PPI Submission to the Work and Pensions Select Committee: The Government's State Pension reform plans

Summary

I. This submission provides the PPI's written evidence to the Work and Pensions Select Committee inquiry into the Government's State Pension reform plans.

II. This submission contains initial PPI high level analysis, and considers:
- The impact that the proposals will have on specific groups of individuals.
- The future need for means-tested benefits and the potential impact on private pension saving.
- Implications of the ending of contracting-out of the State Second Pension.
- The impact on future levels of Government spending on state pensions and related benefits.

The impact that the proposals will have on specific groups of individuals

III. In general, individuals who would have qualified for relatively small amounts of State Second Pension (S2P) are most likely to gain from the implementation of the single-tier pension as set out in the White Paper. 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 date.

IV. All individuals will receive at least as much state pension as they would have got in the current system based on their National Insurance Contribution histories up to the point at which the single-tier pension is introduced. However, some individuals will build up lower state pension entitlements after the introduction of the single-tier pension than they would have done had the current system remained in place. 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.

V. The reforms affect different age cohorts in different ways. Individuals who reach state pension age in the years just after the introduction of the reforms will be more likely to have lower state pension entitlements under the current state pension system, and so benefit from the proposed single-tier pension. Individuals reaching state pension age longer after the reforms are introduced are likely to have benefited from the

introduction of S2P and so would have been more likely to have state pension incomes higher than the proposed single-tier pension level had the current state pension system continued.

VI. Some individuals who initially have lower state pension incomes under the proposed single-tier pension than under the current system, could have higher incomes than under the current system later in retirement. This is because all of the single-tier pension would be increased at least in line with average earnings, while in the current system only the Basic State Pension increases at least in line with average earnings. This makes it difficult to say who would definitively gain and who would definitively lose under the reforms, and to estimate how many gainers and losers there may be at any particular point in time.

VII. There will also be individuals who are not affected by the reforms, but who will feel that they have missed out by not being included in the reforms. One group who may be particularly affected in this way are women born between April 1952 and July 1953. Women in this cohort will have a State Pension Age under 65, meaning that they will reach State Pension Age before the illustrative implementation date of April 2017. However, the male State Pension Age for men born between the same dates is 65, so men in this cohort will be eligible for the proposed single-tier pension. In 2010 there were around 450,000 women in this cohort.

The future need for means-tested benefits and the potential impact on private pension saving

VIII. By setting the illustrative level of the proposed single-tier state pension above the level of the Guarantee Credit (GC) 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.

IX. However, even with the level of the proposed single-tier pension above the GC level, relatively high levels of means testing could remain in the future as a result of not all individuals qualifying for a full single-tier pension, some individuals having extra needs leading to higher Pension Credit entitlement, and continued eligibility to Housing Benefit and Council Tax Benefit

Implications of the ending of contracting-out of the State Second Pension

X. The introduction of a single-tier state pension will lead to the end of S2P, and as a result the ending of contracting-out from S2P. The ability to contract-out into a Defined Contribution (DC) pension scheme was removed in 2010, but it is currently still possible to contract-out into a Defined Benefit (DB) pension scheme. The ending of contracting-out from DB schemes will have impacts on both scheme members and scheme sponsors.

XI. Both members and sponsors of contracted-out pension schemes will need to pay higher National Insurance Contributions (NICs), and scheme members will receive higher state pensions in return. Some private sector scheme sponsors will reduce benefits, increase member contributions or some combination of the two rather than face increased pension costs.

XII. Public sector scheme sponsors will not be able to change the benefits paid by their schemes or the contribution levels and so face higher costs, although HMT will collect the higher NICs from public sector employers and so could choose to use these to offset the higher costs. Public sector pension scheme members will therefore receive higher state pensions and no reduction in pension scheme benefits.

The impact on future levels of Government spending on state pensions and related benefits

XIII. The DWP estimates that by 2060, under the proposed single-tier state pension system Government expenditure on state pensions and related benefits would be 8.1% of GDP, compared to 8.5% of GDP if the current system had remained in place. This implies that, on average, state pensions and related benefits will be less generous under the reformed system than under the current system.

