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TRANSITION TRADE-OFFS:  
OPTIONS FOR STATE  
PENSION REFORM



## Transition Trade-offs: Options for State Pension Reform

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## Introduction

Transition from the current UK pensions system to any reform option will be difficult. The complexity of the starting point, the multiple detailed economic calculations needed to understand the impact on different types of household, age and income groups, and the restrictions on how much money is available to spend, all add up to one of the most intractable problems in policy-making.

Many proposals for pension reform have not considered transition issues. However, the short-term implications of different paths to potential long-term visions for pension reform can no longer be ignored. The Government is planning to publish a White Paper that will contain pension reform proposals. At the end of 2005, the Pensions Commission published its preferred approach to reform with other options for consideration<sup>1</sup>.

Consistent with work carried out by the PPI and others over the last few years<sup>2</sup>, the consensus response to the Pensions Commission proposals can be summarised as agreement with the broad construct, but a preference to move more quickly to a simpler end point.

This paper therefore considers other options for the transition approach.

The PPI's first paper on transition<sup>3</sup>, in 2004, highlighted three themes about how the decision to adopt any transition approach is about making trade-offs between the potential 'winners and losers':

- Pension Credit - specifically the Savings Credit element - has significantly complicated transition. How to deal with Savings Credit will therefore 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.
- Simply increasing the current Basic State Pension will be regressive, giving windfall gains to richer pensioners. Replacing Basic State Pension and State Second Pension with a single flat-rate pension can be more progressive, improving income immediately for poorer pensioners.
- Policy reform options that build on the existing State Second Pension may make for an easier transition but do not improve pensioner incomes in the short term.

This paper will return to these themes again, as the current proposals for reform raise the same issues. Chapter 1 highlights the trade-offs made by the Pensions Commission's (the 'Commission') in their preferred option for reform, and identifies alternative reform proposals that make different trade-offs. There then follows a chapter analysing the impact of making each different trade-off choice. A final chapter examines the barriers the Pensions Commission perceived to a simpler solution.

<sup>1</sup> Pensions Commission (2005)

<sup>2</sup> For a more detailed commentary see PPI (2006 SPSS) and PPI Briefing Note Number 18

<sup>3</sup> PPI (2004 MT)



## Summary of conclusions

The broad construct of the Pensions Commission's proposals is consistent with the consensus view of pensions experts.

However, many experts urge a simpler solution to meet the Government's tests for pension reform more effectively. This would involve a faster transition to the ultimate end-point and combine the two state pensions into one. This preference for a simpler solution is explained by unpicking the policy trade-offs made by the Commission:

1. **Earnings or prices?** The Commission proposed fully uprating the Basic State Pension in line with earnings. This is necessary to maintain state pension income in retirement and prevent people slipping back onto Pension Credit at older ages.
2. **Residency or contributory?** The Commission proposed using a mix of residency and contributory criteria for state pension. There is public support for better coverage of state pensions, so that they would be given to most if not all people over state pension age. This could be achieved by a residency criterion or by improving the existing contributory criteria. A residency criterion seems easier to understand from an individual's point of view, but changing the existing contributory system may be easier for Government to implement. Improving coverage is only part of the solution and makes little difference to the number of people on Pension Credit.
3. **One or two tiers?** The Commission proposed maintaining the current two tiers of state pension, Basic State Pension and State Second Pension. This retains unnecessary complexity and gives more to higher income people.

Crucially, a single-tier system could be much more effective at reducing the proportion of pensioners who have to rely on means-testing through Pension Credit, from 50% today to around 10%. The Commission's proposals would only reduce the proportion to around 45%, which is still historically high. Pension Credit makes it difficult to meet the Government's test of promoting personal responsibility, as it makes the value of saving uncertain.

4. **Slow or fast transition?** The Commission proposed a very long transition, taking more than 50 years. A faster rather than slower transition would be simpler and more transparent. It would limit the time available for future changes, so is more likely to be sustainable.

The Commission recognised the benefits of a simpler solution but recommended against it. However, all their concerns can be met. In particular, their concerns about cost and distributional implications of the simpler solution are less significant than feared. A simpler solution can be afforded within the cost range suggested by the Commission.

## Chapter 1: What are the trade-offs?

This chapter identifies the key trade-offs made in the Pensions Commission's preferred option for state pension reform, and sets out a range of alternative reform options that make different trade-offs. The chapter ends by setting out the 5 tests proposed by the Government for evaluating state pension reform.

### **The Pensions Commission's proposals**

The Pensions Commission proposed both reform of the state pension system and the creation of a new National Pensions Savings Scheme (NPSS). More detail on the NPSS is in another PPI paper<sup>4</sup>. In this paper, the NPSS is included in the assessments where appropriate, but the focus is on different state pension reform options, and different transition approaches in such reform.

The Pensions Commission made a definitive recommendation of:

*Reforms to make the state system of flat-rate pension provision less means-tested than it would be if current indexation arrangements continued indefinitely and to ameliorate the disadvantages suffered by people with interrupted paid work records and caring responsibilities.*

To achieve this general objective, the Pensions Commission considered three options, stating a preference for the third option which is a 'middle way' between the others<sup>5</sup>:

1. Unify Basic State Pension (BSP) and State Second Pension (S2P) into a flat-rate 'Enhanced State Pension' (more commonly called a Citizen's Pension).
2. Let the gradual flattening of S2P play out to around 2055.
3. Accelerate the gradual flattening of S2P to 2030.

The Pensions Commission described the following policies to achieve its preferred approach of accelerated evolution of the current system into a flat-rate, two-tier system:

- *Acceleration of S2P's evolution to a flat-rate system, achieved by freezing in nominal terms the maximum earnings level for S2P accruals.*
- *A halt and reversal of the spread of means-testing, achieved by indexing the BSP to average earnings over the long-term, and by freezing the maximum value of the Savings Credit in real terms.*
- *Moving future BSP accruals onto a universal residency basis.*
- *An indicative plan to increase the SPA in proportion to life expectancy, such as to 68 by 2050 (or 67 for the BSP and 69 for the S2P), but with the precise path to reflect future life expectancy developments.*
- *And ideally, and subject to affordability, the introduction of a universal BSP for pensioners over 75 years old.*

The current system and the Pensions Commission's preferred option are summarised in Charts 1 and 2.

<sup>4</sup> PPI (2006 NPSS)

