not be used to apply retrospectively to the contributory system in conjunction with the Pensions Commission's proposals for making future accruals based on residency. This would improve outcomes quickly and introduce a residency-based system. Without the changes in carer's credits, it would also become easier to apply the changes to current pensioners.

It appears that it is often differences in specific proposals that give rise to concerns, rather than any problem generic to a residency-based test. Either a revised contributory system or a residency-based test would achieve near-universality.

The decision between them may come down to a question of which is easier to administer and understand, on which there are differing views[40].

Most people over state pension age will have less than £135 a week state pension

Although the BSP becomes near-universal, there are still gaps and inequalities in state pensions under the White Paper proposals:

- It will take a long time for the gap in state pension income between men and women to become significantly smaller[41].
- Uncertainty will remain over how much state pension income an individual will receive. In any one year 25% of the working age population will not qualify for S2P.
- The majority of people over state pension age will have a state pension income of less than £135 a week in today's earnings terms (Box 3).

£135 is the figure used by Government to illustrate the outcome of the state pension reform proposals[42]. It represents the weekly amount that an individual with a full Basic State Pension and 40 years of contributions to State Second Pension would receive at state pension age in 2050. In 2050, £135 a week is broadly the income level at which entitlement to Savings Credit would run out[43].

So any individual with state pension income of less than £135 and no, or very little, other income would be potentially eligible for Pension Credit.

39 DWP (2006 WP) pages 126 - 127
40 PPI Briefing Note Number 32 (2006)
41 PPI Briefing Note Number 31 (2006)
42 For example DWP (2006 WP) page 119, John Hutton MP opening the Pensions Reform debate 27 June 2006, House of Commons ***Hansard*** column 145
43 PPI calculations suggest that eligibility for Savings Credit would run out at £139 in 2050, falling to £135 by 2059

Box 3: Not everyone will receive £135 a week from the new proposals

The White Paper states that ***someone working or caring for 40 years can expect to retire on around 30 per cent of median earnings – or around £135 a week in today's earnings terms – before any private saving***[44]. However, many people above state pension age (SPA) will receive a state pension income lower than this, because:

- There will still be gaps in the reformed contributory system that mean that not everyone will qualify for S2P for 40 years.
  - For example, time spent unemployed, in self-employment, and earning less than the Lower Earnings Limit[45] will still not qualify for S2P. Of the 19 separate categories of credit for state pensions, only 7 apply to S2P[46].
  - In addition, not all periods spent caring will qualify – for example, caring where a youngest child is aged older than 12, or combinations of less than 20 hours a week caring and earning less than the LEL will not count towards S2P.

  The reform proposals will mean that around 1 million extra individuals will qualify for S2P each year. But 25% of working age people (9 million individuals) would still not qualify for S2P each year[47]. An individual reaching state pension age (SPA) in 2050 with only 30 years qualifying for S2P would receive a total state pension of only £120 a week[48], instead of £135, and be within the eligibility range for Pension Credit.
- It will take time for S2P to become high enough for low-middle earners and carers to achieve a state pension at state pension age (SPA) of £135 a week. As the changes to S2P only affect future accruals, many people who have 40 years qualifying for S2P (or SERPS) will have a state pension income of less than £135.
  - For example a median earning woman reaching SPA in 2030, with around 40 years of SERPS and S2P, will only receive a state pension income of £122 a week[49].
- Older pensioners will see state pension income fall below £135 a week. As S2P only increases in line with prices when it is in payment, state pension income in payment will fall relative to earnings. So even if an individual has a state pension income of £135 when they reach SPA, it will erode in value. Given that in 2055 the ***average*** life expectancy after reaching SPA age is expected to be 21.8 years for men and 24.4 years for women[50], price indexation of S2P will have a significant impact on the income level of older pensioners.
  - For the individual with 30 years of qualifying for S2P reaching SPA in 2050, his or her state pension income of £120 at age 68 falls below the Guarantee Credit level by age 76.

As a result, even by 2050, as many as 90% of individuals over state pension age will have state pension income of less than £135 in today's earnings terms[51]. For single pensioners, this income level would be low enough to qualify for Pension Credit in the absence of any other income.

[44] DWP (2006 WP) page 108
[45] £4,368 in 2006/7
[46] PQ David Laws House of Commons ***Hansard*** 26 June 2006, column 62W
[47] PPI Briefing Note Number 32 (2006)
[48] PPI estimate, in today's earnings terms
[49] PPI estimate, in today's earnings terms – see PPI Briefing Note Number 31 for further details
[50] DWP (2006 WP) Figure 3.ii, page 114
[51] PPI estimate based on the base case scenario. See Chapter 4 for a description of the base case scenario.

The state pension analysis in the White Paper only considers:

- Individuals with full contribution histories (40 years, either through earnings or credits) for BSP and S2P, and,
- State pension income only at state pension age.

This partial analysis does not therefore take into account the problems of incomplete contribution histories, or what happens to state pension income (and income levels for Savings Credit) after state pension age. Both of these factors would reduce the amount of state pension income received below the £135 level quoted (Box 3).

All of the single pension options in this paper are based on more inclusive qualification criteria than in the current system to achieve a near-universal system. The qualification test could be the improved contributory system in the White Paper proposals, or a residency test. They would be more universal than the White Paper proposals as the more inclusive qualification would apply to all state pension income, not just a component.

The single pension options provide a lower initial state pension income (£114 a week for a single person, £87 a week for each partner in a couple) for many pensioners than under the White Paper proposals. Because the entire state pension would be indexed to earnings, state pension income would not be reduced after state pension age.

The single pension is high enough to ensure that income remains at or above the Guarantee Credit level. As a result any additional income is not subject to the £-for-£ withdrawal of Guarantee Credit. This removes the need for Savings Credit. So in the single pension options Savings Credit is assumed to be abolished, with suitable transitional protection. Means-testing for basic income is therefore substantially reduced in single pension options[52].

[52] See Chapter 4 for more details

The distributional impact of the White Paper proposals is small
Some of the poorest pensioners will not gain significantly from the White Paper state reforms. When the proposals are introduced gains are concentrated on pensioners with the highest incomes. Overall, the impact on the distribution of pensioner incomes is small.

Box 3 demonstrates how an individual can receive a low state pension under the White Paper proposals. But it is difficult to generalise from individual examples, and gauge the impact on the pensioner population as a whole. A full distributional analysis, as used in the rest of this chapter, gives a more comprehensive evaluation of the impact of reform options than considering specific individuals. Distributional analysis combines the impacts on individuals with different characteristics, different levels of pension income and at different ages[53].

