PENSIONS POLICY INSTITUTE

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Managing the transition between the current system and the single-tier pension

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 first briefing (June 2013) described the main components of the Government's state pension reform plans and an initial analysis of the possible impact of the reforms on individuals. Other analysis will cover issues such as:

- The impact of a switch from the triple-lock to uprating by earnings.
- 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.

For more information, please contact the PPI.

This briefing considers the transition between the current system and the single-tier pension and, in particular, the implications for those people reaching State Pension Age before April 2016.

The Government's proposals

The Pensions 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 single-tier impact assessment[1] 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. The changes will not apply to people who are over State Pension Age (SPA) when the new arrangements are introduced, including those people who reach State Pension Age between now and April 2016.

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. This excess is known as the 'protected payment' and will be uprated by prices, using the Consumer Price Index (CPI), whereas the single-tier pension will be uprated by at least earnings (and possibly the triple-lock). The triple-lock is the mechanism used to increase the basic state pension and is the higher of the growth in average earnings, the Consumer Price Index (CPI), or 2.5%. The CPI is typically lower than earnings over the longer term and, therefore, the protected payment might be expected to lose value over time relative to the single-tier pension. However, the triple-lock is only guaranteed until the end of the current parliament. After this date, the law will require the single-tier pension to be uprated annually in line with earnings.

Emerging issues around the transition to the single-tier pension

The introduction of the single-tier pension means that there is an effect, frequently known as a "cliff-edge", whereby those people who have already reached State Pension Age or who will reach State Pension Age before April 2016 are treated differently to those reaching State Pension Age just after the implementation date.

Those people who reach State Pension Age after April 2016 will benefit from the comparison of their accrued rights under the current system with what they would have accrued under the single-tier pension—and take forward the higher of the two amounts. In contrast, people who reach State Pension Age before April 2016 will not benefit from this comparison and may receive a lower state pension than people with very similar National Insurance contribution histories.

This difference is most obvious for people who are likely to have benefitted most from the single-tier pension if they had been eligible, such as individuals who qualify for relatively small amounts of S2P. This includes individuals who have had career breaks, or low earnings, that were not well covered by SERPS or S2P credits, as well as the self-employed.

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Women who were born between April 1951 and April 1953

Women in this cohort will have a State Pension Age under 65, meaning that they will reach State Pension Age before the implementation date of April 2016, compared to men born at the same time whose State Pension Age is 65 and who will, as a result, reach State Pension Age from April 2016 onwards. In 2011, there were around 718,00 women in this cohort.[2]

While this differential treatment of men and women of the same age has been part of the UK state pension system as long as there have been different state pension ages for men and women, the close proximity of the proposed implementation date to 2018 (when SPA is equalised for men and women) brings this different treatment into sharper focus. Similarly, the fact that women as a group are likely to benefit from the single-tier pension exacerbates the different treatment of those women who will reach State Pension Age before April 2016 and those who reach it at or just after April 2016 and consequently benefit from the single-tier pension.

Chart 1: Women who reach SPA from April 2016 onwards may receive a higher pension

