PENSIONS POLICY INSTITUTE

PPI

The impact of the Government's single-tier state pension reform

The impact of the Government's single-tier state pension reform is a research project funded by the Nuffield Foundation

The PPI will publish a series of briefings in the coming months to provide a detailed, comprehensive and independent analysis of the impact of introducing the single-tier state pension. The analysis will cover issues such as:

- The impact on different cohorts of individuals, and individuals with different characteristics.
- The impact on Defined Benefit pension schemes of the ending of contracting-out.
- The impact on future government spending, including the impact of ending contracting-out and trade-offs between the levels of the single-tier pension and how it is increased over time.
- Managing the transition between the current system and the single-tier pension.

For more information, please contact the PPI.

This first briefing summarises and updates the PPI response to the Work and Pensions Select Committee pre-legislative scrutiny of the Pensions Bill.

Introduction

This briefing describes the main components of the Government's state pension reform plans. It also provides an initial analysis of the possible impact of the reforms on individuals with certain characteristics, the future need for means-tested benefits, the implications of the ending of contracting-out and the impact on future levels of Government spending on state pensions and related benefits.

The Government's proposals

On 14 January 2014, the Government published a White Paper[1] setting out plans for state pension reforms. On 9 May 2013, the Government introduced the Pensions Bill 2013-14 to Parliament. The Bill proposes to implement a new single-tier state pension from April 2016 that will replace the current Basic State Pension (BSP) and the State Second Pension (S2P). The White Paper illustrates the new pension as being set just above the current Guarantee Credit level, at £144 per week (in 2012/13 prices), although the actual level will not be set in the Pensions Bill, but will be set by the Government of the day closer to the implementation date of April 2016. DB schemes will no longer be able to contract-out of S2P. The changes will not apply to people who are over State Pension Age (SPA) when the new arrangements are introduced. 35 years of National Insurance Contributions (NICs) will be necessary to qualify for a full single-tier pension with a minimum of somewhere between 7 to 10 years to qualify for any amount.[2]

When the single-tier pension is introduced, a "foundation" amount will be calculated for each individual, based on their entitlement built up under the current state pension system. This will be compared to the amount that the individual would have built up in the new single-tier system had it been in place. Individuals will then take forward the higher of the two amounts (adjusted for time spent contracted -out of the S2P and SERPS) into the new system. If the foundation amount is higher than the new single-tier level, the amount above the single-tier level will be protected and paid on top of the single-tier pension.

The impact on specific individuals

While the precise impact of the reforms on individuals will be highly dependent on each individual's own circumstances, it is possible to identify some groups of individuals who could have higher or lower state pension incomes under the single-tier system.

Individuals who could benefit from the reforms

Individuals who would have qualified for relatively small amounts of S2P are likely to gain from the implementation of the single-tier pension . These include:

- Individuals who have already had career breaks, or low earnings, that were not well covered by SERPS or S2P credits.
- The self-employed.

Individuals who have been contracted-out of S2P and have time to build up more pension after the introduction of single-tier could also gain from the reforms. Since 1978 it has been possible to contract-out of the additional part of the state pension system (SERPS until 2002, S2P thereafter). This meant that individuals paid lower NICs (or received a rebate on contributions) but did not qualify for SERPS or S2P. Instead, they had to be members of an employer's pension scheme that provided benefits at least as good as those provided in SERPS or S2P, or have the National Insurance rebates invested into a qualifying pension scheme.

Under the Government's proposals, people who have been contracted-out of SERPS and S2P will be treated as having built up less state pension rights than similar individuals who have not contracted-out. As part of their "state" pension will be delivered by a private pension scheme, the value of this amount will be deducted from their foundation amount at the time that the single-tier pension is introduced. This means that an individual who has been contracted-out will have a lower foundation amount than an identical individual who has not been contracted -out. This is simply replicating what happens in the current system.

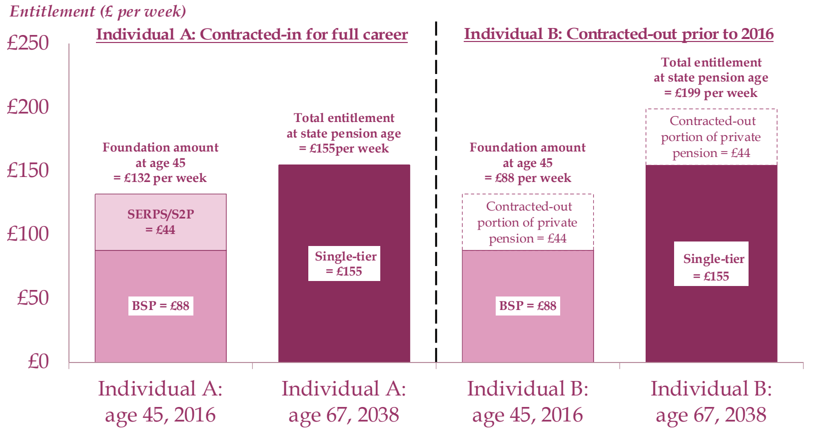
However, if these individuals are younger and have many years to go to retirement, the contracted-out individual may be able to build up more single-tier pension in the future than the contracted-in individual, and both could end up with full single-tier pensions.