When reforms are introduced
There is little in the White Paper reforms to help current pensioners, or those close to state pension age (Table 2). Incomes in the middle of the income distribution are lower under the White Paper proposals than a continuation of the current system. Although not large enough to be seen in Table 2, most of the additional expenditure in 2012 will be directed towards pensioners in the higher parts of the pensioner income distribution.

This is because:
- Women already over state pension age on 5 April 2010 do not benefit from the 30 qualifying years change, or the new credits designed to increase eligibility for BSP and S2P.
- Current pensioners with higher incomes gain most from earnings uprating BSP, as they are more likely to have a full BSP.
- The squeeze on Savings Credit (SC) begins in 2008, at least 4 years before BSP earnings uprating. This reduces eligibility for SC. Most existing SC recipients are women[54].

[53] This is described in more detail in Curry and Steventon (2006) Box 5
[54] PPI analysis of DWP Pension Credit statistics

Table 2[55]: Illustrative weekly total after tax income of people over SPA in 2012 by decile of the income distribution, £ per week in 2006/7 earnings terms

			Single pension options		
	Current system	White Paper	Long transition	Medium transition	Short transition
1st	105	105	105	105	125
3rd	130	125	125	130	140
Median	160	155	155	160	175
7th	205	205	205	205	210
9th	300	300	300	305	310

The next 25 years

By 2030 more women will receive a full BSP, and so gain more from earnings uprating. However, lower earners (who tend to be women) will still have less S2P than higher earners (Box 3):

- Even an individual reaching SPA in 2030 will have spent virtually all of his or her working life with a state pension system that is earnings-related (pays higher pensions to higher earners). Accruals to S2P will not be completely flat-rate until after 2030[56].
- The improved credits for S2P will only have been in operation for at most half of a female pensioner's working life. So the average second pension for women pensioners will still be lower than for men.

So gains from the White Paper proposals will still be higher for higher income people than lower income people. For example, in 2030 average incomes towards the top of the income distribution are projected to be £20 a week higher under the White Paper proposals than in the continuation of the current system. Average incomes for the poorest 10% are projected to be only £5 a week higher (Table 3).

Table 3[57]: Illustrative weekly total after tax income of people over SPA in 2030 by decile of the income distribution, £ per week in 2006/7 earnings terms

			Single pension options		
	Current system	White Paper	Long transition	Medium transition	Short transition
1st	110	115	110	130	120
3rd	140	140	135	165	140
Median	175	180	175	200	175
7th	220	230	220	245	215
9th	370	390	375	405	360

[55] PPI estimates using the Aggregate and Distributional Models, based on the base case scenario. See Chapter 4 for details of the base case scenario. All figures have been rounded to the nearest £5.
[56] DWP (2006 WP) page 117, paragraph 3.48
[57] See note to Table 2

The next 45 years

On average state pension incomes for men and women reaching SPA in 2050 are likely to be more equal[58]. But there will still be little increase in incomes at the bottom of the income distribution compared to the current system (Table 4). This is because:

- Gaps in the contribution system for S2P will mean that some individuals will still receive low amounts of S2P. As a result, they will have state pension income below the £135 'target' level (Box 3). Many of these will be women who have not met the precise definitions of caring in the new system, or men who have been self-employed.
- The squeeze in Savings Credit (SC) means that the proportion of pensioners eligible to Guarantee Credit (GC) but not SC will increase. Pensioners with the lowest incomes will not be entitled to SC, even if they have private savings (Box 4).
- As S2P is still increased in line with prices in payment, successive generations of people reaching SPA will still tend to have higher incomes than older pensioners. Older pensioners (and particularly women) will remain more likely to fall back onto Pension Credit (PC), but because of the squeeze on SC may receive less SC than younger persons who have had similar working lives.

So gains remain higher for high income pensioners than for low income pensioners. For example, by 2050 the average income towards the top of the income distribution is £20 higher under the White Paper proposals compared to the continuation of the current system, while the difference in average incomes of the poorest 10% is only £5 a week (Table 4).

Table 4[59]: Illustrative weekly total after tax income of people over SPA in 2050 by decile of the income distribution, £ per week in 2006/7 earnings terms

			Single pension options		
	Current system	White Paper	Long transition	Medium transition	Short transition
1st	110	115	115	130	120
3rd	140	135	140	155	135
Median	165	170	175	185	165
7th	205	210	210	220	200
9th	305	325	320	330	300

[58] See PPI Briefing Note Number 31

[59] PPI estimates using the Aggregate and Distributional Models, based on the base case scenario. See Chapter 4 for details of the base case scenario. All figures have been rounded to the nearest £5.

Box 4: Less income qualifies for Savings Credit in the White Paper proposals

Less income will be eligible for Savings Credit (SC) under the White Paper proposals, so more low income individuals will be subject to the 100% withdrawal rate of Guarantee Credit (GC) than would happen if the current system remained. Chart 5 in Chapter 4 shows how this affects the numbers qualifying for GC and SC.

The current system

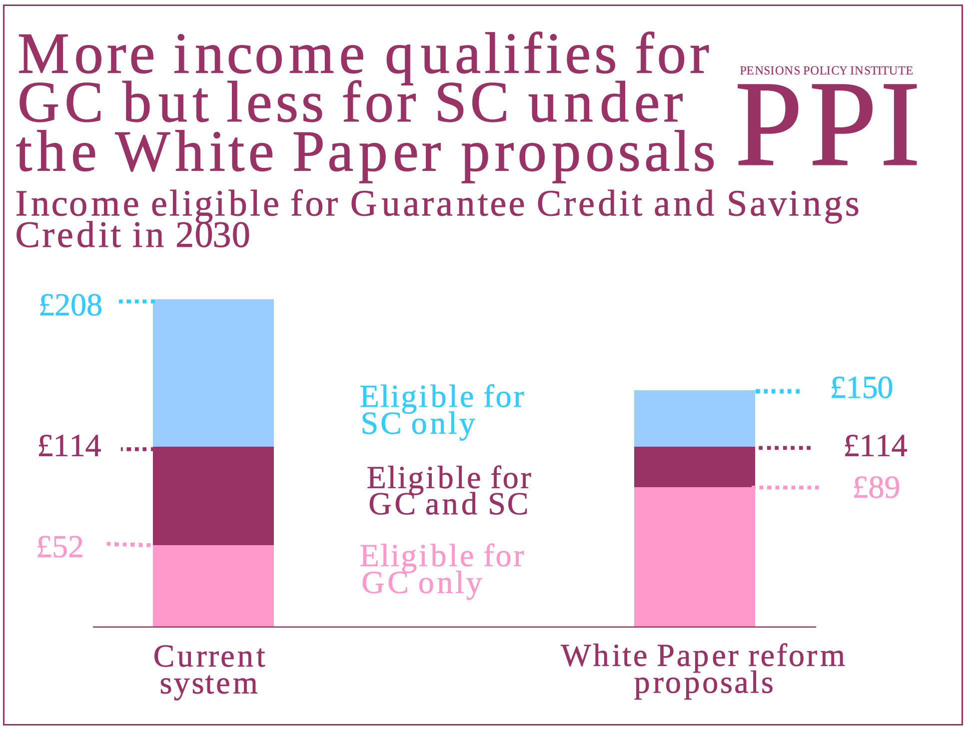
SC is payable on any income individuals have above the full Basic State Pension (BSP) level. Any income below this level qualifies for GC, but not SC, and so is subject to a 100% withdrawal rate. Any income above the BSP level limit and below the maximum GC level qualifies for both GC and SC. Any income above the GC level qualifies for SC only. As income rises SC is reduced until income reaches an upper limit above which no SC is payable.

