Pensions Policy Institute

PPI

State Pension Reform: Managing Transition

State Pension Reform: Managing Transition

Introduction	1
Summary of conclusions	2
Recap: The pension reform models to be tested	3
1. Why the Pension Credit makes transition more complex	9
2. Increasing the Basic State Pension or changing to a Citizen's Pension	14
3. The impact of reforming the State Second Pension	23
Appendix: Details of the analysis	25
Acknowledgements and contact details	31
References	32

A PPI Working Paper

Published by the Pensions Policy Institute

www.pensionspolicyinstitute.org.uk
ISBN 0-9548248-0-6

Introduction

The Pensions Policy Institute has a programme of work analysing pension reform options. In July 2003, *A Guide to State Pension Reform* analysed the current problems in the UK's pension system, and set out a shortlist of potential reform models and the criteria on which these reform models should be assessed.

One of those models was analysed in depth in the March 2004 publication *Citizen's Pension: Lessons from New Zealand*. At the same time, *State Pension Reform: The Consultation Response* shared feedback from seminars held to discuss the original work.

This report is the next in the series. It begins to compare the proposed reform models in terms of the way they would affect individual people, on one of the assessment criteria – how can transition be managed?

These reform options have been proposed because the end result should be better than the current system in certain ways. But the impact in the short-term has generally not been well examined. The transition path – how we get from here to there – is crucial. Even if the logic of benefits for tomorrow's pensioners makes sense, today's pensioners will also have to be convinced.

This report illustrates short-term transition issues. It looks specifically at the impact of some different proposed pension policy reforms on current and new pensioners in the years immediately following a change in policy.

On the next page a summary of the conclusions from the work can be found. Subsequent chapters give more detail on each of these. The first chapter sets the scene by describing the state pension reform models tested.

The PPI's in-house 'Individual Model' used for this analysis was developed with funding from the Nuffield Foundation. The Appendix describes the technical basis used, and the characteristics of the individuals illustrating the analysis.

PPI work on the impact of policy reform on individuals in the short- and long-term will continue. Future reports will analyse the feasibility and costs of policy reform, and the distribution of winners and losers. Other options will also be examined in more depth.

This work in progress is therefore a piece of the pension policy reform jigsaw. Feedback to contribute to future work is welcomed.

Summary of conclusions

Insofar as current and new pensioners will be affected by transitioning to a new pension system:

1. Transition to any new pension policy has been made more complex by the Pension Credit, specifically the Savings Credit element. This means that:
   - What to do with Savings Credit will be an important part of any transition plan.
   - As Savings Credit awards are increasing fast, reform will be easier to do sooner rather than later.

2. The choice between increasing the Basic State Pension or moving to a Citizen's Pension depends in part on the decision on whether the new state pension should be paid in **addition** to accrued state pension entitlement or should be **offset**.
   - The addition method will be more regressive, giving windfall gains to richer pensioners.
   - The offset method will be more progressive, improving income immediately for poorer pensioners.

   The logic of this choice is consistent with the choice between **contributory** or **citizenship** as the appropriate criterion for state pension entitlement: the former tends to favour people who do well at work, the latter protects people who are under-pensioned in the current system.

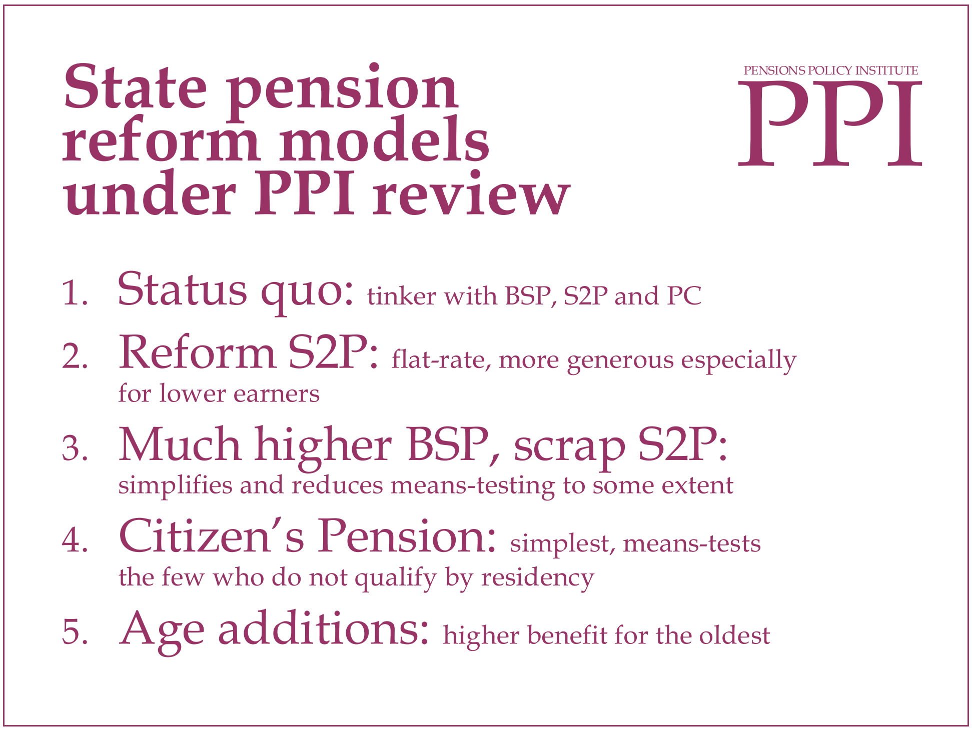
3. Policy reform options that change the rate of accrual of the existing pensions - for example, to make State Second Pension more generous - avoid transition issues but will not improve pensioner incomes in the short-term.

In practice, the choice of a new pension system, and the transition path, will be about making trade-offs between the potential 'winners and losers'. Given the complexity and range of outcomes possible from the current system, it is important to identify the real effects of reform.

Recap: The pension reform models to be tested

The state pension reform models tested in this paper are those in the PPI review[1] (Chart 1). Age additions are not considered as a separate option, as they can be added onto any of the other models. Variants suggested by the consultation feedback[2] are considered in the text.

Chart 1[3]



For each of the reform options, there are further options for the transition process, that is, how and over what timescale the current pension system changes into the new model until it fully takes effect.

For this report, which is designed to show the differences between policy options, assumptions for each transition issue have been made. Other transition paths might be chosen, which would lead to different outcomes. In this analysis, all transitions are set to start in 2006/7.

No future change to State Pension Age (SPA) is covered in this paper. In practice it is likely to be considered as part of any reform package[4]. It is unlikely to happen until after 2020, when retirement ages for women and men equalise. It would, therefore, only affect people currently aged below 45, not the individuals considered in this paper.

[1] O'Connell (2003 SPR)
[2] O'Connell (2004 SPR:CR)
[3] S2P stands for State Second Pension and BSP for Basic State Pension
[4] See O'Connell (2002) and (2003 SPA) for more details on raising SPA

In this paper, the PPI Individual Model is used to test the outcome of various reform models for a number of different people. The individuals analysed are illustrative of different groups, for example, women or higher earners. The pension system gives a wide range of outcomes affected by a number of factors. Further detail is in the Appendix.

The reform options to be tested are described below, and summarised in Table A1 in the Appendix.

1. Status Quo (SQ)

The first option is to retain the structure of the current pension system. Since its implementation in 1948, the pension system has had many amendments, so that it is extremely complex[5].

It is based on the contributory principle, so the pension received depends on each individual's 40-year history of national insurance contributions between ages 16 and SPA; or, in the case of some women, their husband's contributions. Outcomes are very strongly related to past work histories and earnings levels, and this leads to a wide range of pensioner incomes[6].

More recent changes have aimed at improving the prospects for the poorest pensioners, using the means-tested benefit Pension Credit (PC). This policy is controversial. Many older people do not claim their PC entitlement. Further, it creates a barrier to saving: the future benefits of saving are made more uncertain that they would be in the absence of means-testing[7].

The extent of means-testing will increase in future, for two reasons. First, the value of state contributory benefits per year of accrued benefit is declining. Second, state contributory benefits increase when they are in payment in line with prices, while the threshold for claiming Guarantee Credit increases in line with earnings. This means that a middle-income pensioner or pensioner couple aged 65 may not need to claim Pension Credit, but he or she is likely to need to by age 75[8].

The success of current policy in preventing pensioner poverty depends critically on whether Pension Credit is claimed, and on whether Pension Credit continues to be linked to national average earnings[9].

The reform options aim to simplify the pension system, and reduce the need to claim Pension Credit.

[5] See *The Pension Primer,* PPI, updated 2004
[6] Curry (2003 TUP)
[7] See PPI Briefing Notes Numbers 1 and 9
[8] Curry & O'Connell (2003 TPL) Chart 20 and Chart 3 of this paper
[9] See PPI Briefing Note (forthcoming)

2. Reform S2P (RS2P)[10]

The second model is the flat-rate State Second Pension (S2P). When S2P was introduced in 2002, it was designed to give more to lower earners than its predecessor[11], but still give higher benefits to higher earners. S2P will become flat-rate (that is, the same pension benefit is accrued whatever the level of earnings during working life) by around 2050. This will happen because the upper and lower earnings limits to which S2P applies rise in line with prices, while the interim earnings thresholds (which define the accrual rates for S2P benefits) rise faster, in line with earnings[12]. It had been indicated that government would act to make S2P flat-rate earlier[13], but there are no plans to do so yet[14].

A flat-rate S2P should be more generous for low earners than the current system. However, S2P credits are not as comprehensive as the BSP credits so means-testing will still be needed for those people who do not accrue enough S2P to get above the PC threshold.