<sup>5</sup> Pensions Commission (2005) page 300

<sup>6</sup> Pensions Commission (2005) page 159

<sup>7</sup> Pensions Commission (2005) page 301



Chart 1<sup>8</sup>

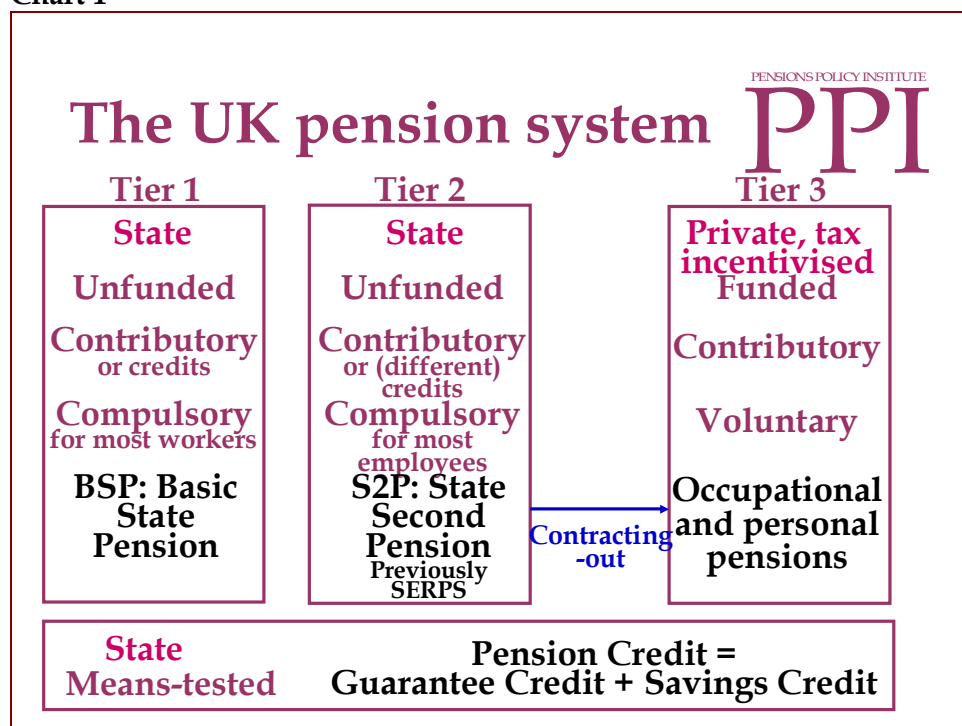
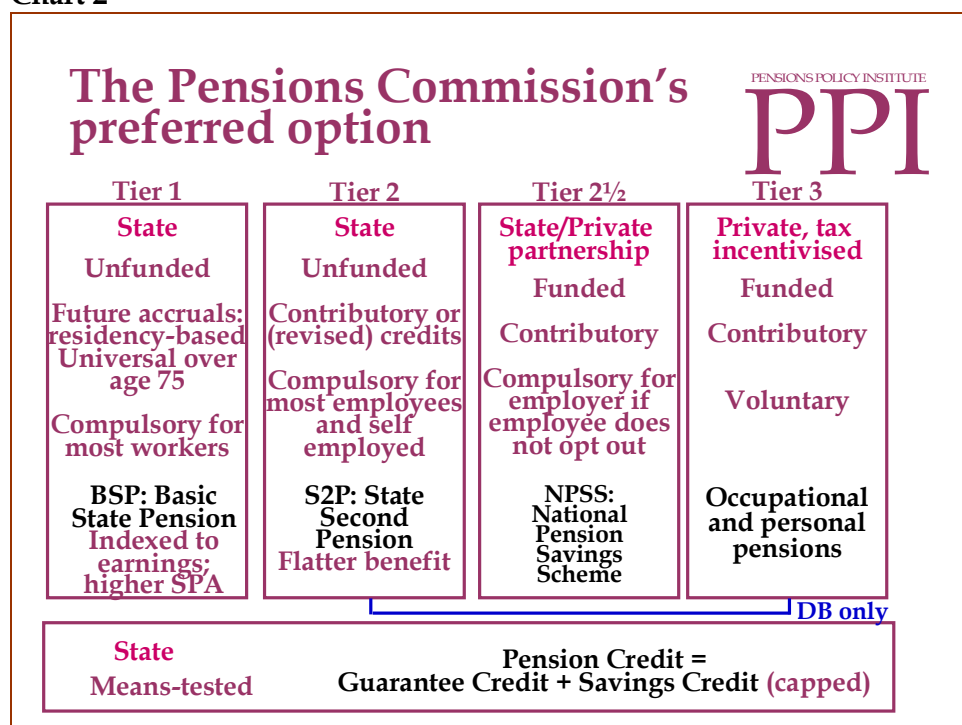


Chart 2<sup>9</sup>



<sup>8</sup> PPI analysis

<sup>9</sup> PPI analysis

However, the Pensions Commission also recognised that there is not a single, solution<sup>10</sup>. Reform will have to be undertaken after considering a series of **trade-offs**, covering all aspects of pensions policy. The next sections:

- Highlight some of these trade-offs.
- Show how the Pensions Commission's preferred option has made these trade-offs, and the implications of these decisions.
- Identify alternative reform proposals that make different trade-offs.

### **The policy trade-off decisions made by the Pensions Commission**

To arrive at the preferred option from the three different policy options, the Pensions Commission made a number of specific trade-offs:

- **Earnings or prices?** Should pensions in payment be uprated in line with the growth in earnings<sup>11</sup>, or as today uprated in line with the growth in prices? The Pensions Commission recommended fully uprating the BSP in line with earnings but retaining the current uprating rules for S2P<sup>12</sup>.
- **Residency or contributory?** Should the final system have entitlement based on residency or on the existing National Insurance (NI) contributory pension criteria? The Pensions Commission recommended making future qualification to BSP based on residency, but retaining eligibility based on how many NI contributions have been paid or credited for S2P.
- **One or two tiers?** Should the reformed system be based on a single pension, or the existing structure of the two-tier pension system? The Pensions Commission recommended a two-tier system retaining both BSP and S2P.
- **Slow or fast transition?** Should the final system be in place in the near future, or should it be allowed to evolve gradually over a long period of time? The Pensions Commission recommended a very slow transition, with the first individuals reaching State Pension Age (SPA) completely under the new system in 2058<sup>13</sup>, though with some immediate improvements in the BSP, particularly for pensioners aged 75 and older.

It is of course possible to make different decisions on these trade-offs. Some people might prefer a different combination, involving a faster transition, or a single-tier system, or a fully residency-based system, or an improved contributory system, or a system with pensions in payment uprated more in line with prices than with earnings.

<sup>10</sup> Pensions Commission (2005) page 301

<sup>11</sup> In this paper, 'uprating in line with earnings' means 'uprating in line with the growth in national average earnings'

<sup>12</sup> The amount of S2P earned ('accrued') each year during working life is currently revalued in line with earnings up to state pension age. The amount of S2P received is then uprated in line with prices in payment.

<sup>13</sup> Based on an individual aged 21 in 2010, reaching a state pension age of 68

To examine the impact of making different decisions for these trade-offs, this paper will analyse eight alternative proposals that make different trade-offs according to different preferences:

- A preference for both state pensions to be uprated in line with prices or uprated in line with earnings rather than different parts uprated in different ways.
- A preference for a pension system which bases entitlement to both state pensions on the existing NI contributory criteria rather than having one state pension based on a residency criterion.
- A preference for making the Basic State Pension universal, so that everybody over state pension age receives it, for current pensioners as well as future pensioners.
- A preference for a single-tier state pension system rather than a two-tier system.
- A preference for a fast transition to a single-tier state pension system, rather than a slow transition. This could be an overnight transition, or over an intermediate period such as 20 years.

More details of the options to be considered are given in Box 1.

All of the options assume that the Pensions Commission's NPSS is introduced in 2010. The BSP is assumed to be made universal for the over 75s in the Pensions Commission's preferred option, a policy which the Pensions Commission said should ideally be put in place, subject to affordability<sup>14</sup>.

#### **Assessment tests**

Each of the options will be tested against the same criteria, both qualitatively and quantitatively.

Many suggestions for appropriate criteria have been made<sup>15</sup>, but they boil down to the five tests to be used by the Government<sup>16</sup>:

- Promoting personal responsibility
- Fairness
- Affordability
- Simplicity
- Sustainability

<sup>14</sup> Pensions Commission (2005) page 21

<sup>15</sup> Pensions Commission (2005), DWP (2005 PR), O'Connell (2003) and Brooks, Regan and Robinson (2002)

<sup>16</sup> John Hutton MP, speech *Securing our Future: The Pensions Challenge*, ippr, 24th November 2005. See Appendix 1 for further details.

**Box 1: Alternative options to be assessed***1. Fully uprated with earnings*

As the Pensions Commission's preferred option, but with State Second Pension (S2P) payments uprated in line with earnings.

*2. BSP uprated with prices*

As the Pensions Commission's preferred option, but with the Basic State Pension (BSP) uprated in line with prices.

*3. Fully contributory system*

As the Pensions Commission's preferred option, but instead of implementing a residency criterion for BSP, improve the coverage of the contributory criteria: change Home Responsibilities Protection to be a weekly credit, automatically award it to those caring for between 20 and 35 hours a week, and reduce the number of qualifying years needed for a full Basic State Pension to 30.

*4. Only make the BSP universal*

Make the current BSP universal at age 75, and reduce the age of eligibility for the universal pension to 70 by 2015, and 65 by 2020. No change in SPA.