The White Paper reform proposal

The White Paper reform proposals squeeze the band of income that qualifies for SC over time. As a result (Chart 2):

- The minimum income level needed to qualify for SC is higher than today.
- So more income is eligible for GC only, including some income above the full Basic State Pension level.
- Less income is eligible for GC and SC, and for SC only.

Chart 2[60]



[60] PPI calculations. For the current system, Savings Credit eligibility would start at the Basic State Pension level (£52 a week in today's earnings), and as the gap between BSP and the Guarantee Credit level (£114) is large would be payable until income reached £208 a week. Under the White Paper reform proposals, eligibility starts at £89 a week, which is higher than the BSP level of £75 a week. As the gap between the minimum eligibility level and GC is small, SC is not payable if income is above £150 a week.

Single pension options have better distributional outcome

The medium and short transitions to a single pension (with wider coverage than the current pension system) increase incomes at the bottom of the pensioner income distribution by more than the White Paper reforms (Tables 2, 3 and 4). This is because:

- In a single pension system, almost everyone receives a full pension that is enough to lift them above means-tested income levels[61]. As benefit levels are set at Guarantee Credit levels, and Savings Credit is abolished, any additional income that individuals have does not fall within the possibility of being means-tested for basic income[62].
- Higher earners receive the same state pension as low earners and carers, irrespective of the number of years qualified. In the current system and under the White Paper reform proposals higher earners will continue to do better. Parts of the system remain earnings-related for at least the next 25 years, and the amount of S2P received still depends on the number of years qualified.
- All state pension income is increased in line with earnings. This leads to the income of older pensioners remaining much closer to that of younger pensioners, reducing poverty at older ages compared to the current system and the White Paper proposals.

A faster transition gives most to lower income pensioners

While the above is true of any single pension system when it has been fully implemented, the long and medium transitions are less progressive than the fast transition (Tables 3 and 4). The fast transition gives more immediately to poorer pensioners than the White Paper proposals (Table 2 and Chart 3).

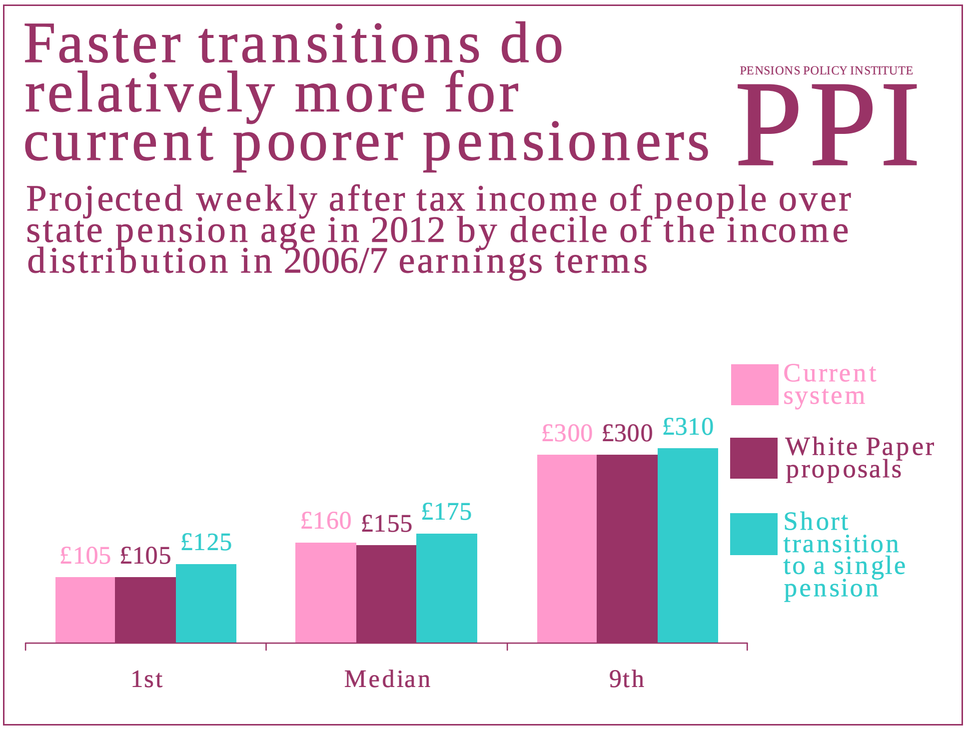
This is because:

- A fast transition is the only option that increases the pension coverage, pension level <u>and</u> indexation for <u>current</u> pensioners.
- High income pensioners do not gain but receive the same as they would have done under the current system under the offset transition.

[61] See Chapter 4

[62] Income could still be means-tested for Housing Benefit and Council Tax Benefit

Chart 3[63]



Moving to a flat-rate state pension system is redistributive in the long-term. This means high earners receiving less state pension than they would under either the White Paper reform proposals or a continuation of the current system. This trade-off decision may be preferred as:

- Any reduction in income is slight, with only the 20% of pensioners with the highest incomes seeing a change of more than £10 a week in today's earnings (Tables 3 and 4). It could be argued that high earners are more able to make voluntary private provision, and be better served by the private savings industry than low-middle earners.
- No individual would receive any lower income from state pension already accrued, and no pensioners would see state pension income fall overnight. Existing Savings Credit payments would be protected during the transition. The difference is a fall in future expectations.
- A more certain guarantee of a flat near-universal foundation can be argued to be a better social policy objective than distributing more state resources to higher income pensioners.
- If the impact on middle-high income pensioners is a concern, this could be addressed by retaining an element of Savings Credit on top of a single pension system. This may better meet the aim of a reward for saving than the current plan of SC on top of an uncertain state pension.