The transition issues for this option include:

- **When does S2P become flat-rate?** In this paper, the change to S2P accruals being made on a flat-rate basis is made in 2006/7, for consistency with other reform options. This means that all pensioners have all their S2P benefit on the reformed basis by 2055.

- **At what level does S2P become flat-rate?** Under the current S2P, benefits are accrued at a higher rate on earnings up to £11,800 a year, compared to the rate at which accruals are made on earnings above this amount. The assumption made here for the reformed S2P is that benefits are accrued at the higher rate on all earnings up to £15,700 a year, and there are no accruals above this amount[15].

[10] Based on the ABI proposal, ABI (2003)
[11] SERPS – State Earnings Related Pension Scheme
[12] See *The Pension Primer*, PPI, updated 2004 for more further explanation
[13] DSS (1998 GP)
[14] Parliamentary Question Mr Webb, House of Commons *Hansard*, 22 April 2004: Column 670W
[15] In 2006 terms; equivalent to that proposed in ABI (2003) to ensure that an individual with a 40 year working history would retire with BSP and S2P just above the GC level

3. Higher BSP, scrap S2P (HBSP)

The third option is to increase the basic state pension (BSP) to at least the level of the Guarantee Credit (GC) element of PC. This is around 22% of national average earnings (NAE), and by indexing to earnings would be kept at that level.

There would be no further accruals to S2P, as the new BSP is intended to be a sufficient amount to live on, so the state need not provide more. By reducing the need for means-tested benefits, saving in private pensions (occupational or personal) should become easier, so that becomes the way second-tier benefits are provided.

The transition issues for the HBSP model include:

- **How long does transition take?** Here it is assumed that it takes 8 years to increase Basic State Pension up to the required level, as in the main suggestion for this reform option[16].

- **What to do with S2P?** The assumption is that S2P accruals are stopped when transition starts, in 2006/7. Accrued rights are maintained, that is, all S2P benefits in payment carry on being paid in full and rights accrued over the working life will be paid in full on reaching state pension age. This means that in transition, there are some pensioners who receive the new higher BSP **in addition** to their accrued SERPS/S2P benefits.

  This addition is consistent with the logic of contributory pensions: everyone who has accrued rights to a benefit should receive whatever the current value of the benefit is. The addition is consistent with the main proposal for this option[17].

  Chapter 2 examines the consequences of this transition method in more detail.

- **At what level should the new BSP be set?** The assumption made here is that it is set at the Guarantee Credit. This is the lowest level to take people with a full BSP out of means-testing for the GC. The number of pensioners needing to be means-tested should reduce dramatically, but would not be eliminated entirely, as not everyone reaches retirement with a full contribution record and significant private pension[18].

[16] IPPR (2002)
[17] IPPR (2002)
[18] See O'Connell (2004 SPR:CR)

4. Citizen's Pension (CP)

This option gives the same state pension – again at the GC level of 22% NAE – to every individual over state pension age provided he or she has passed a residency requirement. One of main aims of this model is to eliminate means-testing, as very few people would not qualify for the pension, compared with the contributory HBSP model where people with time spent out of work, or on low earnings would still reach retirement without a full basic state pension[19].

Like the HBSP model, there would be no further accruals to S2P, as the new Citizen's Pension would be intended to be a sufficient amount to live on, and the state need not provide more.

The transition issues for the CP model include:

- **How long does transition take?** Here it is assumed that there is an overnight transition in 2006/7.

- **What to do with S2P?** As in the previous option it is assumed that S2P accruals are stopped. It would be possible to take the same approach to accrued rights as the previous option, which means continuing to pay full accrued rights to S2P.

  However, the assumption made here is that current and accrued entitlements to state pension (BSP and S2P) continue only if higher than the Citizen's Pension; the actual benefit paid is the greater of the accrued entitlement to BSP and S2P, or, the Citizen's Pension. This **'offset'** is consistent with the logic that the Citizen's Pension is intended to replace both the contributory pensions BSP and S2P. The offset is consistent with the approach taken in the previous PPI report on Citizen's Pension[20].

  Chapter 2 examines the consequences of the offset method and compares it to the 'addition' method illustrated for the HBSP option.

- **At what level should the new CP be set?** The principal assumption made here is that it is set at the Guarantee Credit level. This is the lowest level to take eligible pensioners out of means-testing for the GC.

Practical transitional issues such as defining eligibility criteria are not covered in this paper, which focuses on income effects on current pensioners. Such issues are being covered in a separate, current project[21].

[19] See NAPF (2002), O'Connell (2004 CPNZ)
[20] See O'Connell (2004 CPNZ). In this report, S2P is modelled as if delivered by the state system, but if an individual has been contracted-out for any period during working life, then that part of S2P would be delivered by the private system. The 'offset' could still apply to the S2P benefit, whether contracted-in or out. See also *Note on Transition to a Citizen's Pension*, PPI, www.pensionspolicyinstitute.org.uk
[21] National Association of Pension Funds (forthcoming)

What to do with Savings Credit?

For all the options, there is a fundamental question on what to do with Savings Credit. Most of the reform options aim to reduce or eliminate means-testing, which means that the scrapping of SC is logical. But to scrap it overnight might mean that the c. 2 million pensioner households[22] currently receiving SC could experience a drop in income. So some kind of gradual phasing out would be likely; described in the next chapter and the Appendix (Table A1).

Box 1: A description of Pension Credit

From October 2003 the Pension Credit (PC) became the main means-tested benefit for topping up the income of poorer pensioners. The PC consists of two parts: Guarantee Credit (GC) and Savings Credit (SC).

- GC is payable from age 60 to those with low incomes and low savings. In 2004/5 it will 'guarantee' – provided it is claimed - single pensioners a minimum income of £105.45 per week (22% of NAE) and couples a minimum income of £160.95 per week.

  Although there is no legislation to keep the GC threshold increasing in line with earnings, it is commonly expected to do so, and all current Government projections assume that this is the case[23].

- SC is payable from age 65. It was designed to stop the possibility that someone who has made no non-state provision for retirement could be as well off (with GC) than someone who had made provision.

  SC pays a tax-free benefit of 60p per £1 for any income in the 'gap' between the full BSP level and the GC benefit level. This includes actual income from ongoing employment, state second pension, employer-sponsored schemes, personal pensions and the assumed income from savings.

  The amount of SC received then reduces by 40p for every £1 of income above the GC benefit level. The maximum SC that can be received is £15.51 pw, which is 60p x (105.45 - 79.60)[24]. SC is no longer payable when income exceeds £144 pw.

  For example, someone with an income of £116.31 from full BSP and average S2P would receive £11.17 from SC, calculated as:
  15.51 - 40p x (116.31 - 105.45).

  Someone in the same position with £1 more income from savings would receive 40p less SC, and total income would only be 60p higher.

- Older disabled people can get extra help through the Pension Credit. Disability benefits do not count as income for PC, and some pensioners receiving disability benefits can get higher pension credit entitlements. Pension Credit has also increased entitlement to Housing Benefit and Council Tax Benefit.

[22] Work and Pensions Oral Parliamentary Questions, House of Commons *Hansard* 26 April 2004 Column 630
[23] DWP (2002 GP), HMT (2003), HMT (2004), www.dwp.gov.uk/asd/asd4/long-term.asp
[24] £79.60 is the full BSP for a single person per week in 2004/5

1. Transition to a new pension policy has been made more difficult by Pension Credit

Transition to any new pension policy has been made more complex by the Pension Credit, specifically the Savings Credit element. This means that:

- What to do with Savings Credit will be an important part of any transition plan.
- As Savings Credit awards are increasing quickly, reform will be easier to do sooner rather than later.

The introduction of SC has made transition to any other pension policy option more complicated than it would otherwise be because:

- **The calculation of Savings Credit entitlement has to be done on a case-by-case basis**. For example, two people with the same private pension income, but one with full BSP and one with less BSP, will be eligible for different amounts of SC. This means that when trying to make transition smooth for as many pensioners as possible, there are multiple starting points to be considered (see Box 1).

- **The amount of SC to which any pensioner is entitled changes every year**, as it depends on how much income received (which tends to go up in line with prices) and the GC level (linked to earnings). So transition would have a different starting point for each pensioner on SC depending on which year it starts.

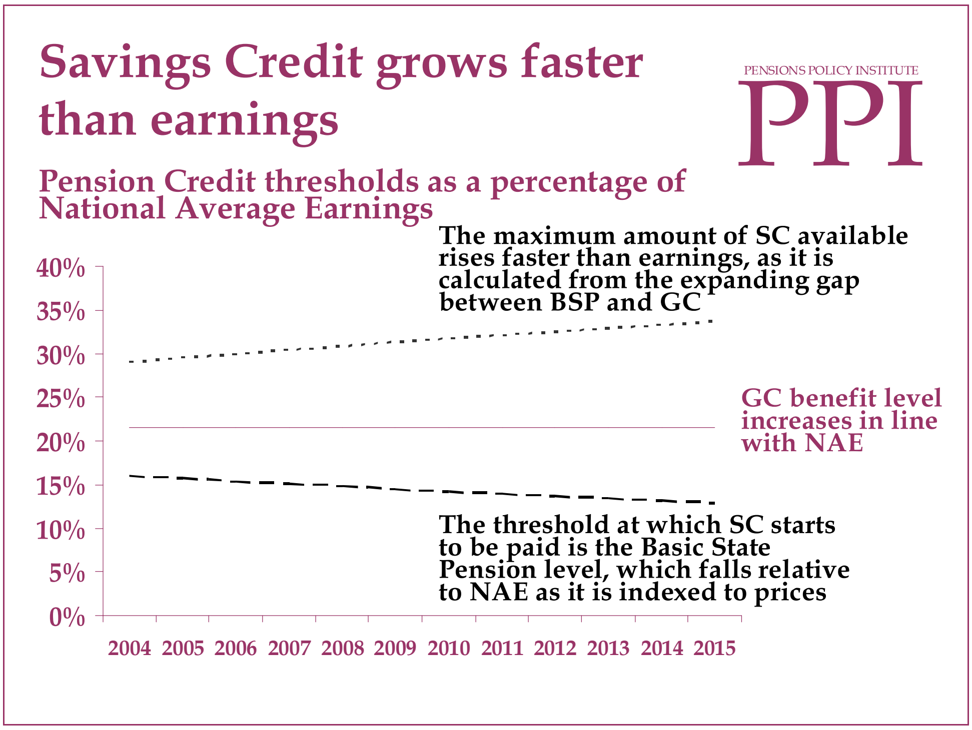
  In practice, the actual SC awarded is calculated for the 'assessed income period' (normally five years) during which time the SC is recalculated each year on the basis of assumed rates of increase for the pensioner's other income. Significant changes to the individual's or household's circumstances (such as marriage, death, divorce, going into hospital) have to be notified as they happen for possible recalculation of the SC.