XIV. However, these figures reflect only direct expenditure on benefits, and do not take account of all of the changes being made to the system. In particular the figures do not take account of the impact of the ending of contracting-out, which will also reduce the amount of pensioner income derived from pensions paid for by the state.

Introduction

1. This submission provides the PPI's written evidence to the Work and Pensions Select Committee inquiry into the Government's State Pension reform plans.

2. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

3. On 14 January 2013 the Government published a White Paper setting out its plans to introduce a new single-tier State Pension. The Government plans to introduce this new State Pension from 2017 at the earliest. It will be set at around £144 per week (in 2012/13 prices). The State Second Pension (S2P) will end, as will the current arrangements for defined benefit pension schemes to contract out of S2P and for lower National Insurance contributions to be paid by both contracted-out employees and their employers. The changes will not apply to people who are over State Pension Age when the new arrangements are introduced.

4. At the date of introduction of the single-tier pension, 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 State Second Pension 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.

5. This submission contains initial PPI high level analysis, and considers:
   - The impact that the proposals will have on specific groups of individuals.
   - The future need for means-tested benefits and the potential impact on private pension saving.
   - The implications of ending contracting-out of the State Second Pension.
   - The impact on future levels of Government spending on state pensions and related benefits.

6. The submission does not cover broader issues, such as the potential impact of the reforms on automatic enrolment, the potential long-term impact on overall incomes in retirement, the numbers of people with higher or lower state pension incomes at any particular point in time, or the potential impact on pensioner poverty. These issues, alongside the

issues covered in this response, are likely to be covered in more detail in future PPI research.

7. A number of the final details surrounding the Government's State Pension reforms have yet to be finalised. For example, the date of introduction, the final level of the pension, the way in which the pension will be increased over time, and the number of qualifying years needed to receive any state pensions will all be decided in the next parliament. The White Paper uses illustrative details when analysing the reforms. The analysis contained in this submission is based on the White Paper illustrative details (unless otherwise stated).

The impact that the proposals will have on specific groups of individuals

8. The precise impact on individuals will be highly dependent on each individuals own circumstances, so it can be difficult to say definitively who would gain and who would lose from the proposals to implement the single-tier pension as set out in the White Paper.

9. But it is possible to identify some broad groups, or specific characteristics, that might be more likely to result in higher or lower state pension incomes under the single-tier system than under the current system.

Groups who are likely to have higher state pension income under the reforms than under the current system

10. In general, individuals who would have qualified for relatively small amounts of State Second Pension (S2P) are most likely to gain from the implementation of the single-tier pension as set out in the White Paper. 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 date

<u>Individuals who have already had career breaks or low earnings that were not well covered by SERPS or S2P credits</u>

11. There are currently two main components to UK state pensions – the Basic State Pension (BSP) and the State Second Pension (S2P). S2P was introduced in 2002 as a replacement for the State Earnings Related Pension Scheme (SERPS).

12. Before the introduction of S2P in 2002, it was only possible to qualify for SERPS through earnings, and the amount of benefit built up was linked to earnings – the higher the earnings the higher the benefit. This meant that although individuals who were not in work could build up entitlement to the Basic State Pension through credits awarded, for

example, for caring or being in receipt of certain benefits[1], they would not build up any SERPS. Individuals with low earnings would only build up low SERPS entitlements.

13. When S2P was introduced in 2002 individuals with caring responsibilities or receiving disability benefits began to receive credits for S2P, and low earners received a boosted S2P entitlement, broadly equivalent to double the benefit someone earning £14,700[2] would have received in SERPS.

14. However, many individuals who are yet to retire will have had career breaks and/or low earnings before 2002, and will not have fully benefited from the introduction of S2P.

15. Some individuals who will reach State Pension Age after the proposed single-tier state pension is implemented may already have retired, and so will not build up further qualifying years. However, even if an individual does not have enough qualifying years for a full single-tier pension, they would get at least the same state pension as in the current system, and possibly a higher state pension under the proposed single-tier state pension system if they have few years of SERPS / S2P entitlement.