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

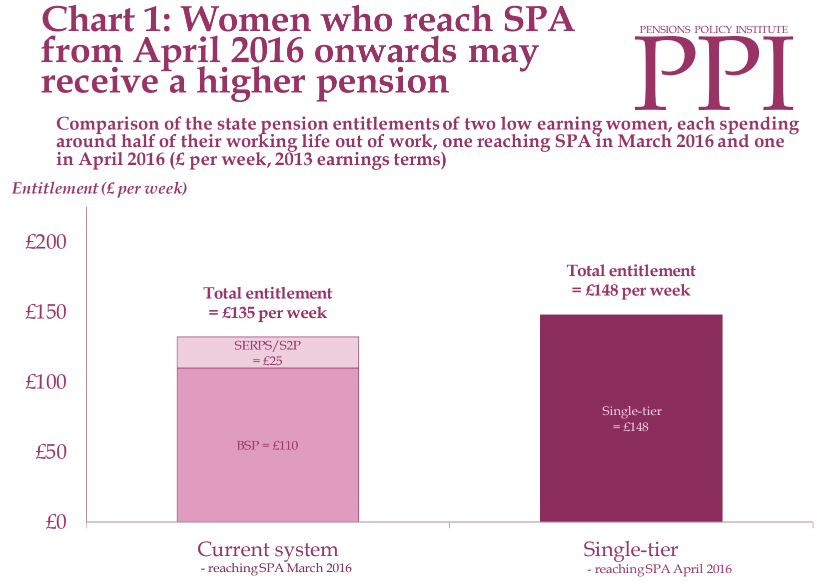


Chart 1 illustrates this using the example of two low earning women, one reaches State Pension Age in March 2016 while the other reaches State Pension Age in April 2016. These individuals have identical earnings histories and each has spent around half of their working life out of work. While the woman who reaches State Pension Age under the current system will receive £135 per week, the woman who retires in April 2016 will benefit from the comparison of her accrued rights under the current system with what she would have accrued under the single-tier pension—and consequently receives the higher single -tier pension amount of £148 per week.

It is likely that the gap between these amounts will increase over the years as, while the full single-tier amount will be increased by at least earnings growth and possibly the triple-lock, only the BSP, for the person who retires in March 2016, will be uprated by earnings or the triple-lock. The additional State Pension (SERPS or S2P) will be uprated by the CPI which is typically lower than earnings over the longer term. However, the Guarantee Credit will ensure that those people who reach State Pension Age before April 2016 have a minimum income (currently £145.50 for single pensioners and a minimum of £222.05 per week for couples). Savings Credit will ensure that those people reaching State Pension Age before April 2016 who have made some savings are better off than people who have not saved for retirement.

The DWP estimates that approximately 90% of women in this cohort would, overall, receive more in lifetime state pension and other benefits under the current system than if they had a State Pension age of 65 and received a single-tier pension.[3]

Trade-off between costs and cliff-edge effects

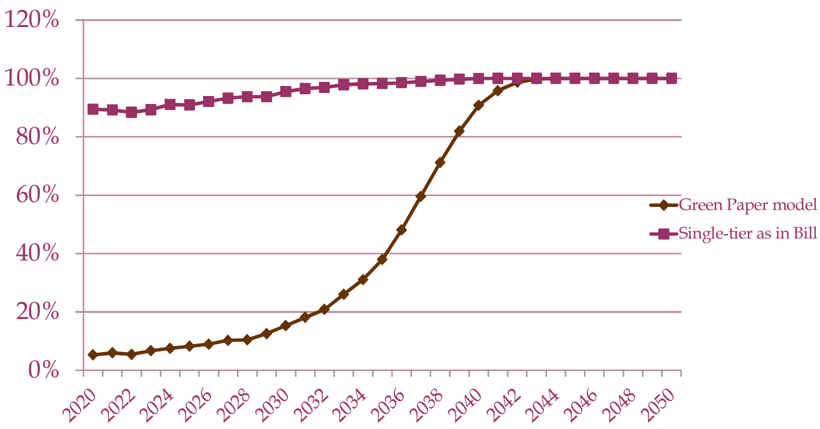
When any new policy is introduced there may be a cliff-edge effect, whereby people in very similar circumstances experience different outcomes. Cliff-edge effects tend to be perceived as unfair and, therefore, governments frequently try to mitigate these. However, this may be costly. If the Government were to offer all pensioners the amount that they would have accrued under the single-tier pension (if this was higher than their accrued rights under the current system) the initial costs would be substantially higher.

For instance, previous PPI research has suggested that, by 2017, government spending on state pensions would need to increase by almost £5 billion (in 2011 earnings terms) if the single-tier pension were offered to all pensioners from 2016, compared to around £1.7 billion if the single-tier were offered to new pensioners only from 2016.[4]

At the same time, the running of two pension systems concurrently represents an administrative burden to

Chart 2[5]: Most people who pay higher National Insurance contributions will get extra state pension for years worked/credited after 2016

Proportion of those who pay higher NI contributions who increase state pension entitlement after 2016, by year they reach State Pension Age



Note: 5 year moving average

the Department for Work and Pensions (DWP). The DWP will have to administer the Basic State Pension and the additional State Pension alongside the single-tier. Not only does this have administration costs, it also means that the simplicity of a single-tier pension could be diluted as the current system will not be completely replaced until everyone reaching State Pension Age before April 2016 and their surviving spouses have died.

