

### Introduction

The Government response to the Pensions White Paper consultation exercise announced that ... *the Government is considering introducing a much simpler flat-rate State Second Pension (S2P), to replace the current complex arrangements...*<sup>1</sup> This has been described as a *radical simplification of the additional state pension*<sup>2</sup>, which would result in ...*in effect, a single pension which fully recognises their social contribution*<sup>3</sup>.

This Briefing Note describes the Government's proposed change, and estimates what the impact could be on pension incomes. It shows that the proposed change allows S2P to be presented in a simpler way than today, that any gains or losses are likely to be marginal, but that there would still be significant differences between BSP and S2P.

### What is S2P?

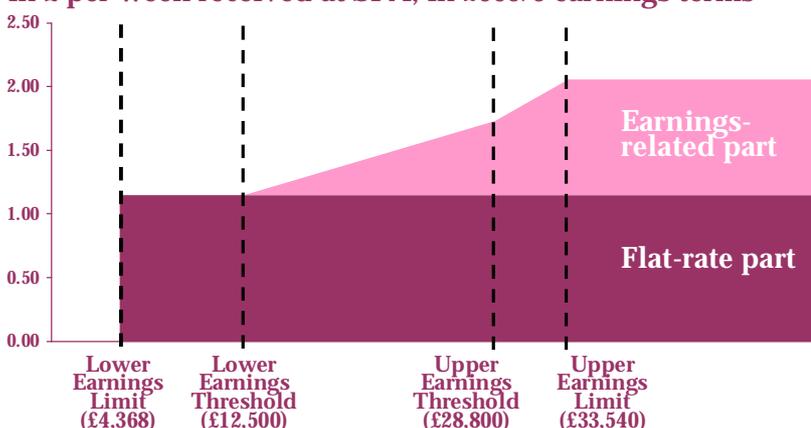
State Second Pension (S2P, or the additional state pension) is a separate state pension paid in addition to the Basic State Pension (BSP), with the amount received by an individual depending on how much he or she earned or had credited during their working life.

There are two parts to S2P<sup>4</sup>. An individual who earns between the lower earnings limit (LEL, currently £4,368 p.a.) and the lower earnings threshold (LET, currently £12,500 p.a.), or who qualifies for a credit, currently

## Chart 1: S2P accruals depend on earnings

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S2P accrued in 2006/7 for the cohort reaching State Pension Age (SPA) in 2050, for different levels of earnings, expressed in £ per week received at SPA, in 2005/6 earnings terms



receives a flat-rate amount of S2P. Individuals earning above the LET receive more S2P, through an additional earnings-related part (Chart 1)<sup>5</sup>.

The amount of the 'flat-rate' part of S2P can vary in two ways under the current formula used to calculate it:

- The flat-rate amount differs according to when an individual reaches state pension age (SPA). For a 51 year old today (reaching SPA in 2020), the flat-rate amount (payable each week after reaching SPA) is £1.42 (2005 earnings terms). For a 42 year old today (reaching SPA in 2030) the flat-rate amount is £1.20.
- The flat-rate amount is slowly increasing. In 2002 the flat-rate amount for someone reaching SPA in 2030 was £1.16 (2005 earnings terms).

### What changes are proposed?

The original White Paper proposals for S2P would mean that the earnings-related component would become smaller over time, and eventually disappear by around 2030. Only the flat-rate component of S2P would be earned after this point.

Under the new proposals, the earnings-related part of S2P will still become flat-rate by 2030. But from 2012 the value of the flat-rate component would be the same in every year— £1.40 a year<sup>6</sup>.

### What are the advantages?

The technical change to the S2P calculation will make it easier to see how much pension is being accumulated each year as the amount is fixed, and allow S2P to be presented as a weekly 'top-up' to BSP. The Government are interested in combining BSP and S2P together in a single pension.

**Who gains and who loses?**

As the underlying qualification criteria for S2P are not changed by the new proposals, there is unlikely to be anyone who will gain or lose a significant amount from the proposed change.

But the value of S2P earned in any one year will be changed as a result of the proposed reform. The impact on S2P received by an individual will depend on his or her age, and the years in which they qualify for S2P.

For example, people reaching SPA in 2020 (aged 51 in 2006) would, under the new proposals, receive a smaller flat-rate S2P payment for each year they qualify after 2012 (Chart 2)<sup>7</sup>.

For people reaching SPA in 2030 (42 in 2006) the value of the flat-rate payment under the new proposals is higher than the current system between 2012 and 2019, but lower after 2020.

For people reaching SPA in 2050 (24 in 2006), the new proposals would result in a higher flat-rate until 2024, but then lower than in the current system. For this group, the overall impact is expected to be neutral if they have qualified for 40 years. Individuals who have qualified for less than 40 years may be better or worse off, depending on which years they qualified for S2P.

However, any losses in any year from this change to S2P would be more than offset by gains S2P in payment to individuals

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## Chart 2: Older people could lose from the simplification and younger people could gain

Flat-rate S2P accrued by different cohorts of individuals, by year of accrual, expressed in £ per week received at State Pension Age (SPA), in 2005/6 earnings terms



from the changes to the BSP proposed in the White Paper<sup>8</sup>.

**Towards a single state pension?**

Although the proposed change will simplify S2P, there will still be some significant differences between S2P and BSP:

- S2P may not become flat-rate for all individuals until 2030.
- Some people may qualify for BSP but not S2P, for example the self-employed.
- S2P will still be uprated in line with prices when it is payment, while BSP is uprated in line with earnings.
- Some of S2P will be delivered by private pensions, through contracting-out.

As a result of these differences, there will still be uncertainty as to the amount of S2P that individuals will receive. Amounts of

will still vary according to lifetime characteristics, and by age. For example, because S2P is uprated by prices when it is payment, a woman with exactly the same contribution record as her younger sister will receive less S2P each year than her sister does.

**Conclusion**

This technical change to the way that S2P is calculated will allow for a simpler presentation of essentially the same benefits. Any gains or losses are likely to be marginal. Although the proposal appears to move closer to a single state pension, many of the differences that currently exist between BSP and S2P will remain.

<sup>1</sup> Department for Work and Pensions (DWP) Press Release 30 October 2006, *Further simplifications being considered—Purnell*

<sup>2</sup> DWP Press Release 30 October 2006

<sup>3</sup> DWP Press Release 30 October 2006

<sup>4</sup> For further information as to how S2P is currently calculated see PPI (2006) *The Pensions Primer: Updated April 2006*

<sup>5</sup> PPI calculations, based on SPA of 68 in 2050

<sup>6</sup> DWP (2006) *Security in retirement: towards a new pension system Summary of responses to the consultation page 71*

<sup>7</sup> PPI calculations assuming that the LEL continues to increase each year in line with prices, and that SPA is 66 in 2030 and 68 in 2050

<sup>8</sup> DWP (2006), restoring the earnings-link to BSP between 2012 and 2015, and reducing the number of qualifying years need for a full BSP to 30