<u>The Self-employed</u>

16. Another group who will have lower S2P entitlements, and will therefore be more likely to gain from the implementation of a single-tier state pension, are the self-employed.

17. Periods of self-employment do not build up entitlement to S2P (or to SERPS pre-2002), in recognition of the lower NI contributions paid by the self-employed. So individuals with long periods of self-employment may have little state pension above the level of the BSP.

18. As self-employment will qualify for the proposed single-tier state pension, individuals with periods of self-employment are therefore more likely to get a higher state pension under the reformed system than under the current system.

<u>Those who are contracted out and have time to build-up more pension after the introduction date</u>

19. One group of individuals who, perhaps unexpectedly, will do well from the proposed single-tier state pension system are some of those who have not built up entitlement to S2P because they have been contracted-out of S2P.

[1] See PPI (2012) ***The Pensions Primer: A guide to the UK pension system***. Although at the time caring was recognised by a system called Home Responsibilities Protection (HRP) which reduced the number of qualifying years needed rather than increased the number of qualifying years achieved, for individuals yet to reach state pension age years of HRP have been converted into credits.

[2] In 2012/13. See PPI (2012) ***The Pensions Primer: A guide to the UK pension system*** for further details.

20. Since the introduction of SERPS in 1978 it has been possible to contract-out of the additional pension part of the state pension system (not the Basic State Pension). In essence this meant that individuals paid lower National Insurance Contributions (NICs) (or received a rebate on contributions) but did not qualify for SERPS, or from 2002 S2P. [3] 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. [4]

21. Under the White Paper 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.

22. 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.

23. If these individuals are close to retirement, then the contracted-out individual will receive a lower single-tier pension than the not contracted-out individual. However, if these individuals are younger and have a number of years to go to retirement, the contracted-out individual may be able to build up more single-tier pension in the future than the not contracted-out individual, and both could end up with full single-tier pensions.

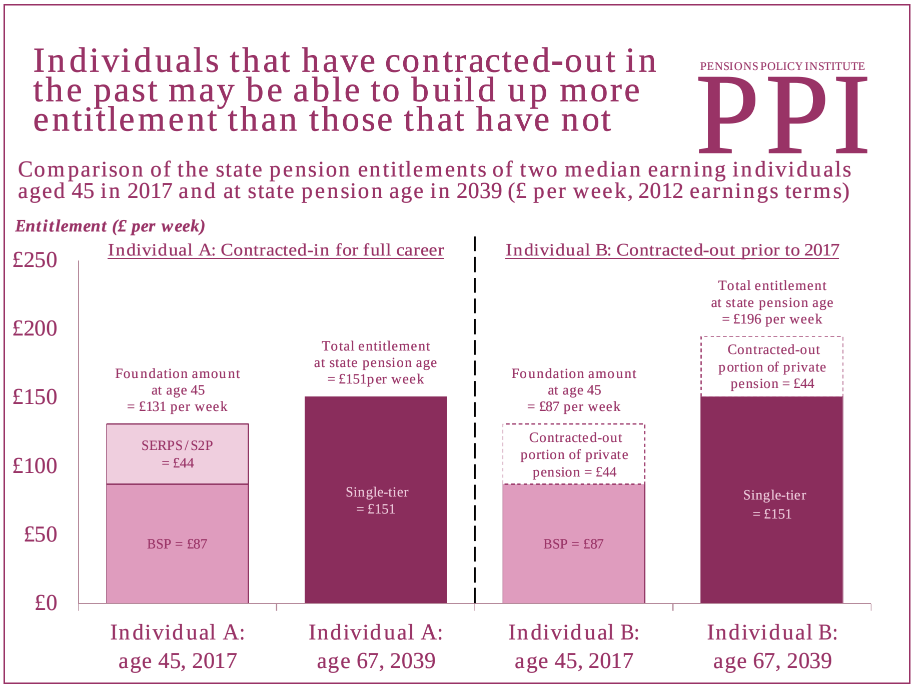
24. In this case, it could be argued that the individual who contracted-out has done much better than the not-contracted out individual. They receive the same single-tier pension. The individual who did not contract out has his SERPS / S2P incorporated into the single-tier pension but the contracted-out individual, who paid lower NICs , still receives the equivalent of his SERPS / S2P built up before 2017 through a private pension, in effect being paid on top of the single-tier pension.