- **The amounts of SC to be paid in future (and the number of pensioners eligible for it) are increasing quickly**. This is because the SC entitlement is calculated with reference to the gap between the price-linked basic state pension and the earnings-linked GC. This gap increases faster than earnings (Chart 2). This means that the number of pensioners eligible to claim SC will increase fast. Over the next ten years there will be no increase in the number of pensioners eligible for GC alone, but the number eligible for both GC and SC will increase by one-third and the number eligible for SC only will increase by two-thirds[25].

  In view of the increasing numbers of pensioners who will otherwise be entitled to SC, if it is to be phased out as part of wider pension reform, the sooner this is started the better.

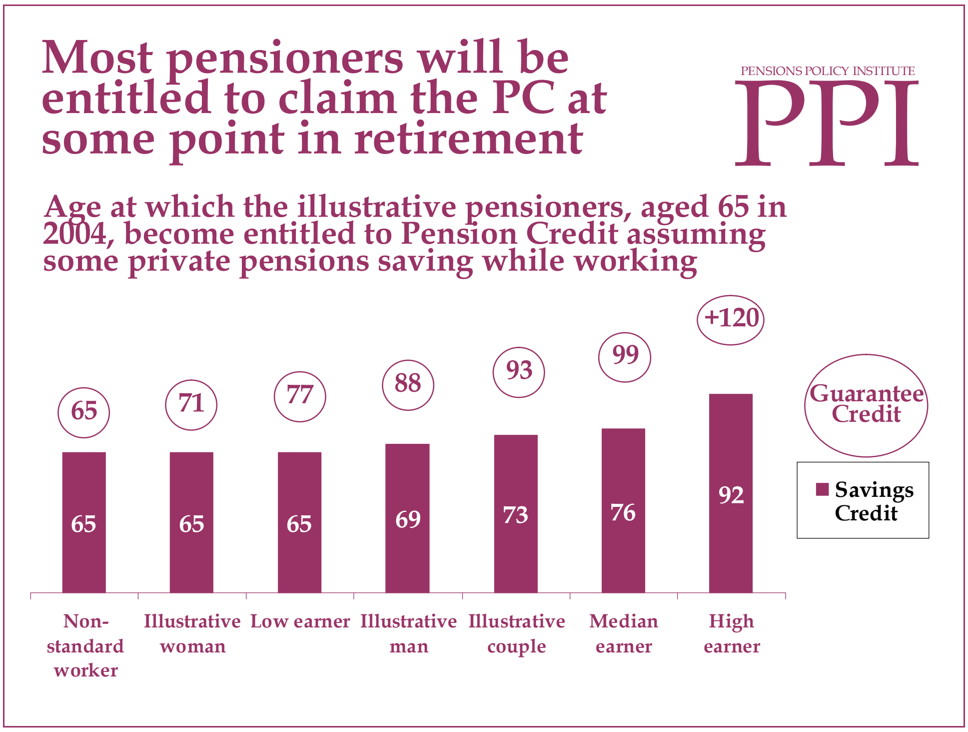
[25] DWP estimates

Chart 2[26]



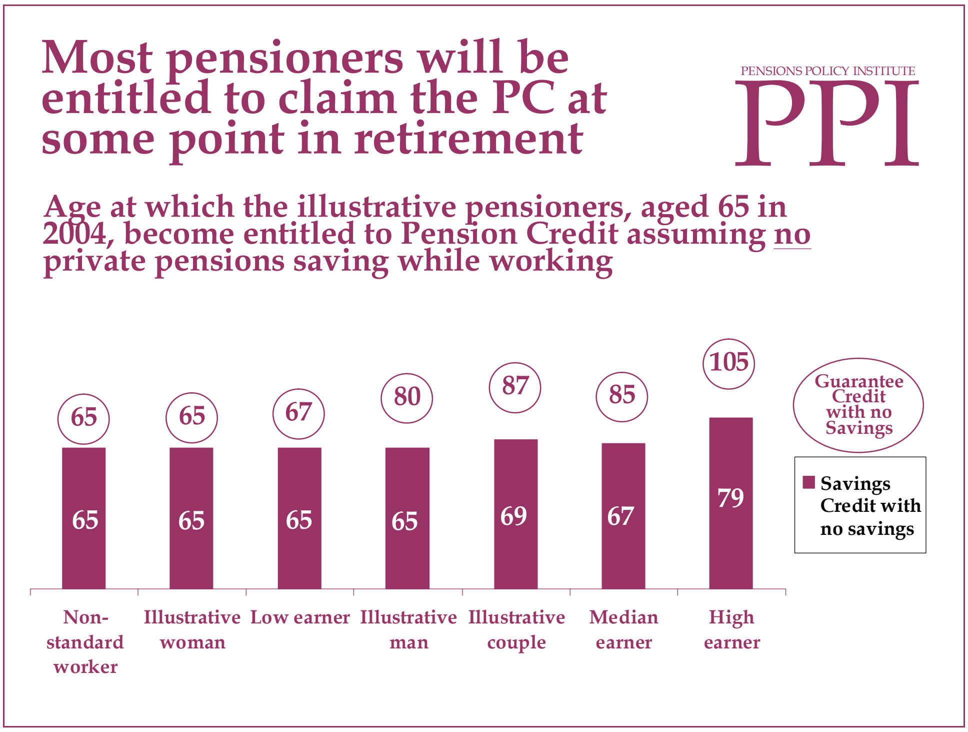
Most pensioners will be entitled to claim Pension Credit at some point in retirement (Chart 3a and 3b).

Chart 3a[27]



26 PPI analysis using the Individual Model
27 PPI analysis using the Individual Model. See Appendix for details.

Chart 3b[28]



Each reform option assumes that the minimum income the state should give pensioners is the Guarantee Credit benefit, so there is no 'gap' between state pension and GC. This means that after reform there is no logic for the Savings Credit to continue; indeed, drastically reducing means-testing is the aim of all of the reform options.

Any transition from the Status Quo pension policy will therefore probably involve scrapping or phasing-out SC. A transition in which there are any pensioners who experience a drop in income is unlikely to be acceptable, and much attention will be placed on the immediate 'winners' and 'losers' among the current pensioner population. Fine-tuning of the Savings Credit will be an important feature to get right in transition.

Someone with very little pension above the first tier – so with no S2P and/or little private pension – will have little or no entitlement to Savings Credit in retirement. The reform options will give very similar results, without the complications of what happens to SC in transition. The illustrative non-standard worker is a good example of this, as he/she is self-employed for much of his working life so does not accrue S2P (see Chart 9 on page 18).

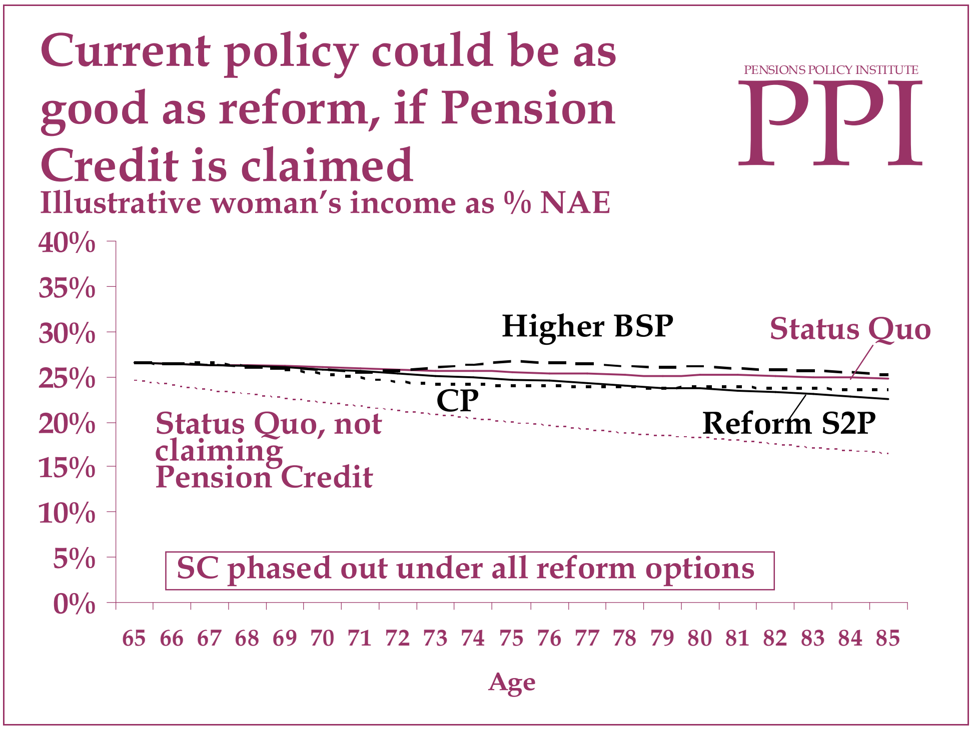
[28] PPI analysis using the Individual Model. See Appendix for details. For the single median earner, private pension is proportionately more important than is the case for the couple who (both having made NICs) have a proportionately higher state pension. This explains why the removal of private saving has a more pronounced effect on the median earner.