[63] PPI estimates using the Aggregate and Distributional Models. All figures have been rounded to the nearest £5.

Chapter 4: How many people remain eligible for Pension Credit?

This chapter compares the projected proportion of people eligible for Pension Credit under the alternative reform options.

Future eligibility for Pension Credit is uncertain. Between one-third and two-thirds of pensioner households might still be eligible for Pension Credit in 2050, with a rise in the number eligible from around 4 million today to up to 6 million. Government estimates are at the bottom of this range. A single pension would reduce eligibility for Pension Credit to around 10%, with a fast transition to a single pension achieving this by 2010.

Reducing Pension Credit eligibility helps to meet the Government's reform tests

The proportion of people eligible for Pension Credit is a key measure of success for state pension reform. Reducing the extent of Pension Credit helps secure success against the Government's tests for state pension reform[64]:

- To promote personal responsibility successfully, any barriers to saving should be removed. But widespread Pension Credit means the value from saving is uncertain for many people: it is impossible to predict whether savings made now will fall inside or outside the ambit of Savings Credit in future[65]. The impact of the White Paper state pension reforms in reducing the potential extent of Pension Credit will therefore be crucial in determining the success or otherwise of Personal Accounts (see Chapter 5).
- Simplicity: Pension Credit is complicated and adds significantly to the number of parameters on which an individual's future income depends. Further, it is not certain, as its parameters can be set at short notice in a Budget rather than being set in legislation. Small changes in these parameters can make a big difference to being eligible or not in future. So continued reliance on Pension Credit means that people (and their advisors) will continue to be uncertain about the income they can expect from the state in future and about the value of saving.
- Sustainability: Means-testing can be seen as 'something for nothing' and the process of having to claim means-tested benefits, while improved, is still disliked by many. So extensive means-testing is unlikely to be a sustainable policy.

[64] See Curry and Steventon (2005) Appendix 1 for the full set of Government tests for state pension reform.
[65] See PPI (2006 SWPSC) paragraphs 18 to 30

- Fairness: Because Pension Credit imposes at least a 40% withdrawal rate on savings, less Pension Credit could be seen as being fairer than the current situation. But by the same token, increasing the number of people subject to a 100% withdrawal rate through Guarantee Credit may be seen as unfair. Fairness to all those eligible is undermined by less than full take-up: currently between 31% and 39% of people eligible do not claim[66].
- Affordability: Means-testing pension income may be perceived as more affordable than increasing the level of non-means-tested pension. However, as demonstrated in this Chapter and Chapter 2, it is possible, within the costs of the White Paper proposals, to reshape the state pension system into a near-universal flat-rate pension high enough to reduce the extent of Pension Credit to a residual benefit.

Future eligibility for Pension Credit under the White Paper proposals is very uncertain

Future eligibility for Pension Credit under the White Paper proposals is very uncertain. This is because the state pension will not take everybody above the means-tested level (see Box 3). Therefore, eligibility for Pension Credit depends on the circumstances at the time of each individual or couple, and in particular the amounts of different types of income that they have then, for example:

- The amount of state pension that individuals have will depend on how many years they qualified for S2P.
- The amount of income from private pensions will depend on how much they contributed, how much employers contributed, how contributions were invested and annuity rates applied.
- The amount of income from other savings will depend on how much they saved, how their savings were invested, and how much of any savings were spent before pension age, and whether they use equity in property.
- The amount of income from earnings will depend on the availability of employment opportunities, and willingness to work.

How these amounts are distributed among pensioners will have a significant influence on the extent of Pension Credit. PPI estimates of eligibility for Pension Credit are therefore shown as a range. The scenarios used to generate this range are shown in Box 5.

[66] DWP (2006 TU)

Box 5: PPI range for PC eligibility under the White Paper proposals

Future eligibility for Pension Credit (PC) under the White Paper proposals is very uncertain. PPI estimates in this paper are therefore presented as a range. This box describes how the range has been derived.

The proportion of pensioner 'benefit units' eligible today is uncertain because of data limitations. Official estimates are presented as a range: from 43% to 49% for 2007/8[67]. How the proportion will change in future depends on how much income people have 'taken into account' for the calculation of their eligibility for PC in future. This depends on how much people save and to what extent older people work in future, so there is a wide funnel of doubt when looking as far ahead as 2050.

The assumptions used in the base case scenario for the White Paper proposals in this paper are described in detail in a separate modelling paper published alongside this report[68]. Using these assumptions, on average:

- Income from BSP is projected to grow in line with average earnings growth, reflecting the new policy.
- Income from SERPS / S2P grows considerably faster than earnings, as people receive more SERPS and S2P as the system matures, especially at the lower end of the pensioner income distribution.
- Private pension income grows by less than earnings, reflecting current experience of pension contributions not keeping pace with the increasing costs of private pension provision.
- Income from other sources, including non-pension saving, other state benefits such as disability benefits, and earnings grows broadly in line with average earnings, reflecting growth in earnings and saving, but a decline relative to earnings in the value of other state benefits.

These projections seem reasonable compared to what we know about the likely trends in each of these components. They are equivalent to assuming all income grows at 2% a year, real, between 2005 and 2050 (Table 5). In this scenario, Pension Credit eligibility under the White Paper proposals remains roughly at today's levels of 45%-50% (Chart 4).

Different scenarios are possible. To derive a range, higher and lower income growth is modelled. Changing the assumed rate of income growth has a significant impact on the extent of Pension Credit:

- If average income grew faster, at 2.5% a year in excess of prices, Pension Credit eligibility in 2050 would be lower, at around one-third.
- But if it grew slower, at 1.5% a year in excess of prices, Pension Credit eligibility in 2050 would be higher, at around two-thirds.

Therefore PPI estimates give a range of the possible extent of Pension Credit under the White Paper proposals of one-third to two-thirds in 2050, with a base case of no change from today's level of 45%-50% (Table 6 and Chart 4). This would mean between 4 million and 6 million households eligible for Pension Credit.