25. Chart 1 illustrates this using the example of two median earning individuals, aged 45 in 2017. These individuals have identical earnings histories, but one has been contracted-out of SERPS/S2P for their entire working life, whilst the other has remained contracted-in. Both have higher entitlement under the current system in 2017 than if single-tier had been in place throughout their careers, so this becomes their foundation amount. However, the contracted-out individual has a lower

[3] This is a simplification, as there are circumstances in which individuals can be contracted-out and still qualify for SERPS or S2P, but the principle is that all or some of the SERPS or S2P benefit is given up. See PPI (2012) ***The Pensions Primer: A guide to the UK pension system*** for further information.
[4] The option to have rebates invested into a qualifying pension scheme was introduced in 1989.

foundation amount, reflecting the fact that he paid lower NICs and so part of his ‘state’ pension is provided through his private pension.

Chart 1[5]



26. By the time the individuals reach State Pension Age, 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 still receive his contracted-out private pension, equivalent to the SERPS / S2P that he would have built up before 2017 if he had been contracted-in. The contracted-in individual does not receive this, as it was counted as part of his foundation amount.

Groups who are likely to have lower state pension income under the reforms than under the current system

27. 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 National Insurance Contribution histories up to the point at which the single-tier pension is introduced.

[5] PPI Individual Model. As a simplification, it has been assumed here that the contracted-out portion of individual B’s private pension is exactly equal to the entitlement that could have been accrued under S2P/SERPS. It has also been assumed that this amount is uprated in line with average earnings growth until SPA, as would have been the case with S2P/SERPS entitlement.

28. However, some individuals will build up lower state pension entitlements after the introduction of the single-tier pension than they would have done had the current system remained in place. 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.

<u>Individuals who would have built up high S2P entitlements</u>

29. Individuals who would have built up high entitlements to S2P had the current system remained in place will get lower state pensions under the single-tier pension reforms as set out in the White Paper.

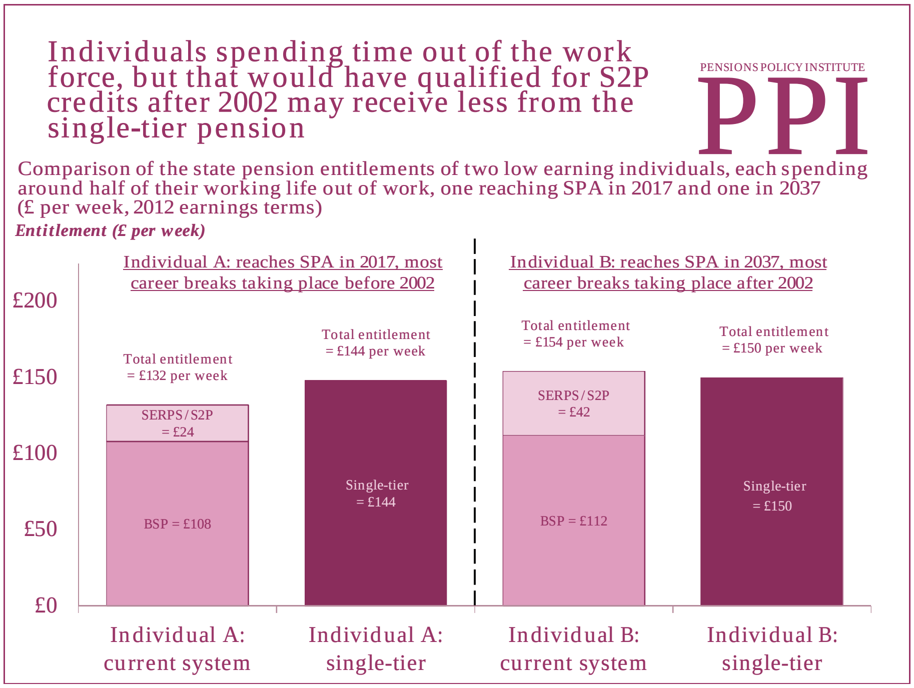
30. In the early years after the implementation of the single-tier pension, it will be individuals who have had high earnings in the past and continue to have high earnings after the implementation date who will see the largest differences in their state pension. Although the transitional arrangements mean that they will still receive all of the state pension built up before implementation, they will not be able to build up any further state pension.