The illustrative woman does accrue some second tier provision, partly through credits to S2P. This means that she does have some entitlement to Savings Credit in retirement, and the outcomes from the reform options depend upon what is done to SC in transition.

If SC is phased out under the reform options, then in comparison the status quo looks a good option for the illustrative woman, assuming that she claims the Pension Credit to which she is entitled (Chart 4).

Provided she claims the Pension Credit, there is very little difference between the options for the first ten years.

Chart 4[29]

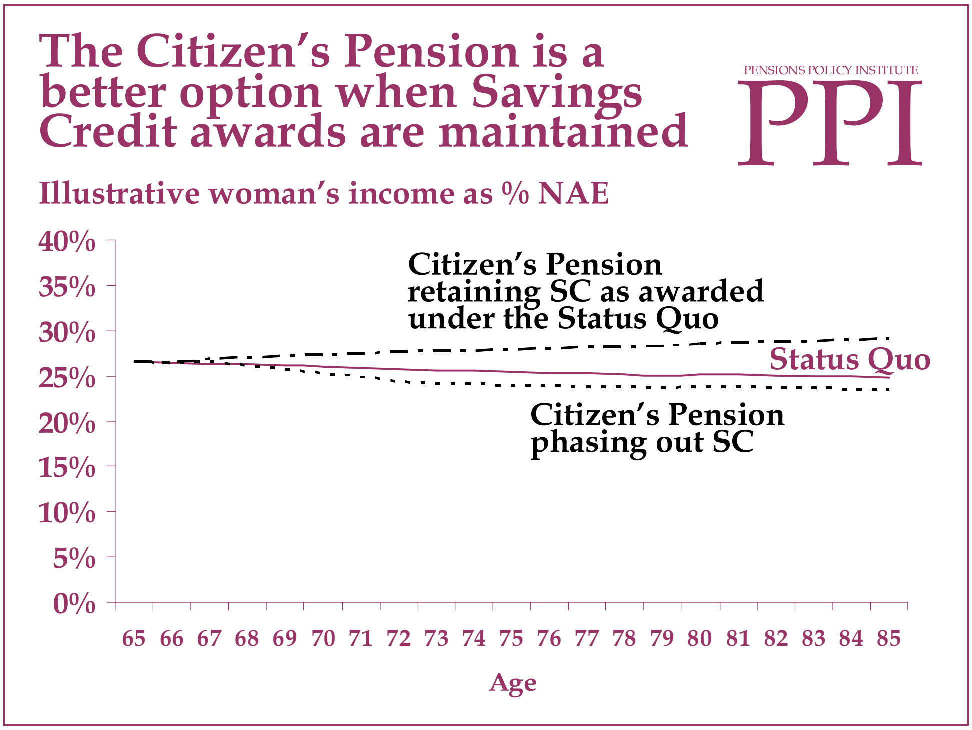


However, if she does not claim her Pension Credit entitlement, then current policy is much worse than all the reform options. The current take up rate of Pension Credit (which is in the middle of changing to a new claim process) is around 70%[30].

[29] PPI analysis using Individual Model for the illustrative woman described in the Appendix, aged 65 in 2004. Reform starts in 2006.
[30] DWP Press Release 16 July 2004 and Parliamentary Question Mr Willetts, House of Commons *Hansard*, 14 June 2004: Column 728W

If instead of phasing out Savings Credit, awards of the same amount are maintained after transition to the Citizen's Pension (CP) policy, say, then the CP could be slightly better than the status quo (Chart 5).

Chart 5[31]



Increasing the level of the CP – for example to 25% of national average earnings - would reduce or eliminate the consequences of Savings Credit, as then more pensioners would receive state pension income above the maximum award of SC.

In the following chapters, the reform options are shown under the assumption that SC is phased out over the transition period (as explained in Table A1), consistent with Chart 4. However, it should be remembered that the outcome from any of the options could be bettered by taking a different transition approach to Savings Credit.

[31] PPI analysis using Individual Model for the illustrative woman described in the Appendix, aged 65 in 2004. Reform starts in 2006.

2. The choice between increasing BSP or moving to a Citizen's Pension is linked to the choice on who state pension should favour

The choice between increasing the Basic State Pension or moving to a Citizen's Pension depends in part on the decision on whether the new state pension should be paid in **addition** to accrued state pension entitlement or should be **offset**.

- The addition method will be more regressive, giving windfall gains to richer pensioners.
- The offset method will be more progressive, improving income immediately for poorer pensioners.

The logic of this choice is consistent with the choice between **contributory** or **citizenship** as the appropriate criterion for state pension entitlement: the former tends to favour people who do well at work, the latter protects people who are under-pensioned in the current system.

In transition: addition or offset?

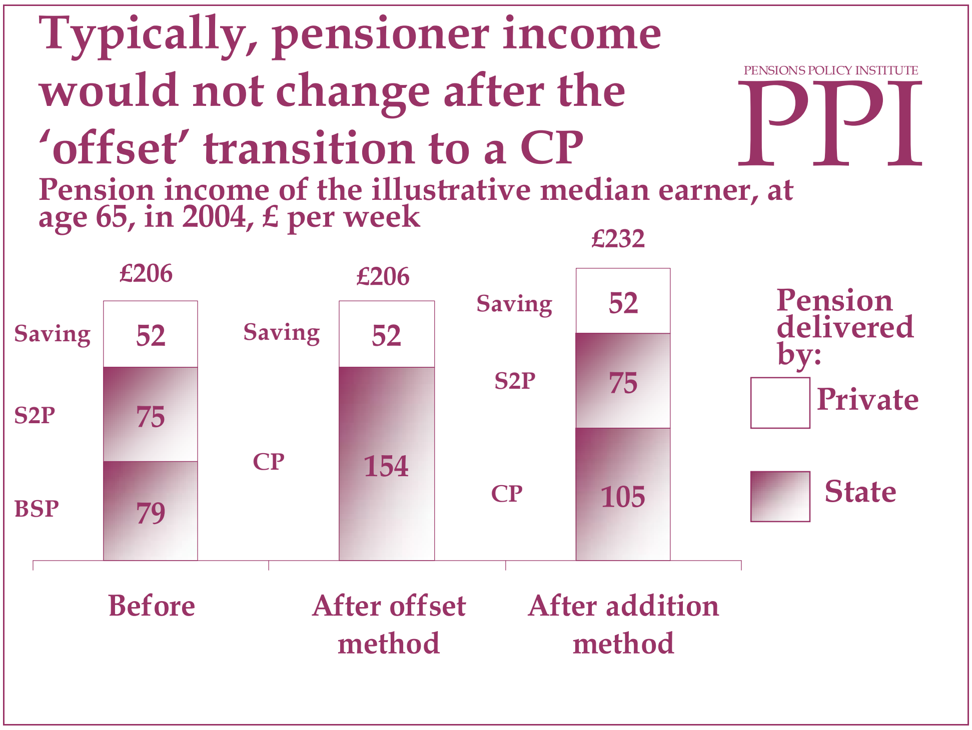
With the Higher Basic State Pension model (HSBP), pensioners with some entitlement to BSP will receive more of that benefit. Any other pension income received – SERPS/S2P and contracted-out equivalents and private savings – continues unaffected. Future accruals of S2P would be stopped, but in transition, current and new pensioners would continue to receive their accrued rights to SERPS/S2P **in addition** to the new, higher basic state pension.

It would be possible to take the same approach to accrued rights for the Citizen's Pension option (CP). This would mean that the CP is paid in addition to S2P and full accrued rights to S2P would continue to be paid as well as the CP.

However, the assumption made here for the Citizen's Pension option is that current and accrued entitlements to state pension (BSP and S2P) continue only if higher than the Citizen's Pension; the actual benefit paid is the greater of the accrued entitlement to BSP and S2P, or the Citizen's Pension: there is an **'offset'**.

The offset approach means that any pensioner receiving less than the CP amount from their state pension would immediately have that income increased to the CP amount (Chart 6).

Chart 6[32]



During transition, any pensioner receiving more than the CP amount from BSP and S2P would carry on receiving the higher amount – so no pensioner's state pension income falls because of transitioning to a new pension system.

In this context 'state pension' means entitlement to BSP plus SERPS/S2P. For people who contracted-out of SERPS/S2P, the SERPS/S2P accrued right entitlement is provided by their private pension arrangements, and is identified by an item on their state benefit statement benefit called the 'Contracted-Out Deduction'.

The offset method is logical for the Citizen's Pension model which is intended to replace both the contributory pensions BSP and S2P, with an entirely new system[33].