A useful comparison, which indicates the potential length of any transition, is with category C state pensions. These ceased in 1948 but remained payable to people over State Pension Age in 1948 or the widows of men who were over 65 in July 1948. However, DWP figures show that, in February 2013, around 20 were still in payment.[6]

Speed of transition

Policy has been designed so that the transition to the single-tier pension happens as quickly as possible, at least for future pensioners.

When the single-tier is implemented contracting out will also end. In Defined Benefit (DB) schemes, employees who were members of a contracted-out scheme will no longer receive the contracted-out rebate and will start to pay full National Insurance contributions. While these employees will have a lower foundation amount than those employees in the same circumstances who have not been contracted out, they will be able to build up extra state pension for years worked after 2016, up to the full amount of the single-tier pension. In practice, this means that employees who have previously contracted out benefit relative to other employees—as many will be able to receive the full single-tier pension while also benefitting from extra contributions to their private pensions funded by the contracted out rebate that they received before the introduction of the single-tier pension.

Chart 2, taken from the DWP's impact assessment shows that, under the single-tier pension, from 2020 onwards, at least 90% of those people who pay a higher rate of National Insurance contributions as a result of the ending of contracting out will be able get extra state pension for years worked or credited after 2016, up to the full single-tier pension. The DWP estimates that approximately 90% of people who pay higher National Insurance contributions and reach State Pension Age within 20 years of the implementation date of the single-tier will receive enough extra state pension in their retirement to offset the increase in National Insurance contributions and any adjustment to their occupational pension schemes.

The above contrasts with the single-tier option initially outlined in the Government's Green Paper.[7] Under the current system people who have spent periods in contracted out pension schemes receive a reduced state pension. Under the Green Paper single-tier this reduction would continue, meaning that during the transition many would receive the equivalent of the single-tier pension from a combination of their state and contracted out pension scheme. This means they would receive less than the full value of the single-tier (at the time estimated at £140 per week).

Under both options, by 2044, all of those people who pay a higher rate of National Insurance contributions as a result of the ending of contracting out would increase their state pension entitlement. However under the single-tier pension outlined in the Green Paper the transition would be much slower - for instance, by 2035, only 38% of those people previously contracted out would get extra state pension for years worked or credited after 2016.

The implication of this is that the single-tier proposals currently in the Pensions Bill are more generous to those who have been contracted-out than the proposals contained in the Green Paper. This is why most people receive a full single-tier pension much sooner. However, both proposals are cost neutral over the longer term. To retain the cost neutrality of the Pensions Bill proposals, other aspects of the policy have been made less generous. For instance, the Pensions Bill entitles an individual to a full state pension if they have 35 or more qualifying years compared to 30 years in the Green Paper. While the Pensions Bill does not specify the minimum number of qualifying years for a state pension, it states that these must be contained in regulations and must not be more than 10. In comparison, this figure is 7 years in the Green Paper. While a faster transition may help the long-term stability of the single-tier pension, this is just one trade-off of many that could be made.

As noted there will still be a long transition for those pensioners who remain under the current system. One potential alternative could be to transition people who reach SPA under the current state pension system over to the single-tier at a later date if resources allow. For example, one option would be to offer the amount that individuals would have accrued under the single-tier pension (if this is higher than their accrued rights) once they reach a certain age, such as 75. While this would be less costly than offering the single-tier pension to all pensioners immediately, it would not be cost-neutral. It would however mean that the transition to the single-tier pension would be less protracted as within 10-12 years all pensioners would be assessed under the single-tier.

Transition for people with an entitlement based on their spouse's contributions—Basic State Pension

While some people receive a state pension based on their own National Insurance contributions, others receive a state pension based on their partner's contributions. Under the current system, some married people, people in civil partnerships, widows, widowers and surviving civil partners may access the state pension on the basis of their partner's contributions, known as category B pensions. The number of people in receipt of a category B pension has been decreasing from just over a million people in February 2010 to 886,000 people in February 2012.[8]

The single-tier pension does not make this provision.