Chart 1 illustrates this using the example of two median earning individuals, aged 45 in 2016. These individuals have identical earnings histories, but one has been contracted-out of SERPS/S2P for their entire working life, while the other has remained contracted -in. Both have higher entitlement under the current system in 2016 than if single-tier had been in place throughout their careers, so this becomes their initial foundation amount. However, the contracted-out individual has his initial foundation amount reduced, because he paid lower NICs and so part of his "state" pension is provided through his private pension.

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

Chart 1: Individuals that have contracted-out in the past may be able to build up more entitlement than those that have not

Comparison of the state pension entitlements of two median earning individuals aged 45 in 2016 and at state pension age in 2038 (£ per week, 2013 earnings terms)



Individuals who could not benefit from the reforms

It is important to note that no individual will lose any state pension rights that they have already built up. All individuals will receive at least as much state pension as they would have got in the current system based on their working histories up to the point at which the single-tier pension is introduced.

However, some individuals could build up lower state pension entitlement under the reforms than they would have in the current system. These include:

- Individuals who would have built up high S2P entitlements.
- Individuals who may have been eligible for Savings Credit.
- Individuals with less than 7 – 10 qualifying years.

In the early years after the implementation of the single-tier pension, individuals who have had high earnings in the past and continue to have high earnings after the implementation date will see the largest differences in their state pension.

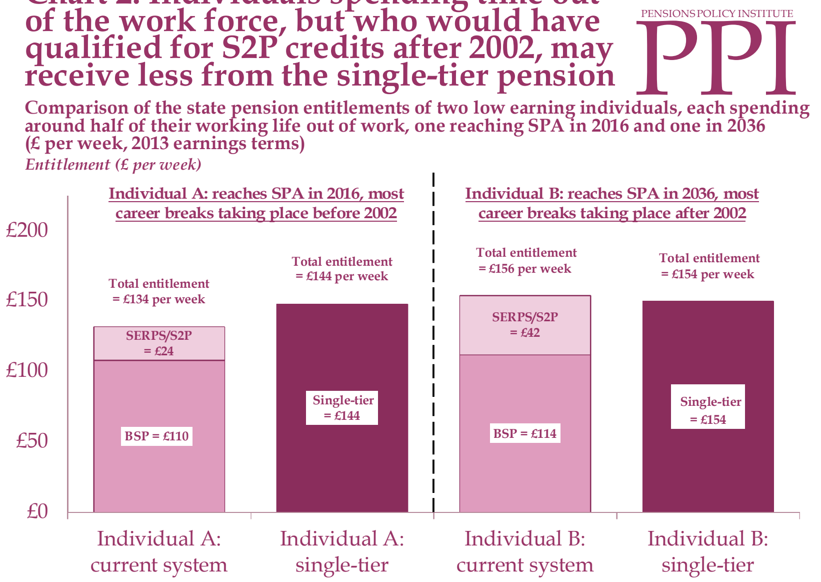
Over time, even relatively modest earners may initially get less from the single-tier state pension than they would have had under the current system. This is because in recent years the S2P credit system and the boost for low earners has made S2P more valuable.[3] Individuals reaching SPA further in the future will have spent more time in the S2P system, and so will benefit more from it than individuals reaching SPA in the next 10 to 15 years. They are therefore more likely to reach SPA with relatively high S2P, and therefore overall state pension amounts.

The impact of the Government's single-tier state pension reform

Chart 2 considers the potential outcomes at SPA under the current system and the single-tier for a hypothetical low earning individual that takes time out of the work equivalent to approximately half of their working life. During their time out of work, the individual is performing an activity, such as providing care for a disabled relative or child under 12 years old, which would qualify them for S2P credits after 2002. Prior to the introduction of S2P in 2002, however, the individual only qualifies for BSP when not in work.

Chart 2: Individuals spending time out of the work force, but who would have qualified for S2P credits after 2002, may receive less from the single-tier pension

Comparison of the state pension entitlements of two low earning individuals, each spending around half of their working life out of work, one reaching SPA in 2016 and one in 2036 (£ per week, 2013 earnings terms)



The example shows the difference in possible outcomes for an individual with this working pattern depending on their current age. An individual aged 63 today reaching SPA in 2016 and having had the majority of their career before 2002 would receive a higher state pension under the single-tier pension system. For someone aged 44 today, their SPA occurs 20 years later in 2036 and the majority of their career takes place after the introduction of S2P, so they would receive a higher state pension had the current system continued.

Individuals who would have qualified for Savings Credit under the current system may also have a lower retirement income under the single-tier system. This is because the single-tier pension is set just above the Guarantee Credit level. In the current system they would be entitled to Savings Credit but in the single-tier system Savings Credit will be abolished for individuals reaching SPA after April 2016.