[67] DWP estimates, consistent with published 2004/5 National Statistics take-up estimates for Pension Credit
[68] Available from the PPI website www.pensionspolicyinstitute.org.uk

Table 5[69]: Projected annual rate of real growth in the average income received by individuals over state pension age between 2005 and 2050 in the base case scenario for the White Paper proposals, by type of income

	PPI base case
Basic State Pension	2%
SERPS / State Second Pension	3%
Private pension (including Personal Accounts)	1%
Other income	2%
Equivalent growth factor applied to all income:	2%

Table 6[70]: PPI estimates of the projected proportion of pensioner benefit units eligible for Pension Credit and number eligible in millions

			Single pension options		
	Current system	White Paper	Long transition	Medium transition	Short transition
2012	45% - 55%	45% - 50%	45%	45%	10%
2020	60% - 70%	50% - 55%	50%	40%	10%
2030	70% - 80%	45% - 60%	50%	5%	10%
2040	75% - 85%	35% - 60%	40%	5%	10%
2050	80% - 90%	30% - 65%	25%	5%	10%
2012	4.0 – 5.0	4.0 - 4.5	4.5	4.5	0.5
2020	5.0 - 6.0	4.0 - 5.0	4.5	3.5	1.0
2030	7.5 - 8.5	4.5 - 6.0	5.0	0.5	1.0
2040	8.5 – 10.0	4.0 - 6.5	4.0	0.5	1.0
2050	9.0 – 10.5	3.0 - 6.5	2.5	0.5	1.0

69 Results from the Aggregate and Distributional models. ‘Other income’ includes non-pension saving, earnings and state disability benefits. ‘Real’ means in excess of prices. For comparison, annual growth in average earnings is assumed to be 2% real.

70 PPI estimates using the Aggregate and Distributional Models. See Steventon (2005) for a technical description of the models. See Box 5 for details of the assumptions used to generate the range for the White Paper proposals. For the current system the range is 0.5% real above and below the central estimate. Figures are based on the central scenario for Personal Accounts. A pensioner benefit unit is a single or a couple who can apply for Pension Credit. Percentage figures are rounded to the nearest 5% while figures in millions are rounded to the nearest 0.5 million. Figures for the medium transition are lower than in the short transition as state pension income is higher, but this affect is accentuated in later years by the rounding convention used. In the short transition, Savings Credit that is in payment when the reforms are introduced would be protected. The amount in payment is assumed to be paid for life, increasing with prices. The number receiving this protection is not shown in the chart because it would no longer be a means-tested amount. Around 25% of pensioner benefit units would receive the protection in 2010, reducing to around 5% by 2030. See Curry and Steventon (2006) Appendix 2 for further details.

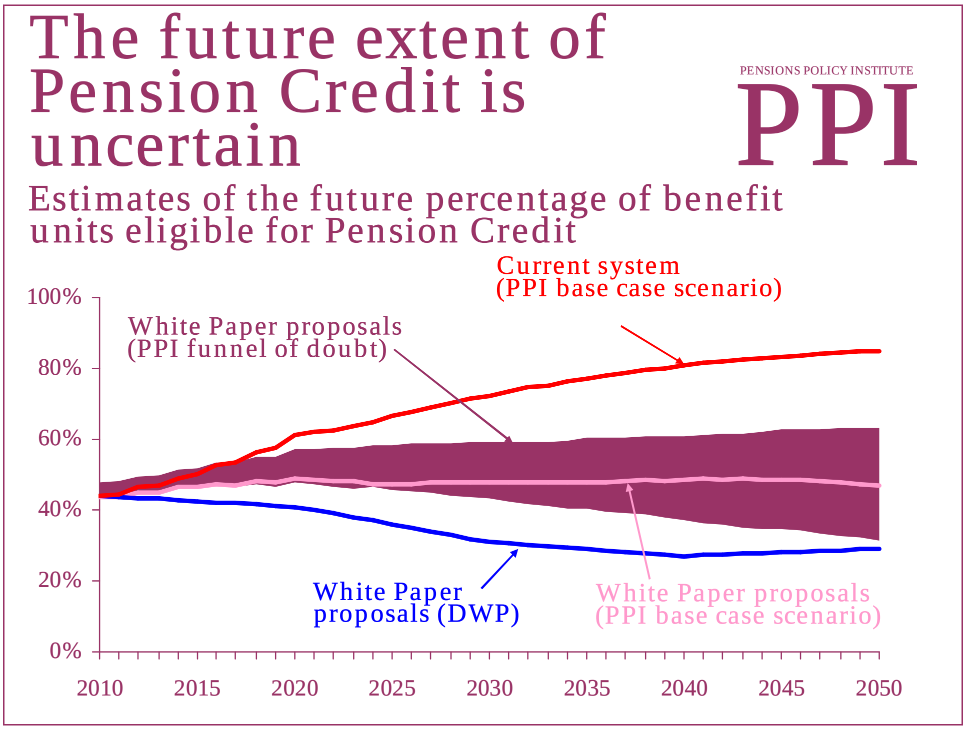
The White Paper may underestimate future eligibility for Pension Credit

Under the White Paper proposals, PPI analysis suggests that between one-third and two-thirds of pensioner benefit units might still be eligible for Pension Credit in 2050 (Table 6 and Chart 4).

The Government's estimate in the White Paper lies at the bottom of the range at around one-third of pensioner benefit units being eligible in 2050 after the reforms. The Government's estimate differs from the PPI base case estimate because different assumptions are used (Box 6). If the same assumptions are used, DWP and PPI models give similar estimates. By only giving a point estimate of the outcome on this measure, the White Paper does not reflect the high degree of uncertainty that exists on the potential future extent of Pension Credit after the proposed reforms.

If the current state pension system remains in place the proportion of pensioners eligible for Pension Credit would grow rapidly over the next 50 years. By 2050, between 80% and 90% of all pensioners could be eligible for Pension Credit, representing around 10 million households (Table 6). But even one-third of pensioners eligible is an historically high level of means-testing for basic income for pensioners[71].

Chart 4[72]



[71] PPI (2006 WPSC) paragraph 27

[72] PPI estimates based on the Aggregate Model and Distributional Model. See Box 6 and the separate modelling paper for details of the assumptions used to generate the range. Figures are based on the central scenario for Personal Accounts.

Box 6: Impact of different modelling assumptions and methodologies

As discussed in Box 5, future eligibility for Pension Credit is very uncertain. The outcomes from modelling projections depends on the modelling assumptions and methodologies used.

The projections of eligibility for PC shown in the White Paper are based on the average of results from two different Government models. The first, PENSIM2, models in detail the life histories of a large number of individuals over the next 50 years. Although in theory this should produce a more 'realistic' picture of the future income distribution, in practice results depend on a large number of assumptions concerning, for example, work and earnings histories, and individual savings behaviour. This is a sophisticated approach which does not necessarily mean more reliable figures because of the multiplicity of assumptions and the interactions between them. This model suggests that 27% of pensioners would be eligible for PC in 2050[73].