31. However, over time, even relatively modest earners may initially get less from the single-tier state pension than they would have had had the current system continued. This is because in recent years the credit system and the boost for low earners has made S2P more valuable. Individuals reaching State Pension Age further in the future will have spent more time in the S2P system, and so will benefit more from it than individuals reaching State Pension Age 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.

32. 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.

33. The example shows two possible outcomes for this individual; in the first they reach SPA in 2017 having had the majority of their career before 2002, and they would receive a higher state pension under the single-tier pension system. In the second, their SPA occurs 20 years later and the majority of their career takes place after the introduction of S2P, and they would receive a higher state pension had the current system continued.

Chart 2[6]



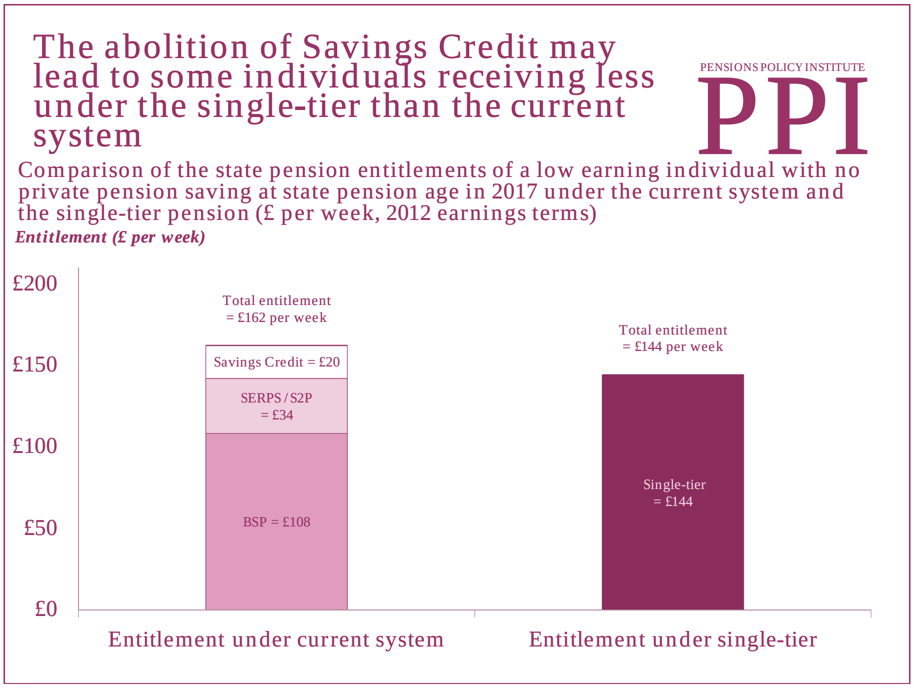
<u>People who may have been eligible for savings credit</u>

34. There will be some individuals who, even after the introduction of the single-tier pension, will have incomes only just above the Guarantee Credit level. In the current system they would have been entitled to receive Savings Credit. As part of the proposed reform package, Savings Credit will no longer be available for these individuals, and they may therefore receive lower retirement incomes that they would have done had the current system continued.

35. An example of this is provided in Chart 3, which considers a low earning individual reaching SPA in 2017, with state pension entitlement under the current system exactly equal to the Guarantee Credit threshold. This individual has no private pension saving and under the current system, would qualify for the maximum level of Savings Credit.

[6] PPI Individual Model

Chart 3[7]



Individuals with less than 7 – 10 qualifying years

36. Since 2010, an individual has only needed 1 qualifying year to receive any BSP in their own right. Before 2010, individuals needed to have enough qualifying years to qualify for at least 25% of the full BSP to receive any. The proposed requirement that individuals must have at least a minimum number of qualifying years in order to receive a pension is therefore a reversion to the situation in place before 2010.