*5. Long transition to a single tier (same rate for individuals in couples)*

Introduce a new pension over a 40 year period, with the full amount eventually equal to the level of the Guarantee Credit<sup>17</sup>, uprated each year in line with earnings and received by everyone (based on either residency or improved contributory criteria). Stop accruals to BSP and S2P (and contracting-out), and at the same time introduce accruals to the UP of 1/40 of the full amount for each future year resident in the UK.

*6. Long transition to a single tier (lower rate for individuals in couples)*

As Option 5, preserve individual eligibility but reduce the amount of pension for people in a couple so they each receive 80%<sup>18</sup> of the amount received by a single person.

*7. Medium transition to a single tier*

A new pension, lower for each individual in a couple as in Option 6, increased each year from the BSP level in 2010 until reaching the full Guarantee Credit level by 2030. Existing accruals to SERPS / S2P (and contracted-out equivalents) are paid in full on top of the new pension (which replaces BSP).

*8. Short transition to a single tier*

A new pension, introduced immediately, lower for each individual in a couple as in Option 6. Transition is assumed to use the 'offset' method, so the amount of pension received is the maximum of the new pension and the total of BSP and SERPS/S2P that was accrued before the new pension was introduced<sup>19</sup>.

<sup>17</sup> £114.05 p.w. from April 2006

<sup>18</sup> Each individual in a couple would receive the full amount in his or her own right, but their amount would be set lower so that the total amount received is equal to the couple's rate of Guarantee Credit of £174.05 p.w.

<sup>19</sup> For a description of the offset method, see Box 9 and NAPF (2005) or NAPF (2004) Chapter 2.

The analysis in this paper concentrates on the key questions that can be informed by factual analysis:

- To **promote personal responsibility** successfully, good incentives to save are required and therefore a limited extent of means-testing. Pension Credit causes uncertainty about the value from saving, because it is impossible to predict whether savings made now or later will fall inside or outside the ambit of Savings Credit in future<sup>20</sup>.
- **Fairness:** How progressive are the reform options? Do they give more help to the poorest pensioners, or the better off?
- **Affordability:** How much do the different reform options cost when they are implemented and over the next 50 years? Affordability is more likely to be constrained in the short term (say, 2010 to 2020) than the long term (2050), when policy tools such as raising state pension age are more readily available.
- **Simplicity:** How easy is the reformed state pension system for individuals reaching state pension age at different times over the next 50 years to understand, and are the pension outcomes clear?
- **Sustainability:** Is the stability of reform undermined by long periods of uncertainty or complexity?

The number of people eligible for Pension Credit is the key measure of success. Reducing the extent of Pension Credit not only helps to promote personal responsibility, as described above, but also helps secure success against other tests:

- **Simplicity:** Pension Credit is complicated and adds significantly to the number of parameters on which an individual's income depends. Further, it is not certain, as its parameters can be set at short notice in a Budget rather than being set in legislation. Small changes in these parameters can make a big difference to being eligible in future or not. So continued reliance on Pension Credit means that people (and their advisors) will continue to be uncertain about the income they can expect from the state in future and about the value of saving.
- **Sustainability:** Means-testing can be seen as 'something for nothing' and the process of having to claim means-tested benefits, while improved, is still disliked by many. So extensive means-testing is unlikely to be a sustainable policy.
- **Fairness:** Because Pension Credit imposes at least a 40% withdrawal rate on savings, less Pension Credit could be seen as being fairer than the current situation.

Chapter 5 will show that a significant reduction in Pension Credit can be **affordable** and that alternative ways of targeting state spending can be found.

<sup>20</sup> See PPI (2006 WPSC) paragraphs 18 to 30

The appropriate measure for the extent of Pension Credit is the proportion eligible for Pension Credit, rather than the proportion receiving or the amount left unclaimed. This is because it is the uncertainty caused by being near to eligible that is the problem. This paper therefore contains projections of the number of pensioner 'benefit units' (singles or couples over SPA who can apply for Pension Credit) who are eligible for Pension Credit.

There is not a single 'right' answer for how many people 'should' be eligible for PC. This is because its problems are about public perceptions of the value of saving and of fairness.

### Quantitative testing

The quantitative testing in this paper, where appropriate, is carried out using the PPI's economic models<sup>21</sup>. The models have been designed to allow different types of analysis under different pensions systems:

- The Aggregate Model projects long-term Government expenditure on pensions and contracted-out rebates, income from the private pensions system and the fiscal cost of tax relief. This shows how much reforms would **cost** relative to alternatives.
- The Individual Model projects future state and private pension income for hypothetical individuals. This can show how pension reforms affect different examples of **individuals** at different points in time.
- The Distributional Model projects forward the **distribution** of pensioner incomes consistently with the Aggregate Model. This highlights how **progressive** reforms are for the pensioner population as a whole, relative to the alternatives.

Most of the quantitative analysis in this paper will focus on:

- The **number of pensioner benefit units eligible for Pension Credit**, estimated using the Distributional Model. Such estimates are very uncertain and so should be treated as approximate (Box 2).
- The **costs** of reform options, estimated using the Aggregate Model. Costings require assumptions to be made (Box 3). The definition of spending used in this paper differs from that used by the Pensions Commission, as it concentrates of spending on pensions rather than pensioners (Box 4).
- The **distributional impact on the pensioner population as a whole**, estimated using the Distributional Model. A full distributional analysis gives a more comprehensive evaluation of the impact of reform options than considering specific individuals (Box 5).

<sup>21</sup> See Steventon (2005) and Curry (2003) for further details of the PPI's three economic models

**Box 2: Uncertainties in the number eligible for Pension Credit**

For simplicity, single ('point') estimates are given in this paper for the proportion of pensioner benefit units eligible for Pension Credit in future, rather than a range of estimates. However, the future proportion eligible is uncertain, as this box illustrates. The possible uncertainty means that the estimates are better at showing the relative differences between the options rather than the absolute level of each. As discussed further in Appendix 2, the uncertainty is caused by data limitations concerning the current distribution of pensioner income and possible future changes in the distribution.

The point estimate given in this paper for the proportion eligible for Pension Credit in the current pension system is 50% in 2005, increasing to 85% by 2050. This lies within a reasonable 'funnel of doubt' (Table 1).

- A pessimistic scenario is private pensions grow more slowly than expected, with prices rather than between prices and earnings. In this scenario, 95% of pensioner benefit units could be eligible for Pension Credit in 2050.
- An optimistic scenario assumes that all income – state and private – grows faster, with average earnings. In this scenario, around 80% of pensioner benefit units could be eligible for Pension Credit in 2050.

Other organisations have produced different estimates for the current system:

- The DWP recently estimated that between 75% and 78% of pensioner benefit units could be eligible in 2050. But this range only reflects the data uncertainties in the current distribution of pensioner incomes and not uncertainties in how the distribution changes in future. It is therefore possible for the true amount to lie outside this range. DWP assumptions appear to be closer to the PPI 'optimistic' scenario<sup>22</sup>.
- The Pensions Commission estimated that 75% would be eligible in 2050. However, their model started from an estimate of 39% in 2005, which is lower than Government estimates. Having started from a point that seems to low, it seems likely that their estimates for future years are too low<sup>23</sup>.

**Table 1<sup>24</sup>: Estimates of the proportion of pensioner benefit units entitled to Pension Credit under the current pensions system**

	Pensions		PPI estimates		
	DWP	Commission's	Optimistic	Base case	Pessimistic
<b>2005</b>	44% - 51% *	39%	50%	50%	50%
<b>2030</b>	59% - 64%	64%	70%	75%	85%
<b>2050</b>	75% - 78%	75%	80%	85%	95%

Modelling tools such as DWP's Pensim2 require additional assumptions than the PPI's models concerning how behaviour changes. This is a more sophisticated approach but does not necessarily mean more reliable figures.