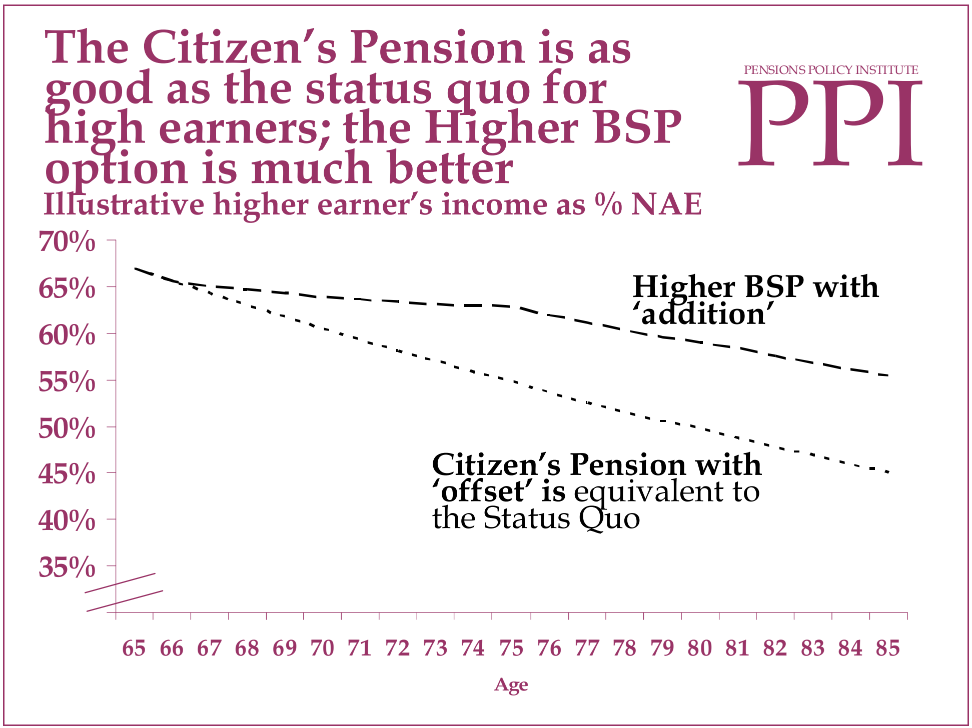
It might be possible to adopt the offset method for the HBSP model, but that would be inconsistent with the contributory system. It might appear to pensioners that the value of the contributions they made to S2P has reduced. It would also be possible to take the addition approach to accrued rights in the Citizen's Pension (CP) model. The decision has implications for the transition cost, and affects how better-off pensioners may benefit during the transition.

[32] PPI analysis using Individual Model for the illustrative median earner described in the Appendix, aged 65 in 2004 when there is an immediate change to a Citizen's Pension, ignoring Savings Credit
[33] See O'Connell (2004 CPNZ) and *Note on Transition to a Citizen's Pension*, PPI, www.pensionspolicyinstitute.org.uk

The HBSP model with the addition method means that in transition, pensioners with good SERPS/S2P and private savings will receive a 'windfall gain'[34] as their BSP is boosted.

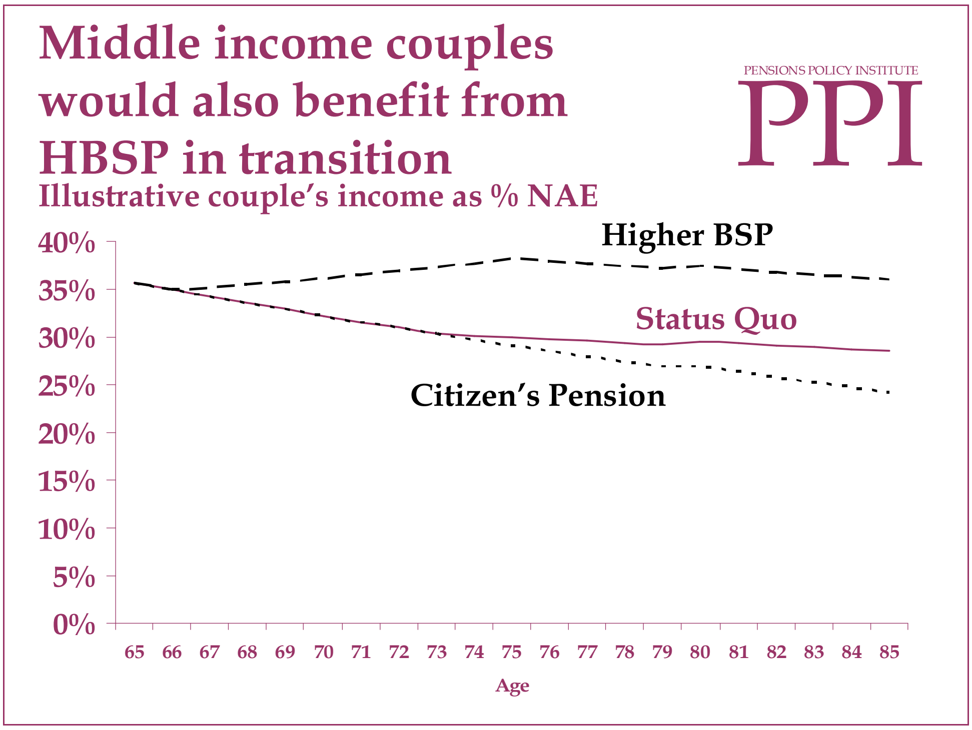
Under the Citizen's Pension option with an offset, pensioners with good SERPS/S2P do not experience an increase in their income in transition (Chart 7 shows this for the illustrative higher earner, on twice-median earnings; Chart 8 shows it for an illustrative middle income couple).

Chart 7[35]



[34] IPPR (2002) p. 74
[35] PPI analysis using Individual Model for the illustrative higher earner described in the Appendix, aged 65 in 2004. Reform starts in 2006.

Chart 8[36]

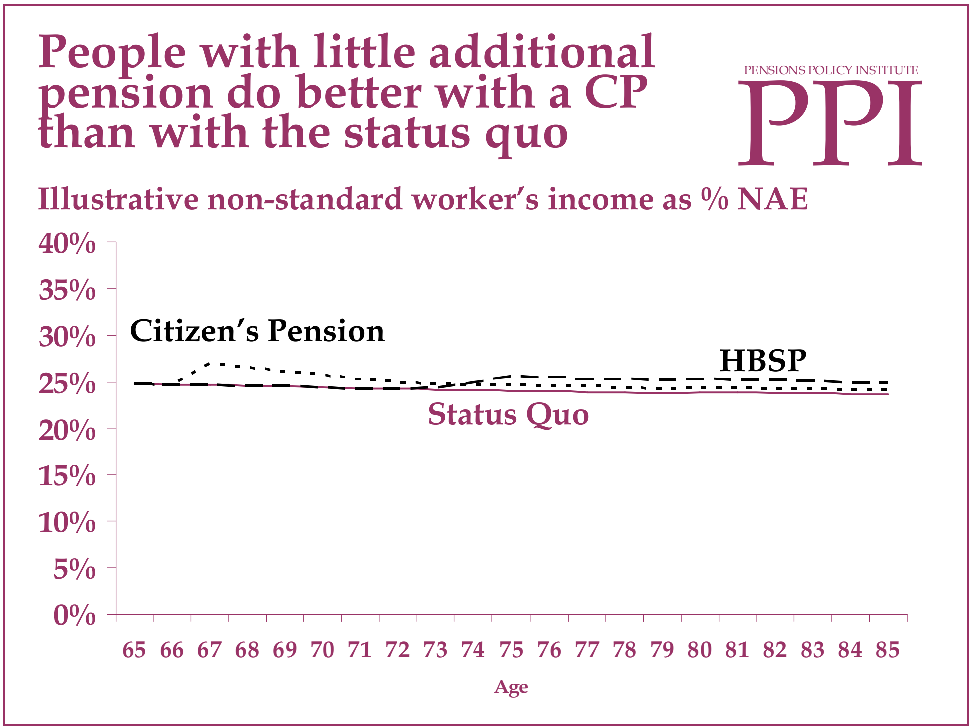


In the HSBP option, pensioners who do not have a full entitlement to BSP (and these tend to have been lower, less regular earners) benefit from the increase in BSP, but only in proportion to the lower BSP they receive.

In the CP option, these pensioners benefit immediately by an increase to the CP level (Chart 9 shows this for the illustrative non-standard worker).

[36] PPI analysis using Individual Model for the example couple described in the Appendix, man aged 65 in 2004. Reform starts in 2006. Income is adjusted to make it comparable to an individual by dividing by the factor used in the state system, 1.6. Under the Citizen's Pension option, Savings Credit is assumed to be phased out. The SQ option diverges from the CP from age 73 as this couple become eligible for SC then.

Chart 9[37]



The Higher BSP reform option with the addition method in transition is regressive in the short-term, because it gives 'windfall gains' to higher income pensioners.

The Citizen's Pension reform option with the offset in transition is progressive relative to the Higher BSP option in the short-term; that is, it gives higher payments to lower income pensioners compared to those with higher income. It could be made more progressive relative to the current system by increasing the level at which the CP is set.

There are cases where there may be perceived to be an unfair windfall gain with the offset approach, for example, a wife in a well-off household without a contribution record for a full state pension in her own right would get a Citizen's Pension. However, this can be mitigated by a couple's CP being set at less than twice an individual's CP.

The choice on the method of transition – offset or addition – raises an important policy issue of how much benefit 'richer' pensioners should have during transition. Because of the contributory logic linking the addition method with the Higher BSP option, and the offset with the Citizen's Pension option, to some extent this is an important question about the choice of long-term reform model (Chart 10).

[37] PPI analysis using Individual Model for the illustrative non-standard worker described in the Appendix, aged 65 in 2004. Reform starts in 2006.

Chart 10[38]

Transition methods compared

PENSIONS POLICY INSTITUTE
PPI

	Addition	Offset
Higher Basic State Pension	•Fits with HBSP contributory logic •No one loses in transition •Gives windfall to richest pensioners	•Possible, but pensioners' past contributions appear to have lost value
Citizen's Pension	•Possible but complicated: keeps contributory system as well as introducing citizenship system	•Fits with CP citizenship logic •No one loses in transition •Gives windfall mainly to poorest pensioners

There would be cost implications from the choice of transition method – the addition approach being more expensive than the offset approach. Outside the scope of this paper, other PPI papers will deal with the costs of reform[39].