37. 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.

38. There are also other ways in which the proposed single-tier is less generous to this group than even the pre-2010 system:
    - In the pre-2010 system, even if individuals did not have enough qualifying years to receive any BSP, all years of SERPS or S2P entitlement were paid. In the proposed single-tier system there is no SERPS or S2P equivalent.
    - In the pre-2010 system individuals without any BSP in their own right could 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

[7] PPI Individual Model

based on individual entitlement, with no scope to take into account partners contributions.

39. So individuals with less than the minimum number of qualifying years will not receive any state pension under the new system, and will not be able to rely on a partner's contributions. If they are retiring in the UK they may, however, still be eligible for the Guarantee Credit.

<u>Some individuals might have lower state pension income initially, but higher state pension incomes later in retirement</u>

40. Even individuals who have a lower state pension at state pension under the single-tier state pension system as proposed in the White Paper than they would have if the current system may have a higher state pension later in their retirement.

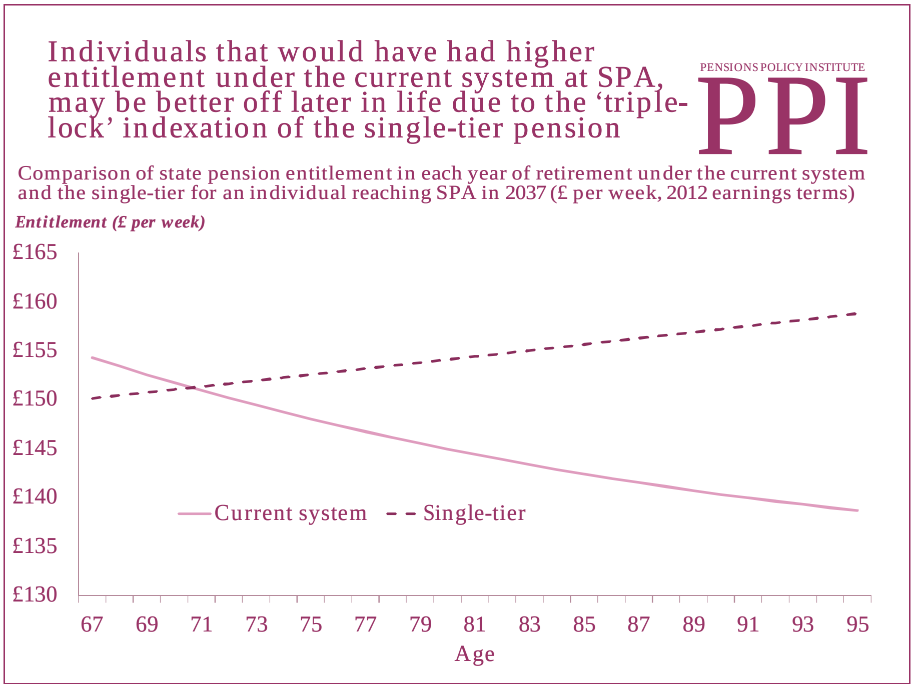
41. This is because all of the proposed single-tier pension will be uprated at least in line with average earnings (and potentially, as illustrated in the White Paper, in line with the triple lock of the higher of earnings, prices and 2.5%), whereas in the current system only the BSP is uprated by this amount.

42. Chart 4 provides a comparison of potential outcomes for an individual reaching their SPA of 67 in 2037 (the same low earner as used in Chart 2). At SPA, their state pension entitlement would have been £154 per week in 2012 earnings terms had the current system still been in place. Under the single-tier, however, their entitlement reduces to £150 per week in 2012 earnings terms.

43. Triple-lock indexation means that the single-tier pension becomes more generous than the individual's pension under the current system by the time they reach age 71. This happens because the individual's S2P/SERPS entitlement is uprated in line with CPI, which is never greater than the uprating applied under the triple-lock and on average assumed to be lower each year[8].