The second, a version of the Policy Simulation Model (PSM), uses a similar methodology to the PPI Distributional Model, and assumptions derived from PENSIM2. This model suggests that 32% of pensioners would be eligible for PC in 2050[74].

The White Paper shows only the mid-point of these 2 results for future years: 29% in 2050[75].

The Government estimates are therefore similar to the lower end of the range projected by PPI modelling. This is because income growth is assumed to be higher in Government modelling than in PPI modelling.

Government estimates of Pension Credit in the current system are based on income ***projected to rise broadly in line with earnings, though this is faster than earnings before about 2030 and more slowly than earnings thereafter***[76], so broadly 2% per year throughout.

Pensioner incomes after the White Paper reforms appear to be projected by Government to increase by more than average earnings growth between now and 2050: equivalent to around 2.5% per year[77].

This is similar to the PPI optimistic scenario, but is presented in the White Paper as the only scenario.

Government estimates of the future extent of Pension Credit therefore assume that one or all of BSP, SERPS / S2P, private pension income or other income will grow faster than in PPI modelling (as shown in Table 5). PPI intends to continue to work with Government officials to explore what is a reasonable range of assumptions and the likely uncertainty in the range of outcomes for eligibility for Pension Credit.

[73] DWP estimate
[74] DWP estimate
[75] DWP (2006 WP) Figures underlying Figure 3.v, page 123
[76] DWP (2006 WP RIA) page 154
[77] The PPI has not been able to confirm the assumptions actually used for the White Paper, but 2.5% appears consistent with PPI modelling results replicating the White Paper results.

Marginal withdrawal rates are uncertain under the White Paper proposals

Under the White Paper proposals there is also uncertainty as to what combinations of PC people are eligible. Pensioners who are eligible for Guarantee Credit (GC) but not Savings Credit (SC) have a marginal withdrawal rate on their savings of 100%, so that £1 of extra saving would mean £1 less in Pension Credit (PC), with no change to their total income. Pensioners who are entitled to Savings Credit would have a lower withdrawal rate, of 40%, meaning £1 of income from saving increases total income by 60p.

Estimates from both the Government and the PPI suggest that White Paper proposals lead to an increase in the proportion of pensioners who are entitled to GC but not SC, relative to what it would be if current indexation continued. This is because the lower threshold for Savings Credit is increased (Box 4).

The Government estimated that 6% of pensioner benefit units would be eligible to GC but not SC in 2050[78]. Using the same 2.5% income growth assumption, PPI also estimates 6% may be eligible for GC but not SC.

PPI analysis shows that the proportion of pensioners eligible to PC is sensitive to assumptions for income growth. Eligibility to GC but not SC is especially sensitive to these assumptions. Seemingly small changes in the assumptions made on future income result in large changes in how many pensioners are in this group.

A single pension would reduce eligibility for Pension Credit to around 10%

Moving to a single pension system would have a more significant, and more certain, impact on eligibility for Pension Credit (PC) than the White Paper proposals (Chart 5 and Table 6).

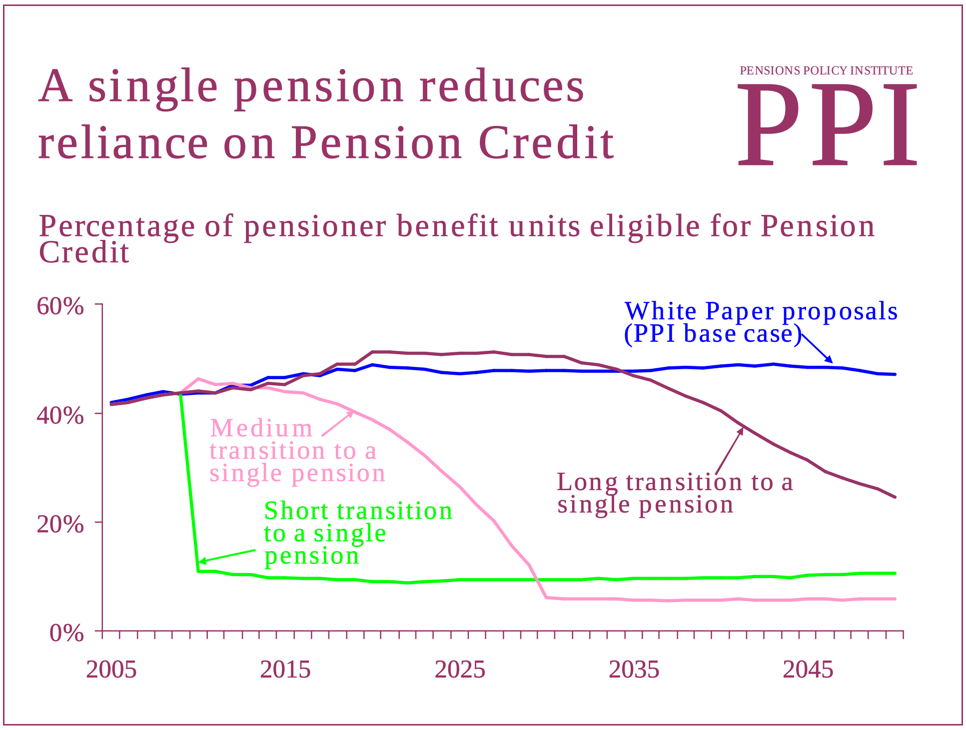
- When transition to a single pension system is complete, very few pensioners would be eligible for PC. This is because the system delivers a flat-rate state pension at the Guarantee Credit (GC) level for nearly all individuals[79] .
- There would therefore be only a very limited rationale for Savings Credit (SC) and it can be abolished (with suitable transitional protection to ensure that incomes do not fall overnight).
- As state pension is above the GC level, GC entitlement is much less sensitive to changes in other income than it is in the current system or would be under the White Paper proposals. And as all state pension income is increased in line with average earnings, older pensioners do not fall back into eligibility for PC. So future eligibility for PC is much more certain under single pension options.

[78] DWP (2006 WP) page 123

[79] Using either the new contributory proposals or a residency-based system would result in approximately 95% of pensioners receiving a full pension. DWP (2006 WP) page 126 Box 3c.

How quickly Pension Credit eligibility is reduced depends on the speed of transition. The short transition to a single pension reduces eligibility to Pension Credit to around 10% of pensioner benefit units (fewer than 1 million) immediately.

Chart 5[80]



[80] PPI estimates using the Aggregate and Distributional Models. Figures are based on the central scenario for Personal Accounts. See notes to Table 6.