Relevance of the 'rich' pensioners

How important is it that 'rich' pensioners benefit even more in transition from the addition method? Possible responses could be that there are not many 'rich' pensioners and that they pay back the extra benefit through the tax system or some other mechanism.

'Rich' pensioners are really only in the top fifth (or quintile, Charts 11 and 12). If the incomes of all single pensioners are lined up in order; the bottom fifth grouped; then the next fifth etc, then the averages of each quintile taken, each one is not much higher than the one before until a jump to the highest fifth. The same pattern is true for the income of couples.

This shows that most pensioners' incomes are quite close to each other, compared to the very large jump to the income of the richest 20% or so. There will of course be variation within each quintile, so some pensioners will be richer than the average of the top quintile.

[38] PPI analysis
[39] O'Connell (2004 CPNZ) estimated the cost of the offset approach to a Citizen's Pension

Chart 11[40]

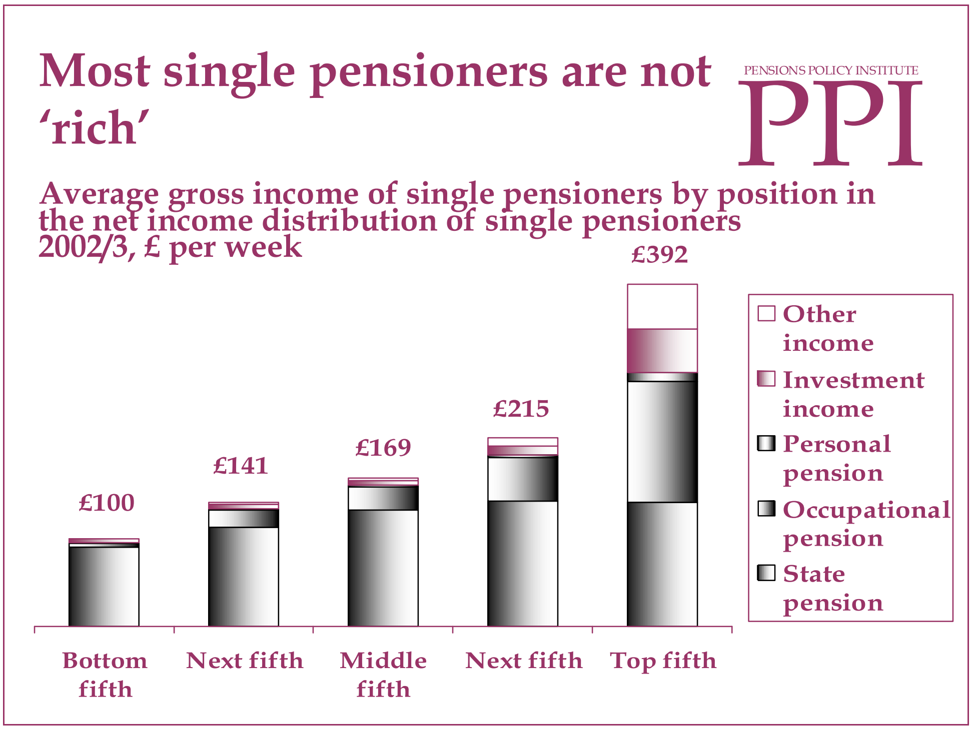
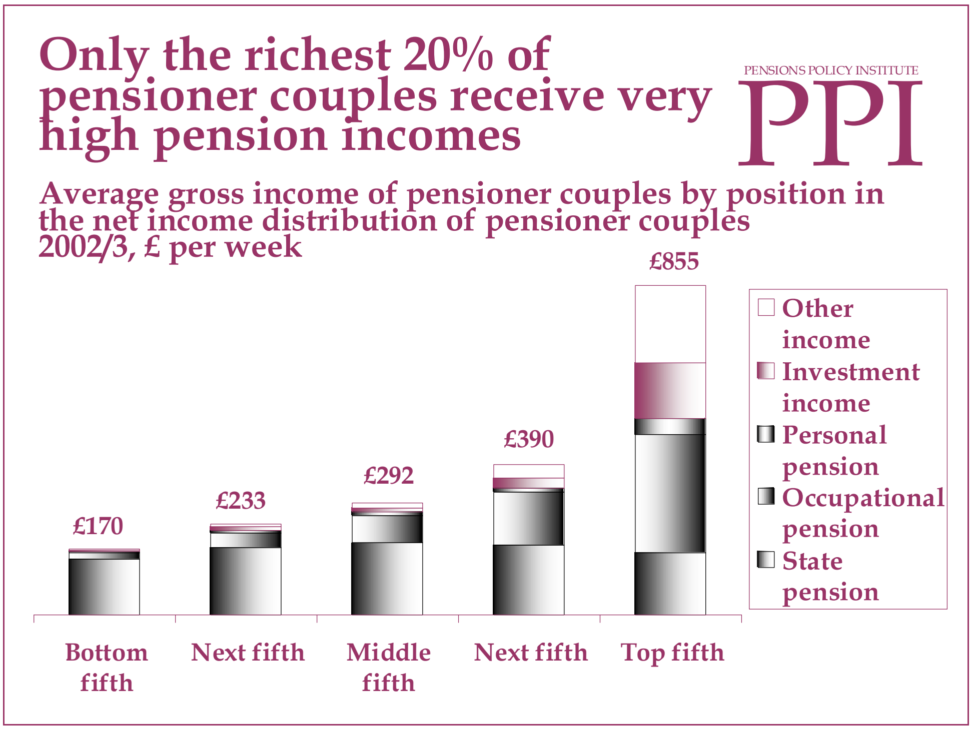


Chart 12[41]



40 PPI analysis from DWP (2004 PIS)
41 PPI analysis from DWP (2004 PIS)

The threshold for a single pensioner to start paying basic rate falls close to median income and the threshold for higher rate tax is significantly above the average of the top quintile. The thresholds for pensioner couples are around the median income and, again, significantly above the highest quintile average respectively. Fewer than 30% of pensioners pay basic rate income tax and 2% of pensioners (around 220,000) pay higher-rate tax[42].

So, there are some 'rich' pensioners and they do pay tax. Under any reform option which increased incomes for pensioners, there would be additional tax revenues. There could be more additional tax from the windfall gain under the HBSP addition method. To reflect the unexpected nature of the bonus, it could be taxed at a higher level[43].

The issue of 'rich' pensioners doing well out of transition may be a particular issue of the current pensioner income distribution. It will of course always be true that there will be richer and poorer pensioners. However, there may be a current temporary increase in the number of comparatively rich pensioners. These are the (usually) men who have benefited from generous state pensions (particularly SERPS or contracted-out equivalent) and generous occupational pensions. Younger people will reach retirement in future having accrued lower rates of SERPS/S2P, some with less generous private pensions that have been invested at lower investment returns and have to pay out over longer lifetimes.

Contributory vs. citizenship

The HSBP reform option will tend to favour people who do well out of the current contributory system, and the CP option protects people who are underpensioned in the current system. This is the decision as to whether **contributory** or **citizenship** is the appropriate criterion for state pension entitlement.

Over time, under the HBSP model, the new higher BSP replaces BSP and S2P. The expectations for the level of state pension of higher and lower earners will move closer together. But even so, to gain most from a higher BSP, a pensioner has to have a full entitlement to the BSP, that is, to have worked regularly and at a high enough level to pay NI contributions, or fallen into a category to collect credits.

Therefore the HSBP reform option will tend to favour people who do well out of the current contributory system – as well as giving relatively well-off recent retirees an unexpected boost in transition.

[42] Parliamentary Question Mr Webb, House of Commons *Hansard*, 11 February 2004: Column 1489W
[43] A 'surcharge' higher rate tax was charged on state pension in New Zealand between 1985 and 1998. It was an unpopular and contentious policy, but there are advocates for bringing it back in today. See O'Connell (2004 CPNZ).

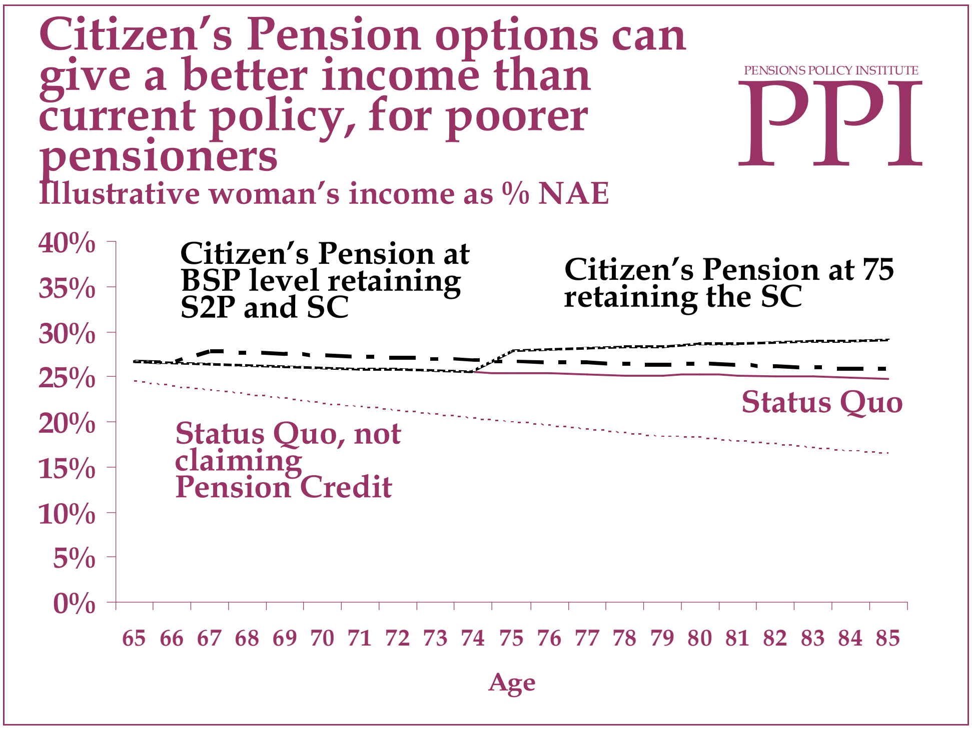
A Citizen's Pension and a Basic State Pension at the same level (e.g., 22% NAE) should be equal in the long term for people with a full entitlement to BSP. The CP reform option gives more income, than the HBSP option, to people who do badly out of the current contributory system. As eligibility for a CP is on a citizenship or residency basis rather than a contributory basis, a pensioner could receive the CP even if he or she did not work regularly at a high enough level to pay NI contributions, or did not fall into a category to collect credits.