Individuals with fewer than the minimum number of qualifying years for the single-tier pension could also receive less retirement income under the new system. For individuals reaching SPA from 2010, only 1 qualifying year has been needed to receive some BSP. Individuals reaching SPA before April 2010 had to qualify for 25% of a full pension to receive any amount. Depending on the number of qualifying years chosen as the minimum level, the proposed system will be more or less generous than the pre-2010 system. If the limit is 7 years, individuals will need 20% of the full amount to receive any pension. If it is 10 years, this rises to almost 30% of the full amount.

In addition, in the current system, individuals without any BSP in their own right can still receive BSP based on their partner's contribution records in some circumstances, or their partner could receive a higher pension in recognition of having a partner. The proposed single-tier system is based on individual entitlement, with no scope to take into account a partner's contributions.

The future need for means-tested benefits

One of the key aims of the single-tier state pension reforms is to reduce reliance on means-tested benefits in retirement. High levels of reliance on means-tested benefits — and particularly on Pension Credit, which provides basic income — risk undermining the policy of automatic enrolment if individuals perceive that being eligible for means-tested benefits means they would not gain significantly from saving in a pension.

By setting the illustrative level of the proposed single-tier state pension above the level of the Guarantee Credit element of Pension Credit, and removing the Savings Credit element of the Pension Credit for individuals reaching SPA after the single-tier pension has been introduced, the proportion of people over SPA eligible for Pension Credit is likely to be significantly reduced.

The Department for Work and Pensions (DWP) estimates that under the current system, eligibility for Pension Credit among the single-tier population is expected to peak at between 15% and 20% in the mid 2020s and fall to around 10% by 2060.[4] Under the single tier, eligibility for Pension Credit is halved compared to the current system in the first few years of reform, and ultimately falls to around 5% cent by 2060. However, a number of pensioners will still remain eligible for Pension Credit because of different reasons, such as having less than the 35 years necessary to qualify for the full single-tier pension or because of having a disability or caring responsibilities.

DWP analysis also shows that eligibility for Housing Benefit (HB) and Council Tax Support (CTS)[5] is not expected to change significantly after the implementation of the single-tier pension. This is because even though some pensioners will have higher income after the implementation of the single -tier pension, it will still take more additional income to lose HB and CTS entitlement. Also, the reforms propose to protect eligibility for CTS for people reaching SPA up until 2022.[6]

The impact of ending contracting-out
This will have an impact on both scheme members and sponsors.

DB scheme members will have to pay higher NICs. They currently pay an NI rate 1.4% lower than individuals not contracted-out. In return, they will build up a higher state pension. There may also be changes to the contributions they pay to the DB scheme, or the benefit they receive from the DB scheme, or both, depending on how the sponsor reacts to the ending of contracting-out.

Scheme sponsors will have to pay higher NICs. They currently pay an NI rate 3.4% lower than scheme sponsors not contracted-out. In the current system lower NICs are designed to offset some of the contributions required to fund the DB scheme. Sponsors will need to decide whether to adjust benefits, contributions or both. The DWP has indicated that it will introduce powers so that sponsors can change scheme rules accordingly without trustee consent. This change will not apply to public service pension schemes. Therefore, sponsors of these schemes will face higher NICs and no reduction in the contributions payable to the DB pension scheme.

The impact on government spending on state pensions and related benefits
The DWP estimates that from the late 2040s, the rise in pensions expenditure is smaller under the single-tier than under the current system.[7] Expenditure on pensions and related benefits is estimated to decrease from 8.5% GDP to 8.1% GDP by 2060. This implies that, on average, state pensions and related benefits will be less generous under the reformed system. However, DWP estimates exclude savings from the abolition of the contracting-out rebate, which are projected to be around £5.5bn (0.3% GDP) in 2016/17. To properly evaluate the impact of the proposed reforms on government expenditure, contracting-out should be accounted for. Furthermore, focusing purely on the impact on long-term government expenditure does not allow for all of the impacts of the reform proposal to be properly accounted for, and will under-estimate the impact on future pensioner incomes. PPI plans to investigate this in further analysis.

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[1] DWP (2013) *The single-tier pension: a simple foundation for saving.*
[2] While the Pensions Bill states that the minimum number of years needed to qualify for the single-tier pension can be no more than 10, the final number will be decided by the Government of the day closer to April 2016..
[3] See PPI (2013) *A guide to the UK pension system*, p. 41
[4] DWP (May 2013) *Single-tier – Impact Assessment*, p. 26
[5] Council Tax Support schemes (also known as Council Tax Reduction) are localised schemes that replaced Council Tax Benefit in April 2013. However, for people over state pension age Council Tax Support operates in the same way as Council Tax Benefit.
[6] DWP (May 2013) *Single-tier – Impact Assessment*, p. 27
[7] DWP (May 2013) *Single-tier – Impact Assessment*, p. 38

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For more information on this topic, please contact
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