Chapter 5: State pension reform and Personal Accounts

This chapter considers the interaction between the White Paper proposals for state pension reform and Personal Accounts.

Even a very successful Personal Account scheme will not significantly reduce the numbers of people eligible for Pension Credit. But, conversely, a potentially high level of eligibility to Pension Credit in future threatens the success of Personal Accounts. The White Paper reforms do not provide a solid state pension foundation for Personal Accounts, which means that UK policy is different from other countries with national savings schemes.

The White Paper did not include full evaluation of alternative state pension reform models or of ways in which a better state pension foundation could interact with a Personal Account-type scheme. Such evidence-based assessments should be made in more detail to help develop consensus on future policy.

The quantitative analysis in the previous chapters in this report has been based on a central scenario for the success of Personal Accounts. It is similar to the central case estimated by the Government of one-third[81] of eligible employees opting-out of Personal Accounts, or an approved employer scheme alternative.

The success of Personal Accounts could theoretically have an impact on the extent of eligibility for Pension Credit. If low-middle earners increase private pension saving through Personal Accounts, this could reduce the amount of Pension Credit that they are entitled to.

The analysis in this section investigates how different scenarios for the outcome of Personal Accounts could impact on the proportion of pensioners eligible for Pension Credit.

[81] DWP (2006 WP RIA) paragraph 2.50

The alternative scenarios modelled are:

1. An optimistic opt-out scenario of 20% of eligible employees opting-out of Personal Accounts or an approved employer scheme alternative, in line with the top-range estimate made by the Government[82].
2. A pessimistic opt-out scenario of 75% of eligible employees opting-out of Personal Accounts, or an approved employer scheme alternative, in line with the estimates made by the New Zealand Government of the proportion of eligible employees who will remain opted-in to the KiwiSaver[83]. Although KiwiSaver may appear less attractive than Personal Accounts, as it does not include a compulsory employer contribution and has a smaller Government incentive than Personal Accounts, this is at least partially counter-balanced by having more flexibility available in the use of funds and hardly any means-testing in retirement. The high opt-out level assumed for KiwiSaver highlights the uncertainty and lack of hard evidence on which to base estimates for Personal Accounts in the UK.
3. A 'levelling-down' scenario, based on the level of opt-out as in the central scenario but in which contributions made by employers who already offer pension schemes are 'levelled down' towards the minimum Personal Account contribution level[84]. In this scenario:
   - Employees whose employers already run Defined Contribution (DC) schemes are assumed to be auto-enrolled into the existing DC scheme. Employers reduce their contribution rate so that employers in aggregate contribute what they did before auto-enrolment. Average total contribution rates drop accordingly, from around 8.9% of salary to 6.9% of salary[85], but because more people are saving, the total amount saved in such schemes remains the same.
   - More significantly in terms of total saving, Defined Benefit (DB) schemes in the private sector are assumed to close more rapidly than in the base case scenario, which assumes that half of DB schemes in the private sector are closed for future accrual by 2035. In the levelling down scenario all private sector DB schemes are assumed to be closed for future accrual by 2035. This could be because, following the introduction of Personal Accounts, DC schemes are seen to be an acceptable standard. The closed DB schemes are all assumed to be replaced by DC schemes with a lower contribution rate than currently, although still higher than the 8% default contribution rate in Personal Accounts.

[82] DWP (2006 WP RIA) paragraph 2.54
[83] See O'Connell (2006 NPSS) for a detailed discussion of the differences between KiwiSaver and the original proposals for the NPSS
[84] See Chapter 5 for further details
[85] 6.9% of salary is more on average than the default contribution to Personal Accounts because it is based on entire salary rather than on salary lying between two earnings limits. PPI analysis based on GAD (2006) and McKay (2006).

A successful Personal Account system will not affect the numbers of people eligible for Pension Credit

The different scenarios for Personal Accounts make little difference to the proportion of pensioners eligible for Pension Credit under the White Paper state pension proposals (Table 7). This is because:

- It takes a long time for a Personal Account to build up into a sizeable asset, particularly for low and middle income earners where contributions are smallest and may be erratic.
- Higher earning individuals who would have the highest incomes from Personal Accounts may already have income above Pension Credit levels.
- Personal Accounts do not add much to total saving, even in the optimistic scenario. This is demonstrated by the Government base case, in which Personal Accounts account for less than 10% of total funded pension assets[86].

As the system of Personal Accounts will continue to mature beyond 2050, the impact on Pension Credit eligibility may become larger in later years.

Table 7[87]: Projected proportion of pensioner benefit units eligible for Pension Credit and number of pensioner benefit units eligible in millions

	Current system base case	White Paper base case	Personal Account scenarios with White Paper state pension reforms		
			Optimistic opt-out	Pessimistic opt -out	Levelling down
2012	45%	45%	45%	45%	45%
2020	60%	50%	50%	50%	50%
2030	70%	50%	50%	50%	50%
2040	80%	50%	50%	50%	50%
2050	85%	45%	45%	45%	45%
2012	4.5	4.0	4.0	4.0	4.0
2020	5.0	4.0	4.0	4.0	4.0
2030	7.5	4.5	4.5	4.5	4.5
2040	9.0	5.0	5.0	5.0	5.0
2050	10.0	5.0	5.0	5.0	5.0

[86] DWP (2006 WP RIA) page 69 paragraph 2.111

[87] PPI estimates using the Aggregate and Distributional Models. See Steventon (2005) for a technical description of the models. Figures are based on the central scenario for Personal Accounts. See footnote to Table 6.

The White Paper reforms do not provide a solid state pension foundation for Personal Accounts

The introduction of Personal Accounts has been proposed to overcome the perceived problem of 'undersaving'[88]. Personal Accounts are expected to top up state pensions to provide a reasonable total 'replacement rate'[89] for individuals, of around 45% for a median earner[90].

This is on top of a state pension system with two stated objectives[91]:

- To tackle pensioner poverty.
- Provide a foundation for retirement income for all.