[8]The single-tier pension and the BSP portion of entitlement under the current system have been increased in line with a long-term triple-lock assumption of 4.96% per year. S2P/SERPS entitlement has been increased in line with a long-term CPI assumption of 2.00% per year. The actual timing of the single-tier pension becoming more generous in this scenario will depend upon the actual values of the relevant economic indices.

Chart 4[9]



44. This makes it difficult to say who would definitively gain and who would definitively lose under the reforms, and to estimate how many gainers and losers there may be at any particular point in time. The PPI plans to investigate this, and other related issues such as the impact on pensioner poverty, in further analysis.

Individuals who reach State Pension Age before implementation of the reforms

45. There will also be individuals who are not affected by the reforms, but who will feel that they have missed out by not being included in the reforms. There is a "cliff-edge" to the policy which means that individuals who have already reached State Pension Age, or who reach it just before the implementation date for the reforms, are treated differently than those reaching State Pension Age just after the implementation date.

46. Cliff-edges are often a feature of state pension reform (there was a similar effect in April 2010 when the 2007 Pension Act reforms were introduced, which required only 30 qualifying years for a full pension rather than 39 for women and 44 for men).

47. One group who may be particularly affected in this way are women born between April 1952 and July 1953. Women in this cohort will have a State Pension Age below age 65, meaning that they will reach State Pension Age before the illustrative implementation date of April 2017. However, the male State Pension Age for men born between the same

[9] PPI Individual Model.

dates is 65, so men in this cohort will be eligible for the proposed single-tier pension. In 2010 there were around 450,000 women in this cohort[10].

48. 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. Delaying implementation until 2018 when SPA for men and women is the same would remove the differential treatment, but still would not mean that women born between April 1952 and March 1953 qualify for the single-tier pension.

The future need for means-tested benefits and the potential impact on private pension saving

49. 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. Currently 40% of pensioners are eligible for Pension Credit.

50. By setting the illustrative level of the proposed single-tier state pension above the level of the Guarantee Credit (GC) 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.

51. The DWP estimate that by 2060 the proportion eligible for Pension Credit will be 5% under the proposed single-tier pension, compared to 10% if the current system remained in place. PPI has not yet produced independent estimates of the likely impact of the proposed single-tier pension on eligibility to Pension Credit, but DWP estimates of the proportion of pensioners eligible for Pension Credit under the proposed single-tier state pension appear to be broadly consistent with earlier PPI estimates based on the policy contained in the DWP Green Paper. [11] Although the White Paper policy differs from the Green Paper policy significantly in the short term, long term impacts are likely to be similar.

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[10] Based on ONS mid-2010 UK population estimates

[11] PPI (2011) ***An assessment of the Government's options for state pension reform. A PPI report for the NAPF.*** Alhough DWP and PPI estimates of eligibility to Pension Credit under the single-tier pension are similar, PPI estimates suggest that eligibility to Pension Credit could be much higher than 10% if the current system continued.

52. However, even with the level of the proposed single-tier pension above the GC level, relatively high levels of means testing could remain in the future. This is because:
    - Not everyone will receive the full level of the single-tier state pension. The minimum number of qualifying years required for a full single-tier pension will be 35 compared to 30 for the current BSP. And more individuals will qualify for no state pension at all in the single-tier system than in the current system, because of the minimum requirement of between 7 and 10 years to receive any pension and the loss of being able to receive a pension based on a partners contribution record.
    - Some individuals with additional needs or responsibilities are eligible for higher levels of Guarantee Credit, through, for example, special premiums for people with disabilities or caring responsibilities. Under the proposed reforms individuals with these characteristics would still have a Guarantee Credit income level above the level of the single-tier pension.
    - Eligibility for Housing Benefit (HB) and Council Tax Benefit (CTB) will still extend to incomes much higher than the single-tier pension level. Although this is arguably a different type of means-testing than Pension Credit (HB and CTB are to meet specific housing costs rather than for basic income) they can still result in a reduction in the value of private pension saving to individuals. PPI estimates based on the Green Paper proposals suggest that in 2050 up to a third of pensioners might still be eligible for at least one of Pension Credit, HB or CTB.