In transition, the 'winners' from the CP option include those who are eligible for but not claiming Pension Credit. The CP will be received without needing to go through the means-testing process. This means that someone who is eligible for GC, but does not claim it, will immediately have income at the GC level received automatically from the state.

Even if this is not an advantage at age 65, it may be for people later in retirement. Many pensioners with typical work histories will become entitled to Guarantee Credit during retirement under current policy (Chart 3).

Variants of the Citizen's Pension option have been proposed, for example: changing the entitlement to the Basic State Pension to citizenship; and, introducing the Citizen's Pension (at the GC level) at age 75 only. If current SC awards are retained, then both of these options would give a better outcome for poorer pensioners than current policy (Chart 13).

Chart 13[44]



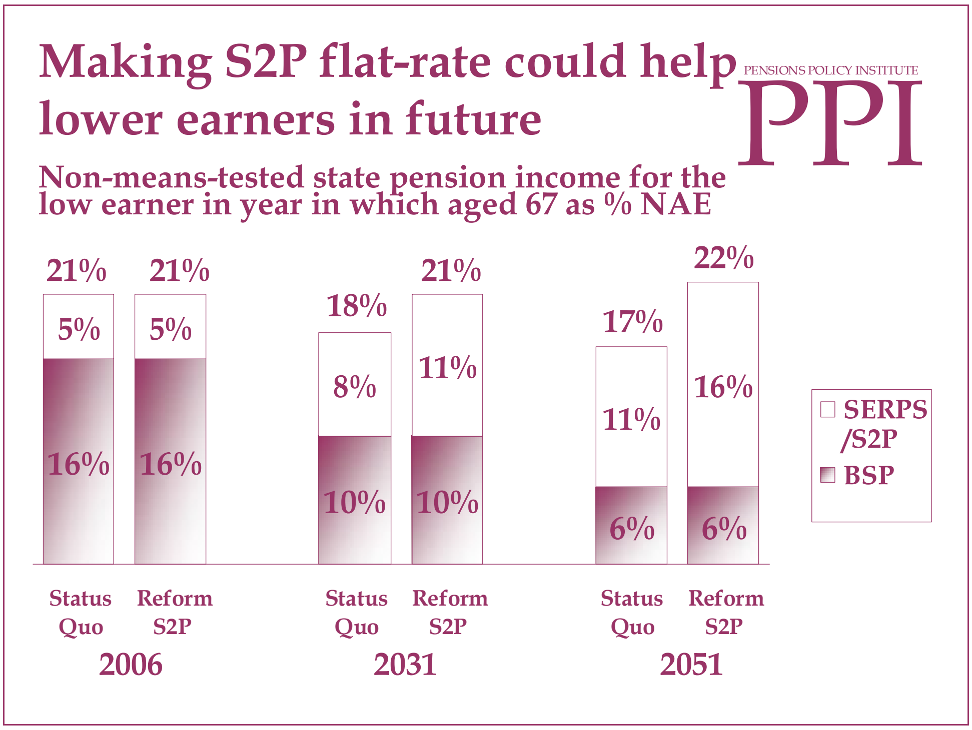
[44] PPI analysis using Individual Model for the illustrative woman described in the Appendix, aged 65 in 2004. Reform starts in 2006.

3. Making S2P accrual more generous will have little immediate impact

Policy reform options that change the rate of accrual of the existing pensions - for example, to make State Second Pension more generous - avoid transition issues but will not improve pensioner incomes in the short-term.

This is because new pensioners during transition will have only accrued rights on the new, more generous basis, for a small part of their contribution history. So it will be younger workers who will benefit from such a policy, especially low earners (Chart 14).

Chart 14[45]



Current policy – the status quo option – improves S2P in future for low earners, but this is not enough to make up for the decline in the value of the BSP. The illustrative low earner would be eligible for Pension Credit (Chart 3). The Reform S2P option increases the value of S2P in future, to maintain the same level of BSP plus S2P for the low earner.

If reforming S2P were also accompanied by phasing-out of Savings Credit, then pensioners who retire before the end of the transition period would not benefit from more generous future accruals but would suffer the loss of SC (shown for example in Chart 9).

45 PPI analysis using Individual Model for the illustrative low earner described in the Appendix. Reform starts in 2006.

Therefore, if the aim were to improve pensions for current pensioners, for example to reduce the extent of means-testing in the short-term, then SC awards might have to be retained or this policy option would need to be supplemented with other measures.

Appendix: Details of the analysis

This work is based on modelling pension outcomes under different policy options for a number of hypothetical individuals. This Appendix describes the methodology used and the characteristics of the individuals chosen for analysis[46].

Modelling Methods

Introduction

The Individual Model (IM) is a model of pension income that simulates pension income for individuals and households reaching state pension age today and in the future. The IM can be used to carry out a range of different analyses.

The IM was first used to identify how income varies within the pensioner population. This showed that people on higher earnings and with uninterrupted working and contribution histories receive a much higher pension income relative to people with lower earnings and interrupted working and contribution histories[47].

In addition, the IM has also been used to quantify the effect of the Pension Credit (PC). According to this analysis, more and more people will become entitled to claim PC in future years[48], making state pension income more equal across a wider range of hypothetical pensioner families, if PC is claimed[49]. Recent studies show that the current average levels of private pension contributions are not sufficient to provide the levels of retirement income achieved today[50].

The IM has been extended to model pension income of pensioner couples and widowed pensioners and to compare income across a much wider array of pensioner families[51].

In this publication, the IM has been used to assess the impact of different policy options on pension incomes of current pensioner families. The policy options considered here follow from a series of previous studies on state pension reform[52,53].

[46] In the main text of this report selected results are shown, not all the permutations of illustrative individuals and reform options. Full information is available from the PPI on request.
[47] Curry (2003 TUP)
[48] Curry and O'Connell (2003 TPL)
[49] PPI Briefing Note 10
[50] PPI Briefing Note 9
[51] Di Pace (2004 MPU)
[52] O'Connell (2003 SPR) and O'Connell (2004 SPR:CR)
[53] PPI Briefing Note 5 shows the impact of the Conservative Party's pension policy for the 'average man' and 'average woman'

The main characteristics of the IM
The model uses a set of assumptions about an individual's working and pension contribution histories, the performance of the economy and the current up-rating conventions used in the pension system.

Using these assumptions[54], different earnings and benefit levels can be simulated to calculate pension entitlements, state and private, for illustrative individuals in current and future generations of pensioners. Pension income can be calculated at any given point in time while in retirement[55,56].

How is pension income calculated?
State pension entitlement is calculated according to the individuals' work and contribution histories. The 'rules' used are the actual rules of the past pension system year by year, and the current rules projected into future for the model under the status quo. For the other reform options, the required changes to the future rules have been made.

Private pension accrual is also assumed to depend on the work history, as detailed for each individual. In each year where private pension is accrued, for simplicity it has been assumed at an average rate of 8% of all earnings (except for the non-standard worker)[57]. Contributions are made into a money-purchase pension scheme (such as a stakeholder pension) by the individual and/or the employer.

Pension Income: State and private pension accruals are used to calculate weekly pension income[58] from state pension age[59].

- State pension provision includes Basic State Pension (BSP), Graduated Retirement Benefit (GRAD), State Earnings Related Pension Scheme (SERPS), State Second Pension (S2P), other state benefits such as Winter Fuel Allowance and the Pension Credit (PC)[60].
- Private pension provision includes pension saving and can include other forms of savings (such as housing[61]). Future streams of private pension provision are calculated through annuity purchases.

[54] For a technical discussion of how this earnings profile is calculated, see Curry (2003 TUP:TP) and Di Pace (2004 MPU)
[55] State pension age is currently 65 for men and 60 for women
[56] This analysis focuses on the impact that such policy changes have on recently retired pensioners
[57] This is somewhat higher than the current average rate of private pension savings and tends to overstate private pensions for lower earners, and understate for higher earners
[58] Pension income is expressed weekly as a proportion of national average earnings to show the position of retired individuals relative to the average working population
[59] IM can model people retiring before and after state pension, but pension income is calculated from state pension age. In addition, state and private pension deferrals are also possible.
[60] See PPI *The Pensions Primer*, updated 2004
[61] See Curry (2004 PoP)

Modelling policy reform options
The starting point for modelling the reform options is the 'status quo'. It is important to have a clear understanding of how the current system works in order to model the alternative policy options.

It is also important to know what the ultimate level of future benefits are or might be. Once the final targets are set, a wide range of transition paths can be designed. However, many transition paths arise from this type of exercise, so selection criteria are needed to choose a sensible transition path for each policy reform option.