<sup>22</sup> Discussions with DWP

<sup>23</sup> PPI Briefing Note 30; discussions with the Secretariat to the Pensions Commission

<sup>24</sup> DWP estimates are from House of Lords *Hansard* 25 April 2006 Column WA15 and House of Commons *Hansard* 18 April 2006 Column 432W. The estimates marked \* are for 2003/4. Pensions Commission estimates are from Pensions Commission (2005) page 11. PPI estimates are rounded to the nearest 5%.

**Box 3<sup>25</sup>: Costing methodology**

In this paper, 'cost' or 'state expenditure on pensions' means the annual cost to the public purse of paying Basic State Pension, SERPS/S2P, Pension Credit, other pension benefits such as Winter Fuel Allowances, and contracted-out rebates.

This is a different definition to that used by the Pensions Commission. Box 4 explains the differences between PPI and Pensions Commission estimates.

Increasing the generosity of the state pension could lead to savings in other forms of state expenditure on older people. The cost estimates in this paper include allowances for:

- Reductions in the cost of means-tested benefits: Pension Credit, Housing Benefit and Council Tax Benefit.
- Changes in the amount of income tax paid by older people.

The costings assume that the amount of private income people have in retirement is not affected by the reforms. The estimates also include an allowance for increases in the cost of Incapacity Benefit that result from an increase in state pension age.

It is important to allow for spending on contracted-out rebates, as changes in spending on contracted-out rebates now can have an impact on future spending on pension benefits. For example, not paying contracted-out rebates today would increase the amount of S2P that would need to be paid in future. Spending more on contracting-out could reduce the amount spent on S2P in future if more people contract-out, and reduce spending on Pension Credit if people receive higher contracted-out pensions.

Both sides of the equation – the paying of contracted-out rebates in the short term and the paying of S2P benefits in the long term - need to be taken into account. Otherwise it would in theory be possible to reduce the cost of the state pension system to zero in future by completely pre-funding all pensions, seemingly with no change in spending today.

<sup>25</sup> For a full technical description of the models, see Steventon (2005) and Appendix 2



#### Box 4: Costing the Pensions Commission's preferred option

The estimates of the costs of the Pensions Commission's preferred option included in this paper have been produced using the PPI's Aggregate and Distributional Models. They use assumptions and a methodology consistent with those used to estimate the costs for the other reform options analysed. The Pensions Commission used a different model, Pensim2, which requires different types of assumptions<sup>26</sup>.

The different assumptions and methodology mean that the estimates differ from those presented by the Commission. However, the most significant reason for the differences are the different definitions for what counts as state pension spending.

The PPI estimates are of state spending on **pensions**: they therefore include the cost of contracted-out rebates as well as BSP, SERPS/S2P and Pension Credit. PPI total cost figures exclude the cost of disability and housing benefits for older people, although allowance has been made for changes in the amounts needed for housing benefits and Pension Credit for the severely disabled for different reform options (see Box 3).

The Commission's estimates are of state spending on **pensioners**. Included therefore is the total cost of paying disability and housing benefits for older people but the cost of contracted-out rebates is excluded.

Contracted-out rebates are assumed not to be spent on current pensions under the Pensions Commission's preferred approach: *Additional government cash flow generated from these changes [to contracting-out] should be used to increase government's contribution to national saving<sup>27</sup>*. They are therefore not used to reduce the cost of transition<sup>28</sup>.

Taking into account the different definitions of 'state spending', the Commission's and the PPI's estimates are similar. For example, in 2050:

- The Commission estimated the cost of spending on **pensioners** under their proposals as 7.8% of GDP.
- Subtracting the Commission's estimate of the cost of housing and disability benefits in their option (0.9% of GDP) and adding back on the cost of contracted-out rebates in the current system (0.4% of GDP), gives a cost of spending on **pensions** of 7.3% of GDP.
- This is similar to the PPI's estimate of 7.2% of GDP.

<sup>26</sup> Pensions Commission (2005) Appendix F

<sup>27</sup> Pensions Commission (2005) page 27. See Box 10 for a more detailed discussion of why the Pensions Commission came to this conclusion.

<sup>28</sup> The analysis of the Pensions Commission's preferred option in this paper assumes no increase in overall saving as a result of using the contracted-out rebates in this way. This is so that the impact of the state pension is made clear. There is no evidence to suggest what the additional impact on saving would be. It could be argued that other options would also have an impact on savings levels through better incentive effects, and it is not clear if the rebates would be in addition to, rather than replacing, private saving. This assumption has little impact on future costs (through for example Pension Credit and income tax receipts) or distributional analysis. Details of sensitivity analysis are available on request.

**Box 5: Distributional versus individual modelling**

Analysis of individual examples can give useful insights into some of the likely impacts of state pension reform. However, to give a full indication of the impact across the whole spectrum of individuals who make up the pensioner population at any one point in time requires a very large number of illustrative cases. Analysis becomes unwieldy and difficult to understand.

Analysis which uses individual examples tends to focus on a few stereotype individual characteristics, the importance of which can become exaggerated by disproportionate prominence. For example, the man who worked and earned median earnings every year to age 65 almost certainly does not exist, but is probably the most frequently analysed model point.

But to capture fully the impact of different proposals on the oldest pensioners, on couples and widows, or people with very little work or caring history as well as different earning and saving experiences would require hundreds of individuals to be modelled for each option at each point in time.

Instead, by looking at the distribution of incomes under alternative policies, it is possible to pick up how the impacts of reform on different types of individuals, from different cohorts and at different points in time during their retirement interact with each other to shape the income distribution as a whole. This gives a more realistic and relevant indication of how progressive alternative reforms may be, and, for example, illustrates the potential for reducing pensioner poverty.

Like any modelling, the distributional modelling used in this paper cannot reflect everything that will impact on the pensioner income distribution over time. But it does allow comparison of the impact on the shape of the income distribution between different reform options, and in particular shows which reform options are most likely to result in more progressive (i.e. flatter) income distributions.

## Chapter 2: Earnings or price uprating?

This chapter addresses the first policy trade-off made by the Pensions Commission: Should pensions in payment be increased in line with the growth in average earnings, or as today increased in line with the growth in prices?

The Pensions Commission recommended partially maintaining the value of state pensions in payment, by fully uprating the BSP in line with earnings but retaining the current uprating rules for S2P<sup>29</sup>.

There are a wide variety of different possible uprating policies. Not only could BSP and S2P be updated in different ways, but each could be updated in different ways for different ages.

Given the current levels of BSP and S2P, fully uprating the BSP in line with earnings is necessary to maintain pensioner income in retirement and to prevent people slipping back onto Pension Credit at older ages. Uprating S2P in payment in line with earnings is less critical to control the number of people eligible for Pension Credit. However, uprating S2P in payment in line with earnings increases costs significantly.

### **Fully uprating the BSP in line with earnings is necessary to maintain pensioner income in retirement..**

Uprating all state pension income (BSP and S2P, as in Option 1) in line with earnings would prevent incomes from state pensions from falling relative to the incomes of those in work, and the Government-defined minimum income level of Guarantee Credit<sup>30</sup> (Chart 3).

Without fully uprating all state pension income in line with earnings, income can decline quickly. For example, under the Pensions Commission's preferred option, an individual who receives a state pension of £143 a week at state pension age (68) in 2053<sup>31</sup>, would see that decline to £134 a week by age 75, £124 a week by age 85 and £116 a week by age 95<sup>32</sup>. This is because the Pensions Commission proposed retaining the current system of uprating S2P in payment in line with prices.

<sup>29</sup> The amount of S2P earned ('accrued') each year during working life is currently revalued in line with earnings up to state pension age. The amount of S2P received is then uprated in line with prices in payment.