The implications of ending contracting-out of the State Second Pension

53. The introduction of a single-tier state pension will lead to the end of S2P, and as a result the ending of contracting-out from S2P. The ability to contract-out into a Defined Contribution (DC) pension scheme was removed in 2010, but it is currently still possible to contract-out into a Defined Benefit (DB) pension scheme. The ending of contracting-out from DB schemes will have impacts on both scheme members and scheme sponsors.

The impact on scheme members

54. Under the proposed single-tier state pension, DB scheme members will have to pay higher National Insurance contributions (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, as in the current system they only build up rights to the BSP, not S2P. [12]

55. 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 scheme sponsor reacts to the ending of contracting-out.

[12] This is a simplification, as there are circumstances in which individuals can be contracted-out and still qualify for SERPS or S2P, but the principle is that all or some of the SERPS or S2P benefit is given up. See PPI (2012) ***The Pensions Primer: A guide to the UK pension system*** for further information.

The impact on scheme sponsors

56. The scheme sponsor will also have to pay higher NICs as a result of the ending of contracting-out (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.

57. Scheme sponsors will then need to decide whether to:
    - Retain the existing DB scheme benefits and contribution levels for the sponsor and employees, as well as paying the higher NICs. This would mean the scheme sponsor absorbing extra costs.
    - Retain the existing DB scheme benefits, but increasing member contributions to partially or fully offset the increased NICs, so sharing the extra costs with employees, or passing them on completely.
    - Reduce the existing DB scheme benefits (or replace the scheme completely) and reduce sponsor contributions to partially (or fully) offset the higher NICs.

58. The approach taken is likely to vary between different scheme sponsors. DWP has indicated that they will introduce powers so that scheme sponsors can change scheme rules to allow for the ending of contracting-out without trustee consent, for a limited period of time and only to the extent that the changes offset the higher NICs faced by the scheme sponsor.

59. However, the DWP has also stated that these powers will only apply to private sector DB schemes, not those in the public sector. Public service pension schemes are not expected to change either benefit structure or contribution level in response to the ending of contracting-out.

60. Members of public service pension schemes will therefore pay higher NICs, receive a higher state pension, and continue to pay the contributions and accrue a DB pension as set out in the reforms currently going through Parliament.

61. Sponsors of public service pension schemes will face higher NICs, and no reduction in the contributions payable to the DB pension scheme. The higher NICs will be collected by HMT. The overall impact on the budgets of public service scheme sponsors will depend on whether HMT increases sponsors budgets by the amount of the higher NICs or not.

The impact on future levels of Government spending on state pensions and related benefits

62. The PPI is currently developing its modelling capability to be able to undertake a full evaluation of the potential cost and distributional implications of the proposed single-tier state pension. The current observations are based on the figures published by the DWP in the White Paper.

63. The DWP estimates that by 2060, under the proposed single-tier state pension system Government expenditure on state pensions and related benefits would be 8.1% of GDP, compared to 8.5% of GDP if the current system had remained in place.

64. This implies that, on average, state pensions and related benefits will be less generous under the reformed system than under the current system.

65. However, these figures reflect only direct expenditure on benefits, and do not take account of all of the changes being made to the system. In particular the figures do not take account of the impact of ending contracting-out.

66. In the current system, part of the state pension system is effectively pre-funded. Members and sponsors of DB schemes pay lower NICs (equivalent to a Government contribution to the scheme), and in return scheme members receive lower state pensions in future. In 2012/13, more than £6bn of NICs were foregone by HMRC in contracted-out rebates. [13]

67. The DWP projections of the costs of the current system show the impact of the lower benefits, but do not take into account the value of the benefits that have in effect been pre-funded through contracting-out.

68. To properly evaluate the impact of the proposed reform on the Government finances, contracting-out should be accounted for. Adding the amount of revenue foregone in lower NICs to Government spending on pension and benefits would be one way of doing this, but risks inconsistency as the lower NICs do not benefit today's pensioners. A more consistent way would be to add the benefits built up from the lower NICs to future Government expenditure to give a better indication of the overall impact of the policy. This could be done by projecting the costs of the current system assuming that there is no contracting-out.

69. Focussing 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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[13] HMRC table 1.5