But the analysis in this report shows that the White Paper state pension proposals do not provide a certain foundation for retirement income, because:

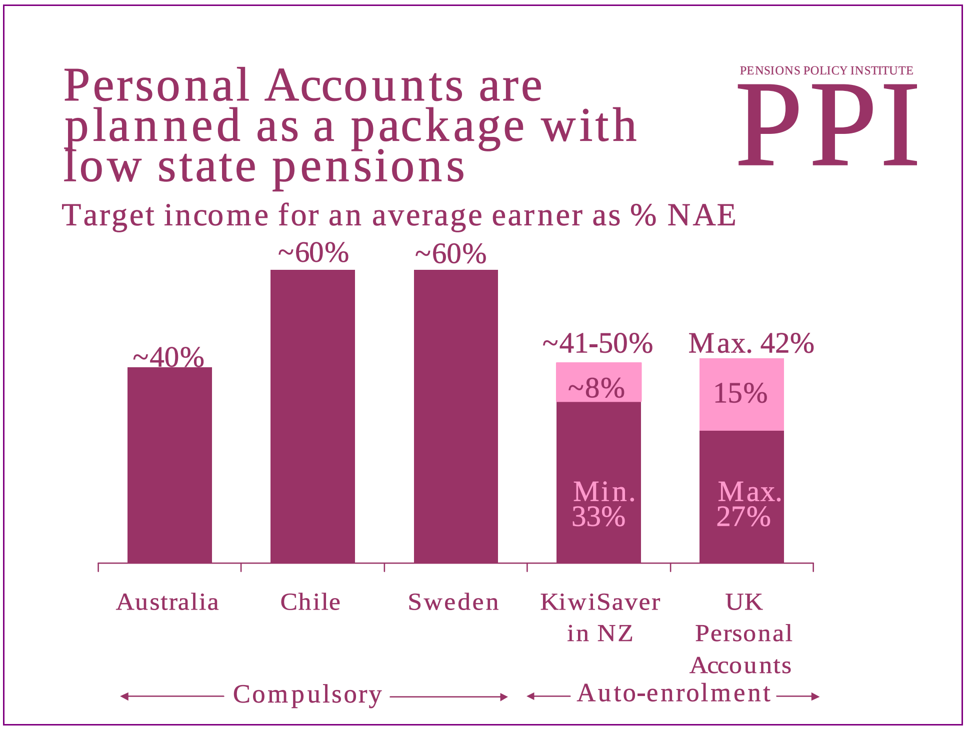
- State pension income remains low even for those who contribute for 40 years (£135 a week, 27% of National Average Earnings, at state pension age).
- Many people will not get as much as £135 from the state (Box 3).
- Eligibility for Pension Credit will remain at uncertain, but high, levels (Table 7).

The White Paper proposals mean that the nature of Government intervention in retirement income policy would be different from that in other countries which have introduced either auto-enrolment or fully compulsory national savings schemes (Chart 6).

In countries which have introduced compulsory private savings, everyone should be taken above and beyond adequacy to a specified replacement rate[92]: to around 40% of National Average Earnings (NAE) in Australia or around 60% of NAE in Sweden or Chile. Governments here have decided that personal choices about saving rather than spending should be restricted for a fairly large slice of an individual's money.

[88] See O'Connell (2006 NPSS) pages 12-13 for a discussion as to the extent of the 'undersaving' problem
[89] A measure of individual retirement income as a proportion of the income that individual had in work
[90] DWP (2006 WP) page 67
[91] See DWP (2006 WP) page 103
[92] In theory at least. There are well documented problems in enforcing compulsory pension contributions – see for example PPI (2005) page 22.

Chart 6[93]



An alternative policy is to guarantee adequacy through the state pension, with no reference to earnings replacement. New Zealand is a fairly generous example of this approach. Its state pension, which has wide political consensus, is set at a minimum of 33% of NAE. Nearly everyone gets this or more. Only 5% or so are eligible for means-tested benefits. Compulsion (in this case through taxes) does not extend as far as the previous countries considered. The Government allows individual choice about savings vs. spending at lower levels, but not so low as to threaten adequacy. The only other proposed national auto-enrolment scheme - KiwiSaver – will allow opt-out, but those choosing to opt out will still be sure of being able to ‘get by’ on the state pension. No target for retirement incomes above adequacy is set.

The UK’s White Paper proposals take a very different approach. Compulsion does not extend very far, and does not guarantee adequacy. There is a low, and uncertain level of state pension that may reach 27% of NAE for some people at state pension age, but for the majority is lower unless they claim means-tested benefits, which not everybody does. But the private pension saving on top is voluntary (through auto-enrolment) so that cannot ensure adequacy either.

Personal Accounts would therefore have to make up for inadequacies in state provision as well as aiming to provide an income replacement.

[93] O’Connell (2006 NPSS). Although the KiwiSaver is shown as an income, there will be no requirement to convert funds from KiwSaver into an annuity. The lump sum figure has been converted to income in this chart to allow for comparisons with other systems.

The White Paper did not include full evaluation of alternative state pension reform models

Neither the White Paper nor the Pensions Commission explored any alternatives for different balances between state and private provision, any different types of intervention into private savings markets (other than to rule out compulsion) or different policies in which auto-enrolment could be effective with less risk. The two options considered for Personal Accounts in the White Paper are different delivery methods.

But many alternatives are possible:

- With a better and more certain state pension foundation, there is less policy rationale for Personal Accounts[94]. The private sector may then be able to operate better than today without the need for Government intervention through auto-enrolment.
- If the idea of a national auto-enrolment savings scheme is still preferred to less interventionist measures, it could be introduced as a less prescriptive product on top of a firmer state foundation, for example with more discretion about contribution levels, and who pays them, with early withdrawal options and without the need to annuitise[95].
- It is possible to provide a near-universal single state pension at the level of the Guarantee Credit at the same cost as the White Paper reform proposals. But if some of the money expected to be contributed to Personal Accounts by employees, employers and the Government were instead contributed to National Insurance, the balance would shift towards the state, making it easier to secure a sound foundation pension[96].
    - For example, NI rates could be increased by 1% for employer and employee and state pensions improved commensurately. Minimum contribution rates to an auto-enrolment savings vehicle could be set at 6% rather than 8%, with no need for contingent compulsion on employers.
    - The total amount going into pensions – state and private - would be broadly the same[97]. This could give a similar overall result to the White Paper reforms at less risk. It could be a better balanced policy, especially beneficial for low earners, and by reducing the extent of Pension Credit could boost voluntary private pension savings.

[94] PPI (2006 SaSPS)
[95] See O'Connell (2006 NPSS)
[96] For example, this might be preferable to using the offset transition method
[97] After allowing for the different income ranges that NI and Personal Account contributions apply to, and allowing for some opt-out of the auto-enrolment schemes

This paper shows the value of a more detailed and independent analysis than that in the White Paper. In particular, it highlights the need to:

- Understand more fully the impact of state pension reform, especially the distributional impact and the implications for Pension Credit.
- Compare the advantages and disadvantages of the White Paper proposals for state pension reform with those of other reform options.
- In particular consider reforms to state pensions to provide a simpler and more secure foundation for an auto-enrolment scheme that could be less prescriptive than the White Paper proposal.

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