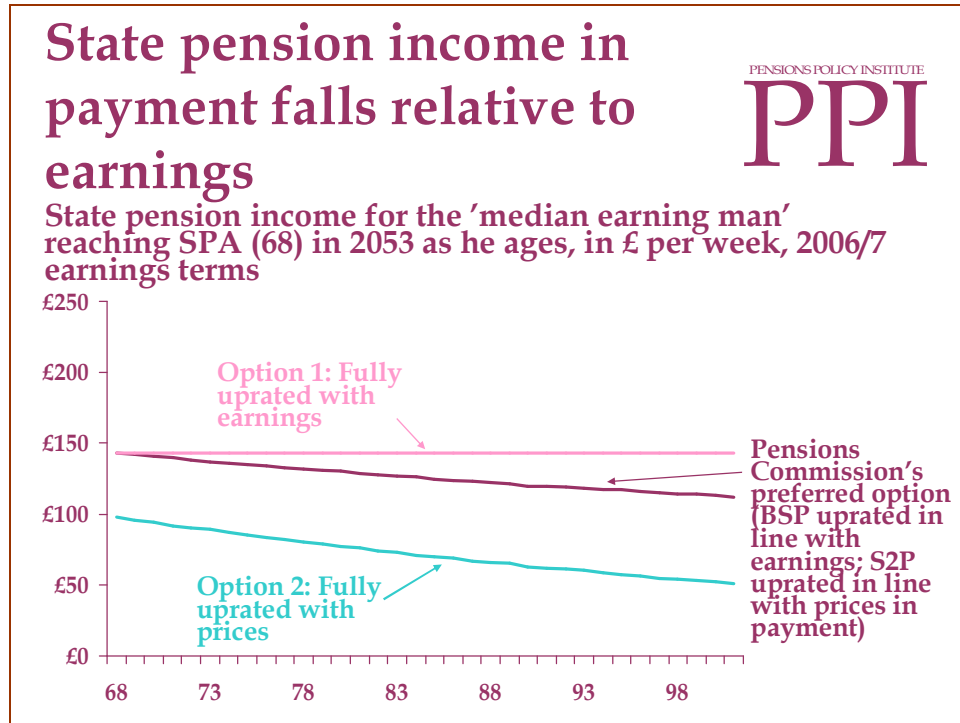
<sup>30</sup> Although there is no long-term commitment to increase Guarantee Credit in line with earnings, it would seem to be the most sensible assumption. If Guarantee Credit were increased by less than earnings each year, the income of the poorest pensioners would fall relative to the rest of the population and there would be an increase in the number of pensioners with incomes below 60% of median income – the definition of 'poverty' used most often by Government.

<sup>31</sup> Based on the state pension income estimated for the median earner, example, page 19, Pensions Commission (2005)

<sup>32</sup> PPI analysis, assuming real earnings growth of 2% p.a. The amounts shown have been adjusted so that they are relative to the level of average earnings today.

If the BSP were uprated in line with prices (Option 2), state pension income at state pension age would be much lower at £98 a week (as the BSP is uprated in line with prices both before and after retirement), and would fall more rapidly during retirement.

Chart 3<sup>33</sup>



As pensioners get older, they come to rely more on state pension income. This is because income from private pensions tends at best to increase in line with prices<sup>34</sup>, and in many cases does not increase at all after coming into payment. Private pension income therefore declines relative to earnings.

Older pensioners are also less likely to have significant levels of income from other sources. They are less likely to work, and have less income from other financial investments<sup>35</sup>.

Fully uprating the BSP in line with earnings is therefore the minimum necessary to maintain pensioner income in retirement.

### **...and to prevent people slipping back onto Pension Credit at older ages**

Decline in private sources of income and state pension income make it more likely that pensioners need to rely on Pension Credit at older ages. If all state pension income is uprated in line with earnings, it provides a more solid foundation that can prevent income falling so low that entitlement to Pension Credit is triggered.

<sup>33</sup> PPI analysis based on the 'median earner' Pensions Commission (2005) page 19

<sup>34</sup> Cannon and Tonks (2006), GAD (2005 OPS)

<sup>35</sup> DWP (2006 PI)

As a result of increasing state pensions by less than earnings, older pensioners are more likely to move into the eligibility zone for Pension Credit. Pensioners becoming eligible to Pension Credit some years after SPA may not be aware that they are eligible for benefit, and may be less able to go through the claims process<sup>36</sup>.

### **Uprating S2P in payment in line with earnings is less critical to control the numbers of people eligible for Pension Credit**

Uprating BSP in line with earnings is important to reduce the growth in the proportion of pensioner benefit units eligible for Pension Credit. Also uprating S2P in line with earnings, on top of a BSP that is also uprated in line with earnings, is less critical.

Earnings uprating of BSP plays an important role in reducing the growth in the proportion eligible for Pension Credit (Chart 4). Under the Pensions Commission's preferred option, the proportion eligible for Pension Credit would fall slightly, from 50% in 2010 to 45% by 2050. Uprating the BSP in line with prices rather than earnings would increase the proportion eligible for Pension Credit in 2050 to around two-thirds<sup>37</sup>.

In a two-tier pension system that includes S2P, uprating S2P in payment in line with earnings is less critical to control the proportion eligible for Pension Credit, compared to the Pensions Commission's preferred option. It would reduce the proportion eligible for Pension Credit in 2050 by less than 5%. This assumes S2P comes on top of an earnings-uprated BSP of the magnitude suggested by the Pensions Commission (£75 a week, in 2005/6 earnings terms).

Changing the uprating of S2P in payment has less effect on Pension Credit than changing the uprating of BSP because:

- Accruals to S2P would continue to be uprated in line with earnings during working age, regardless of how S2P is uprated in payment. This prevents successive cohorts of people with the same career history reaching SPA with successively smaller amounts of S2P. S2P would therefore still be partly earnings-uprated, even if it were price-uprated in payment.
- S2P is partly earnings-related, so that higher earners are entitled to larger amounts. This earnings-related element would persist to 2050 and beyond, even under the Pensions Commission's preferred approach of speeding up the mechanism currently in place to make S2P flat-rate. So uprating S2P in line with earnings is more advantageous for higher earners, rather than the lower earners who are more likely to be eligible for Pension Credit.
- Coverage of S2P is currently less universal than for the BSP<sup>38</sup>, and would remain so under the Pensions Commission's preferred approach of improving coverage for each. So individuals who do not qualify consistently for S2P receive lower pensions.

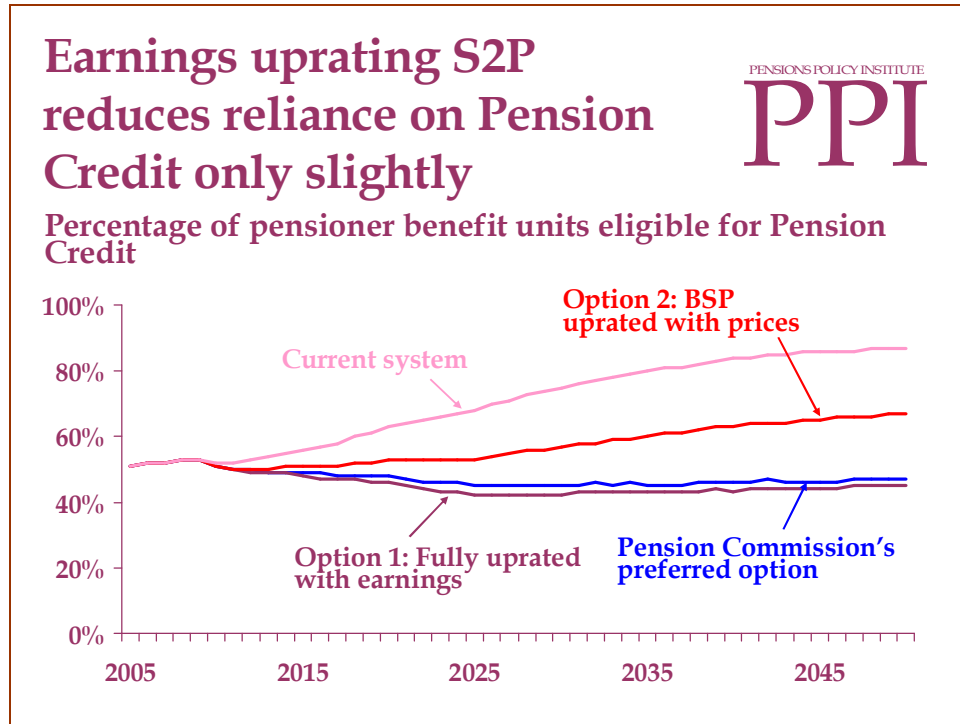
<sup>36</sup> PPI (2004 WPSC) paragraphs 32 to 35

<sup>37</sup> Assuming that the scope of Savings Credit is reduced in the way the Pensions Commission proposed

<sup>38</sup> See PPI (2005 SEM3) Chart 1, page 9

There is a trade-off between the relative sizes of BSP and S2P, given the same expenditure constraints. Depending on the relative sizes of the two tiers, uprating S2P in payment in line with earnings could be more or less important. It would be more important if S2P came on top of a smaller BSP, because then S2P would play a larger role in taking people above Pension Credit.