In this publication, the criteria for choosing the transition path, given an assumed reform option at a specified level of benefit were:
- **Reduce means-testing:** all the policy options retained the Guarantee Credit[62] at 22% of National Average Earnings. However, the SC was phased out to attain a smooth transition path for currently retired pensioners.
- **Pension mathematics vs policy acceptability:** some of those transition paths that appear logical in mathematical terms seemed not to be as coherent in political and/or economical terms. Considerable attention was paid to avoiding 'downwards jumps' in pension income as well as to determining the appropriate span for each transition path.

The reform options
The policy options analysed are:

1. Status quo
2. Reform S2P
3. Higher Basic State Pension
4. Citizen's Pension

The design of the reform S2P and HBSP options followed very much the lines of the current pension system as they can be thought as refinement to the status quo. On the other hand, the CP reform option incorporated a new set of residency requirements and different types of transitions. A summary of the reform-specific assumptions is in Table A1.

[62] See main text

Table A1: Summary of policy reform models tested

	Status Quo SQ	Reform S2P RS2P	Higher BSP HBSP	Citizen's Pension CP
Year implemented	Current	2006	2006	2006
End of transition period	No transition period	2055	2014	Depends on when the last pensioner has accrued state benefits of more than the CP (no later than 2055)
Level of benefit	Current	BSP as current: c.16% NAE S2P accrued at the current rate for earnings of up to £15,700 pa	BSP at GC level: c.22% NAE	CP at GC level: c.22% NAE
Level of benefit for a couple	1.6x individual benefit	1.6x individual benefit	1.6x individual benefit	1.6x individual benefit
Benefit uprating in payment	BSP, S2P:Prices GC: Earnings	BSP, S2P:Prices GC: Earnings	BSP, GC: Earnings S2P (in transition): Prices	CP, GC: Earnings BSP, S2P (in transition): Prices
Treatment of S2P	No change	New accruals on reformed flat-rate basis. Accrued benefits paid in full.	Accruals stopped. Accrued benefits paid in full.	Accruals stopped. Accrued benefits offset against new CP.
Treatment of Savings Credit	No change	Gradually phased out by increasing the SC threshold to reach GC level by 2055	Gradually phased out by increasing the SC threshold to reach GC level by 2014	Gradually phased out by increasing the SC threshold to reach GC level by 2014

Illustrative Individuals
The individuals analysed are illustrative of the wide range of characteristics in the working population that affect current and future pension outcomes. They are based on previous studies carried out by the PPI[63].

This approach can only simply illustrate a few examples, whereas in real life there is huge diversity in work histories, earnings levels, household structure and standards of living in retirement. The model is capable of analysing all possible variants on these parameters. However, the simplicity of taking a few examples has the merit of being able to see the basic differences between the reform models. Further details about the illustrative individuals are summarised below:

- **Median earner**: This man worked full-time throughout his working life, starting at the age of 21 and retiring at state pension age[64]. He had an uninterrupted record of private pension contributions. He also had median (middle) earnings every year, so half of the people of his age (who were earning) earned less than him.

- **Low earner**: As the median earner, but earning half of median earnings each year. Around 20% of workers earn less than half median earnings.

- **High earner**: As the median earner, but earning twice median earnings each year. Around 6% of workers earn more than this.

- **Illustrative man**: This man received the median earnings for men of his age throughout his working career. He worked mainly full-time from age 21, but was unemployed for two years in his twenties and worked part-time from 55 until he retired at 60. He made private pension contributions from age 41.

- **Illustrative woman**: This woman had the median earnings for females of her age (around 20% less than that for males) and an interrupted working life. She started work at the age of 21, working full-time until 28. She then had a career break to care for her children for six years, but the break did not coincide with the financial year, so she lost two credits to the BSP. She returned to part-time work for four years, but earned below the Lower Earnings Limit (LEL), so she did not accrue rights to the BSP or S2P. She then worked full-time, earning above the LEL, from 41 until retiring at state pension age. She made private pension contributions while in full-time work from the age of 41.

[63] See Curry (2003 TUP:TP) and Di Pace (2004 MPU). Note that for simplicity, the examples here are all assumed to retire at state pension age. In previous reports the woman and non-standard worker examples retired 2 years after SPA.
[64] SPA is currently 65 for men and 60 for women. Between 2010 and 2020 the SPA for women will increase to 65.

- **Non-standard worker**: This man represents a typical 'flexible' worker. He is a man who earned at 80% of median earnings, whose working career started at 21 and ended at state pension age. He worked on a temporary basis from 25 to 27 and he was self-employed from the age of 40. He made private pension contributions while in full-time work, but when self-employed he made lower and less regular contributions (4% of salary from age 50).

- **Couple, with full National Insurance Contributions**: This couple consists of the 'illustrative man and woman'. The individual characteristics are as described above. Both individuals were born in 1939, reaching the age of 65 at the same time[65] in 2004/5. The wife made full rate National Insurance Contributions, so that she was entitled to a pension in her own right by the time she reached pension age[66]. The husband bought a joint life annuity when he retired at 65, while the wife bought a single life annuity at the age of 60.

  To compare against single pensioners, the total pension income of this couple is adjusted downwards. Total pension income is divided by 1.6[67], the factor most commonly used under the current pension system to calculate benefit levels for couples.

[65] Pension income is analysed from the age of 65 regardless of the differences in retirement age between men and women
[66] See DWP (2004)
[67] See Di Pace (2004 MPU)

Acknowledgements and Contact Details

The authors, Chris Curry, Federico Di Pace and Alison O'Connell, are grateful for input from many people in reviewing this paper, in particular:

Ruth Hancock
John Hawksworth
Liz Pepler
Stewart Ritchie
Tom Ross
Holly Sutherland

The authors take responsibility for remaining errors.

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects. To learn more about the PPI, see: www.pensionspolicyinstitute.org.uk

Contact:
Alison O'Connell, Director
020 7848 3751 or alison@pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College
Waterloo Bridge Wing, Franklin-Wilkins Building
Waterloo Road
London
SE1 9NN

The PPI is grateful for a Nuffield grant to support the modelling work used in this publication and other PPI work.

The PPI is grateful for the continuing support of its Gold members:

Aon Consulting
Fidelity Investments
Legal & General
Origen
Standard Life
Threadneedle Investments

A full list of donors is on the PPI's website. All donations are given independently of the PPI's research agenda and report content.

References

Association of British Insurers (ABI) (2003) *Adequacy, affordability and incentives: a better future for state pensions* www.abi.org.uk

Curry, C. (2003 TUP), *The Under-pensioned* London: Pensions Policy Institute

Curry, C. (2003 TUP:TP), *The Under-pensioned: technical paper* London: Pensions Policy Institute

Curry, C. (2004 PoP), *Property or pensions?* London: Pensions Policy Institute

Curry, C. and O'Connell A. (2003 TPL), *The Pensions Landscape* London: Pensions Policy Institute

Department of Social Security (DSS) (1998 GP) *A new contract for welfare: Partnership in pensions* (CM4179)
www.dwp.gov.uk/publications/dss/1998/pengp/main/main_index.asp

Department for Work and Pensions (DWP) (2002 GP) *Simplicity, security and choice: Working and saving for retirement* (CM 5677)
www.dwp.gov.uk/consultations/consult/2002/pensions/

Department for Work and Pensions (DWP) (2004) *A Guide to State Pensions - NP46*
www.thepensionservice.gov.uk/pdf/np46/np46-retirement-apr04.pdf

Department for Work and Pensions (DWP) (2004 PIS) *The Pensioners' Income Series*
www.dwp.gov.uk/asd/asd6/PI_series_0203.pdf DWP

Di Pace, F. (2004 MPU), *Modelling Pensioner Units*, paper presented at the 26th UK Insurance Economists' Conference, Centre for Risk and Insurance Studies (CRIS), University of Nottingham on the 30-31 of March 2004 (available on request)

Her Majesty's Treasury (HMT) (2003) *Long-term public finance report: fiscal sustainability with an ageing population*
www.hm-treasury.gov.uk/media//555E2/longterm_fiscal_1to6_436.pdf

Her Majesty's Treasury (HMT) (2004) *Prudence for a purpose: A Britain of stability and strength*
www.hm-treasury.gov.uk/budget/budget_04/budget_report/bud_bud04_repindex.cfm

Institute of Public Policy Research (IPPR) (2002) *A New Contract for Retirement* London: IPPR www.ippr.org.uk

National Association of Pension Funds (NAPF) (2002) *Pensions – Plain and Simple* www.napf.co.uk

O'Connell, A. (2002) *Raising State Pension Age: Are we ready?* London: Pensions Policy Institute

O'Connell, A. (2003 SPA) *Raising State Pension Age: An Update* London: Pensions Policy Institute

O'Connell, A. (2003 SPR) *A Guide to State Pension Reform* London: Pensions Policy Institute

O'Connell (2004 CPNZ) *Citizen's Pension: Lessons from New Zealand* London: Pensions Policy Institute

O'Connell, A. (2004 SPR: CR), *State Pension Reform: the consultation response* London: Pensions Policy Institute

Pensions Policy Institute (PPI) (updated 2004) *The Pension Primer* London: Pensions Policy Institute

Pensions Policy Institute (PPI) *The Pension Credit,* PPI Briefing Note 1

Pensions Policy Institute (PPI) *The effects of the Conservative Party's pensions policy*, PPI Briefing Note 5

Pensions Policy Institute (PPI) *Why is so difficult to save for retirement?* PPI Briefing Note 9

Pensions Policy Institute (PPI) *The balance between state and private pension provision*, PPI Briefing Note 10

All PPI publications can be downloaded from:
www.pensionspolicyinstitute.org.uk

Published by
PENSIONS POLICY INSTITUTE

PPI

www.pensionspolicyinstitute.org.uk
ISBN 0-9548248-0-6