Specifically, there are two groups of individuals who may be affected by this:

- Individuals who are expecting to receive a pension based on their spouse's National Insurance Contributions. This is currently 60% of the Basic State Pension while their spouse is alive and 100% if they are widowed or divorced.
- Employed married women who, between 1948 and 1977 chose to pay reduced rates of National Insurance on the assumption that they would receive a derived pension based on their husband's contributions (known as the Reduced Rate Election). This is also 60% of the Basic State Pension while their spouse is alive and 100% if they are widowed or divorced.

Under the measures set out in the Pension Bill now before parliament those in the first group reaching SPA under the single-tier provision will not be able to claim on their partner's contributions. However, the White Paper indicates that, under the single-tier, the majority of people will be eligible for a state pension above the basic level of means-tested support based on their own National Insurance contributions and will therefore not need to receive a pension based on their spouse's contributions. However, this is difficult to estimate as the data linking spouses' records is not available.

In contrast, the Pensions Bill outlines provisions for the transition for the second group of women: they will be able to access a single-tier pension based on their own contributions up to the implementation date for the single-tier pension. This will include an amount equivalent to the full rate of the 'married woman's' basic pension rate, ensuring that they are not worse off under the new rules.

Inheritance of additional State Pension

In particular circumstances, surviving partners may inherit the additional State Pension under the current system. The inheritable amount depends on different factors, such as the date on which the survivor was widowed. Under the single-tier it will not be possible to inherit pension rights from a spouse or civil partner. However, transitional arrangements will be in place so that it is possible for a spouse or a partner to inherit the proportion of a state pension that relates to National Insurance contributions made by a deceased person before the implementation of the single-tier pension.

Chart 3: Transition rules for inheritance of the additional State Pension

Survivor	Deceased	Treatment under the reforms
Reaches SPA under the current system	Dies below SPA before the implementation of the single-tier	Current rules apply
Reaches SPA under the current system	Reaches SPA under the single-tier *or* Dies below SPA after the implementation of the single-tier	Current rules apply but inheritable amount based only on contributions made before the introduction of the single -tier
Reaches SPA under the single-tier	Reaches SPA under the current system or died below SPA before the introduction of the single-tier	Amount inherited is equal to the entitlement under the current rules

Chart 3 shows how these rules might apply in different circumstances.

Inheritance of protected payments

At the date of implementation of the single-tier pension, the National Insurance records of some people will give some individuals a "foundation" amount which is more than the full level of the single-tier pension.

These people will get the full single-tier pension, and keep any amount above this as a 'protected payment' when they reach State Pension age. This protected payment relates to the right to the additional State Pension that they have accrued.

Even where neither partner reaches State Pension Age before the implementation of the single-tier, the survivor will be able to inherit 50% of any protected payment to which the deceased was entitled if a partner dies before State Pension Age.

Similarly, where divorced couples have opted to share the value of the additional State Pension to which they may be entitled as part of their settlement, the rules will allow for sharing of any protected payments where these are awarded.

Conclusion

The introduction of the single-tier pension means that there is a cliff-edge effect whereby those people who have already reached State Pension Age or will reach State Pension Age before April 2016 are treated differently to those reaching State Pension Age at or just after the implementation date.

Policy has been designed so that the transition to the single-tier happens quickly, at least for future pensioners. The rules for the single-tier pension enable those people who were previously contracted-out to build up extra state pension for years worked after 2016. The latest reforms are therefore more generous to those who have been contracted-out. In order to retain the cost neutrality of the Pensions Bill proposals, other aspects of the policy, such as the number of qualifying years, have been made less generous.

Current pensioners and those reaching State Pension Age before April 2016 will not benefit from the single-tier pension, meaning that the current system will co-exist with the single-tier pension for decades. While it would be possible to overcome this by offering the single-tier pension to all pensioners, either in April 2016 or when they reach a certain age, this would not be cost-neutral. Transitional arrangements are in place for people with an entitlement based on their spouse's contributions and for the inheritance of the additional State Pension and protected payments.

1 DWP (2013) *Single-tier impact assessment*
2 ONS (2011) *Census*
3 DWP (2013) *Note on the cohort of women born between 6 April 1951 and 5 April 1953*
4 PPI (2011) *The implications of Government policy for future levels of pensioner poverty*
5 DWP (2013) *Single-tier impact assessment*
6 DWP (2013) *Tabulation tool*
7 DWP (2011) *A state pension for the 21st century*
8 DWP (2013) *Tabulation tool*

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