Chart 4<sup>39</sup>



**Uprating S2P in payment in line with earnings increases costs significantly**

In the Pensions Commission’s preferred option, uprating BSP in line with earnings helps to ensure that in future the combination of BSP and S2P continues to give a relatively high state pension at state pension age to those who qualify for S2P for most of their working life<sup>40</sup>. This is made affordable by continuing to uprate S2P in payment in line with prices, so that the value of the state pension (compared to the income of people in work) reduces throughout retirement. Uprating S2P in line with earnings (Option 2) would be much more expensive (Table 2).

<sup>39</sup> PPI analysis based on the Aggregate Model and the Distributional Model. See Appendix 2 for further details.

<sup>40</sup> The Pensions Commission estimate that someone reaching SPA in 2053 with a full BSP and 44 years qualifying for S2P would receive £137 per week, Pensions Commission (2005) page 19

**Table 2<sup>41</sup>: Projected state expenditure on pensions, as a percentage of GDP and in £ billion, 2006/7 prices**

	Current pensions system	Pensions Commission's preferred option	Option 1: BSP uprated with prices	Option 2: Fully uprated with earnings
2010	5.6%	5.8%	5.8%	5.8%
2020	5.2%	5.8%	5.3%	6.0%
2030	6.0%	6.7%	5.7%	7.3%
2040	6.5%	7.4%	5.8%	8.1%
2050	6.6%	7.2%	5.5%	7.9%
2010	82	85	85	85
2020	95	110	100	115
2030	135	155	130	165
2040	175	200	160	220
2050	215	245	185	265

Neither of these options looks attractive:

- A price-uprated Basic State Pension (Option 1) is ineffective. It would reduce spending if it is combined with an increase in state pension age. Eligibility to Pension Credit would continue to grow rapidly.
- Earnings-uprated State Second Pension on top of an earnings-uprated Basic State Pension (Option 2) is inefficient. It is very expensive, and has little additional impact on entitlement to Pension Credit as the extra spending tends to go to those with the highest pensions.

So, if keeping a two-tier system, fully uprating BSP in line with earnings appears the best compromise to achieve adequate incomes at a reasonable cost.

As Chapter 5 will show, if we moved rapidly to a single-tier pension system, then all of state pension income could be uprated in line with earnings, while remaining affordable and reducing entitlement to Pension Credit significantly.

<sup>41</sup> PPI estimates based on the Aggregate Model and the Distributional Model. See Box 3 for a description of what is included in the total of state expenditure on pensions. Uprating the Basic State Pension in line with prices is less expensive than the current system because of the increases in state pension age included in the option and the reduction in the scope of Savings Credit proposed by the Pensions Commission. £ bn figures are rounded to the nearest £1 bn for 2010 and to the nearest £5 bn for subsequent years.

## Chapter 3: Residency or contributory?

This chapter addresses the second policy trade-off made by the Pensions Commission: Should the final system have entitlement based on residency or on the existing National Insurance (NI) contributory pension criteria?

The Pensions Commission recommended making future qualification to BSP based on residency, but retaining eligibility based on how many NI contributions have been paid or credited for S2P.

There are two frequently quoted objectives in reforming the eligibility criteria for state pensions<sup>42</sup>:

- Improve coverage, so that more people qualify.
- Strengthen individual entitlement, so that individuals qualify in their own right rather than based on their spouses' records.

There is public support for better coverage of state pensions, so that they would be given to most if not all people over state pension age. Universality could be achieved by a residency criterion or by improving the existing contributory criteria. A residency criterion seems easier to understand from an individual's point of view, but changing the existing contributory system may be easier for Government to implement. Improving coverage is only part of the solution and is not by itself enough to prevent older people receiving less state pension income in future; and makes little difference to the number of people on Pension Credit.

Individual entitlement could be achieved using either residency or improved contributory criteria. It is assumed in all the options in this paper that first-tier state pensions would be paid to individuals in their own right under the new system.

### **There is public support for better coverage of state pensions**

A residency criterion would give entitlement to anybody resident in the UK. In contrast, 'improved contributory' criteria could aim to include everybody, but would make explicit what kind of activities, working or caring, qualify for entitlement.

Public perceptions of the relative fairness of residency and contributory criteria are not clear, but support better coverage of state pensions, so that they would be given to most if not all people over state pension age (Box 6)<sup>43</sup>.

<sup>42</sup> PPI (2006 SSPS)

<sup>43</sup> PPI (2006 SSPS) analyses this question in a broader context, concluding that *A residency-based system provides better, and gender-neutral, coverage compared to the current contributory system and is seen by many to be fair and simple to understand. However, there are concerns that it is too radical, so reforming the current contributory system may seem like the less risky option.*



**Box 6: Public perceptions of residency vs. contributory pensions**

Perceptions of what the two methods 'mean' – as opposed to what they would actually achieve in practice - will inevitably cloud judgements as to which is the better option. There is relatively little analysis of the two options available. This means that the debate is often in terms of opinion, perhaps based on ideology, rather than facts.

However, a recent public attitudes survey found strong support for the principles of a residency-based pension<sup>44</sup>:

- Over half the respondents supported the view that everyone should receive a flat rate of state pension (rather than the state pension being earnings-related).
- 80% of respondents agreed with the statement that *women should get the same state pension as men, even if they stayed at home instead of going out to work.*

Public attitudes to the contributory principle are also thought to be generally positive overall, but research on this reflects that<sup>45</sup>:

- The public tend not to know or understand how the contributory system works.
- The public like National Insurance contributions (NICs) because they believe that NICs also fund the NHS.
- A perceived willingness to contribute more in NICs than in taxation has rarely been tested, as they are compulsory.

The recent events held on National Pensions Day<sup>46</sup> also asked about attitudes to the principles of residency-based and contributory pensions:

- Half of participants agreed that years living in the UK should count towards the Basic State Pension, regardless of what the individual was doing (i.e. working or not).
- Only 35% of disagreed with this.

<sup>44</sup> MORI research for the NAPF quoted PPI (2006 SSPS) page 22

<sup>45</sup> House of Commons Select Committee on Social Security (1999) paragraph 52

<sup>46</sup> DWP (2006 NPD)

### **Universality could be achieved by a residency criterion or by improving the existing contributory criteria**

The current contributory system has imperfect coverage because the current system of credits does not include everyone (Box 7). Two possible ways to improve coverage, while retaining the contributory system, are:

- A. Improving the credit system used to include people who do not earn enough to qualify automatically.
- B. Reducing the number of years of contributions needed for a full pension from 44<sup>47</sup> to, say, 30.

Box 7 shows that over half of those currently not qualifying are not in paid work or caring. So Method A would require more than altering the criteria so that fewer people are left out for technical reasons. For example, only switching the existing Home Responsibilities Protection (HRP) system to a positive credit and working on weekly basis rather than the annual credit system would not extend coverage to all, or nearly all, individuals.

Method B, reducing the number of qualifying years needed to receive a full pension to 30, could have a greater impact on increasing the coverage of a contributory BSP. BSP would not be affected as much by spending time, for example, in combinations of paid working and unpaid caring, so long as enough other years qualified.

A combination of Method A and Method B (Option 3) could give similar coverage to the Pensions Commission's preferred approach to the BSP, with future accruals based on residency. Different people would not qualify in the two systems, which may affect which system is more desirable.

Further detailed analysis needs to be undertaken to compare the outcomes of an improved contributory system and accruals through residency, for example based on the anonymised National Insurance (NI) records used by the Department for Work and Pensions (DWP) to follow trends in past entitlements to Basic State Pension and State Second Pension<sup>48</sup>. This analysis would have to be undertaken by DWP, unless the anonymised NI records are made accessible to external researchers.

<sup>47</sup> Individuals can contribute to Basic State Pension from age 16 to state pension age. For men (state pension age 65) this gives a maximum number of 49 years of qualifying. The current system allows individuals to have 5 years of not qualifying without reducing pension entitlement, so 44 years are needed for a man to qualify for a full Basic State Pension. For women, as state pension age is 60 only 39 years of qualifying is need for a full Basic State Pension, but this will increase to 44 as state pension age for women increases to 65 between 2010 and 2020.

<sup>48</sup> DWP (2006 CQY) and DWP (2006 STPP)

**Box 7: Coverage in the current contributory system**

Entitlement to state pension is currently through earning above the Lower Earnings Limit<sup>49</sup> and therefore paying National Insurance (NI) Contributions; or receiving a credit.

The credit system that is currently used to include those who do not automatically qualify through earning is based heavily on information already collected by Government:

- Home Responsibilities Protection (HRP) reduces the number of years that a person with caring responsibilities has to contribute to receive a full pension. HRP is awarded to people caring for a child for whom they receive child benefit, people caring and receiving Income Support, and people caring for more than 35 hours a week for someone who receives a disability benefit.
- Men aged between 60 and 64 automatically receive credits.
- People receiving Job Seekers Allowance, Working Tax Credit, Disabled Persons Tax Credit, Statutory Sick Pay, Statutory Maternity Pay, Carers Allowance or on Government Training Schemes also receive credits.

Despite the credit system, there are 4.5 million people not building up rights to the BSP each year.

Of the 4.5 million, half of these are in paid work, or are unpaid carers, or a combination of both, but not in the right 'way' to qualify for a credit<sup>50</sup>. These include:

- People with more than one job who earn less than the Lower Earnings Limit (LEL) in each job but more than the LEL in total.
- People who care for less than 35 hours each per week for a number of different people, but more than 35 hours in total.
- A person who looks after a school age child, but who is not paid or the named recipient of Child Benefit.
- People with combinations of low-paid work and caring that is not enough to qualify though earnings or caring alone.
- Not qualifying to receive HRP for a full year. HRP is only counted for full tax years. So someone whose first child is, for example, born in May, does not qualify for HRP for the first 11 months of the child's life.

<sup>49</sup> £4,368 from April 2006

<sup>50</sup> PPI (2005 SEM3)

**A residency criterion seems easier to understand from an individual's point of view...**

A qualification system based on NI contributions and credits does not have the same transparency as a residency system. It is difficult for individuals to know what they will be entitled to when they reach SPA. Improving the system of credits would not necessarily make the contributory criteria any simpler or more transparent.

A residency criterion seems easier for individuals to understand how the system works and what their pension would be. If a residency criterion were adopted, pension income would be defined only by the number of years resident in the UK. With contributory criteria, pension income is defined by more factors, such as whether the individual has earned or cared enough in each year.

In theory, if the system of credits were extensive enough and/or the number of qualifying years needed for a full pension were low enough so that a significant majority of individuals would be entitled to a full pension, the outcomes from the contributory system could be as certain as the outcomes from a residency system. But this would require a more universal set of criteria than the Pensions Commission's proposals.

**...but changing the existing contributory system may be easier for Government to implement**

One category of state pension already uses a residency criterion, so there is a precedent for administering residency-based state pensions in the UK<sup>51</sup>. However, switching the entire state pension system to be residency-based would involve some complexity for Government.

Improving the existing contributory criteria would also have administrative difficulties. The existing contributory criteria are complicated and, depending on how the system was made more universal, could become even more complicated. But still, changing the existing contributory system may be easier for Government to implement a switch to a fully residency-based alternative.

The rest of this section considers the administrative complexities of a residency criterion and contributory criteria separately.

*Administrative complexities of a residency-based system*

There are a number of particular administrative issues that would need to be addressed if a residency-based system were introduced, including:

1. What would be the precise definition of residency?
2. How would residency be proved and recorded?
3. How many years would be needed to give entitlement to a full pension?

<sup>51</sup> The Category D Basic State Pension is available to people over the age of 80 who pass a residency criterion

The Pensions Commission did not answer all of these questions, but its preferred approach was to make future qualification to BSP based on residency. If a move to a residency-based pension aims to help current pensioners, qualification by residency would have to be made retrospective.

If the qualification were made retrospective, the number of years that would be needed to give entitlement to a full pension would have to reflect how residency could be proven:

- There is no single source of who has been resident in the UK in the past on which to base eligibility. Many individuals might find it difficult to 'prove' which years they resided in the UK, even if the majority of people have resided in the UK all their lives.
- The administrative burden could be reduced by using a short qualification period. It would be easier to find evidence that covered, say, 10 years rather than 44.
- A shorter qualification period would have implication for reciprocal agreements with other countries. Overseas nationals who had spent short periods of time resident in the UK could be entitled to larger UK pensions than under the current system.
- An alternative would be to introduce a longer qualification period, say 44 years, only for younger working age people, for whom a method of recording residency could be put in place for the future. Older working age people and people over state pension age could have a shorter period, say 10 years, which could make retrospective qualification possible.

Without decisions on the three central questions, it is difficult to gauge exactly how complex the administrative arrangements for a residency-based system would be, and how easy it would be to overcome perceived problems. But it should be possible to design a workable system – and the Pensions Commission suggested two such systems<sup>52</sup>.

#### *Administrative complexities of a contributory system*

Although in theory more individuals could be bought into the credit system (as in Method A considered above), in practice this could be difficult to achieve. It would involve the collection, or volunteering, of new information that is currently not used for any other purpose.

One particular problem of this method, of improving the credit system, is that changes would be administratively difficult to make retrospectively. Retrospective changes would be needed if coverage is to be improved for current older people. For example, women currently aged around 45 or over are less likely to have benefited from HRP, which was introduced in 1978.

<sup>52</sup> Pensions Commission (2005) page 209

It may be possible to extend some of the existing credit and HRP system back past when it was introduced, so for example, women who had children before HRP was introduced could receive HRP (or a credit if HRP is changed). But if behaviour that qualifies for credits or HRP (such as caring for one person for 35 hours or more) is not recorded, or if the criteria for awarding credits is changed (for example only requiring 20 hours of caring rather than 35), it may not be possible. This has led the Secretary of State for Work and Pensions to suggest we should be developing a new contributory principle that gives women a fairer entitlement to BSP more quickly<sup>53</sup>.

Method B, of reducing the number of qualifying years needed to qualify for a full pension, would be easier to do retrospectively. However, it would add some of the complexity seen in moving to a residency-based system based on a short qualification period. Overseas nationals who work in the UK for short periods of time would have higher state pension entitlements under EU legislation and the reciprocal agreements that the UK has with other countries.

#### **Improving coverage is only part of the solution**

Regardless of how coverage of state pensions is improved, improving coverage is only part of the solution. It is not enough in itself to prevent pensioners becoming poorer and makes little difference to the number of people on Pension Credit.

Improving the coverage of the state pension system would not in itself lead to a radical change in the amount received from the state pension system, especially in the longer term (after 2030). For example, although making the existing BSP universal, so that everybody over SPA age receives it, in stages between 2010 and 2020 (Option 4) has an initial extra cost, by 2030 the extra annual cost above the current system is less than 0.2% of GDP (£5 bn) (Table 3).

This is because the price uprated Basic State Pension is worth less (relative to earnings and the growth of the economy) in future, and because the average entitlement to the Basic State Pension is projected to increase in the current system.

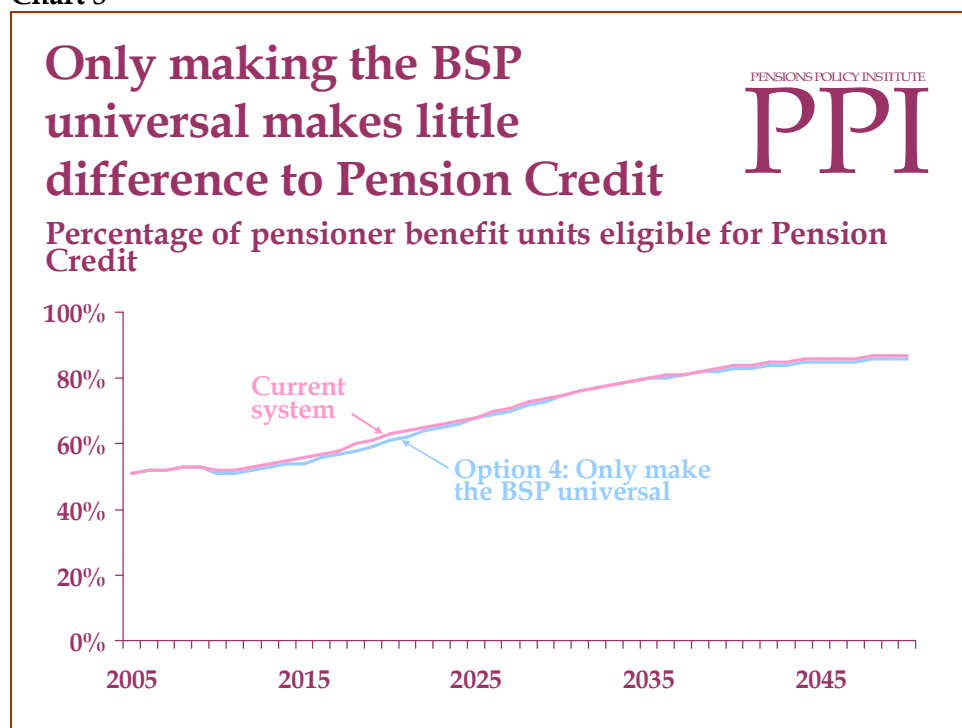
Making the current BSP universal also has little impact on the total number of people eligible for Pension Credit (Chart 5).

<sup>53</sup> John Hutton MP, speech *The State and the Individual – building a lasting pensions settlement*, ippr, 14th March 2006

**Table 3<sup>54</sup>: Projected state expenditure on pensions, as a percentage of GDP and in £ billion, 2006/7 prices**

	Current pensions system	Option 4: Only make the BSP universal
2010	5.6%	5.8%
2020	5.2%	5.6%
2030	6.0%	6.2%
2040	6.5%	6.6%
2050	6.6%	6.6%
2010	82	85
2020	95	105
2030	135	140
2040	175	175
2050	215	215

**Chart 5<sup>55</sup>**



<sup>54</sup> PPI estimates based on the Aggregate Model and the Distributional Model. See Box 3 for a description of what is included in the total of state expenditure on pensions. £ billion figures are rounded to the nearest £1 billion for 2010 and to the nearest £5 billion for subsequent years.

<sup>55</sup> PPI analysis based on the Aggregate Model and the Distributional Model. See Appendix 2 for further details.

## Chapter 4: One or two tiers?

This chapter addresses the third policy trade-off made by the Pensions Commission: Should the reformed system be based on a single pension, or the existing structure of the two-tier pension system?

The Pensions Commission recommended a two-tier system retaining both BSP and S2P.

A single-tier system rather than a two-tier system would be simpler and more transparent, and therefore more sustainable. It could reduce the number of people eligible for Pension Credit by giving more to lower income pensioners and less to higher income pensioners.

The modelling of a single-tier flat-rate state pension in this paper assumes a universal pension, which could be achieved using either a residency criterion or improving the contributory criteria, as shown in Chapter 3. The modelling also assumes the single-rate tier is uprated in line with earnings. This is necessary to maintain pensioner income throughout retirement and prevent people slipping back onto Pension Credit at older ages, as shown in Chapter 2.

### **A single-tier system is simpler and more transparent than a two-tier system**

A single-tier state pension system has the advantage of being easy to understand, particularly if the single-tier is flat-rate. There are fewer pension system parameters available for the Government to change and the impacts of any change that is made would be easier to understand (Box 8).

With a two-tier system there is greater flexibility for future Governments to change part of the state pension system. If there are more parameters available to change (for example, the levels, state pension ages and increases once in payment of different pensions) it is easier for state pension policy to be 'micro-managed' through seemingly small changes. This may be an advantage in terms of short-term policy management. But uncertainty is increased, as it makes it less clear what the system will provide for an individual when he or she reaches state pension age.

Being flexible but complex and uncertain suggests that a two-tier state pension system may be less sustainable than a single-tier system in the long term. Potentially, the different tiers of the state pension system could be 'traded-off' against each other – for example, a reduction in BSP could be offset by an increase in the build-up of S2P<sup>56</sup>. In a single-tier system any change to key parameters would be much more transparent, and should be more likely to be properly debated.

<sup>56</sup> This has an historical precedent: the introduction of SERPS in 1975 is said to have allowed the link between the level of BSP and average earnings to be removed in 1981, PPI (2005 SEM4)



**Box 8: A single-tier pension is easier to understand**

The continuance of S2P under the Pensions Commission's proposals clearly adds to the number of parameters needed to define state pension income, compared to a single-tier system.

Many fewer parameters are needed with a single-tier, flat-rate state system, particularly if it uses a residency criterion. In that case, all that is needed is:

- The level of the pension.
- The number of years residency.
- The age at which the pension becomes payable.
- (Possibly) whether living with a partner or alone in retirement.

In comparison, the current state pension system is complex, with over 100 parameters that determine how much state pension is received, if Pension Credit is included<sup>57</sup>.

The Pensions Commission's preferred option retains much of the complexity of the current system, and makes it even more complicated (see Charts 1 and 2 in Chapter 1). Although some of the complexities are removed in the Pensions Commission's option, such as individual contracting-out and the credit system for BSP, others are added, such as:

- The residency-based qualification criterion for a residency-based BSP.
- Different increases for BSP and S2P when they come into payment
- Potentially different pension ages for BSP and S2P.
- A new threshold for Savings Credit.
- Different Upper Earnings Limits for NI contributions and qualification for S2P (and for NPSS contributions).
- (Possibly) an extended Category D (universal) BSP at age 75.

Although the Pensions Commission's proposed residency-based BSP would mean that individuals have a much clearer idea of how much BSP they would receive, the amount received from S2P is still uncertain. This is in part due to S2P being less universal than BSP, but also because:

- The amount of S2P built-up is still related to the amount of earnings for the next 20 years. Build-up of S2P in each year does not become fully flat-rate until 2030.
- The amount of S2P that is received after state pension age will be different depending on which year an individual reaches SPA. This is because the amount of S2P built-up in each year is linked to average earnings, but once it comes into payment S2P is only increased in line with prices. So the flat-rate pension received from S2P will be a different cash amount for different generations.

<sup>57</sup> PPI (2006 SPSS) page 18

**A single-tier system could reduce the number of people eligible for Pension Credit by giving more to lower income pensioners and less to higher income pensioners**

A single-tier system can better target state pension than a two-tier alternative, and therefore reduce the number of people eligible for Pension Credit.

A two-tier system would remain earnings-related for decades, if it builds on the existing S2P. By paying more to higher earners, earnings-related systems pay less than they could to lower earners, for the same overall cost<sup>58</sup>. They therefore result in more Pension Credit than a flat-rate single-tier pension.

Even in the Pensions Commission's preferred option, where the benefits paid out from S2P become less earnings-related over time, benefits would still be earnings-related, even beyond 2050<sup>59</sup>.

In addition, the particular transition approach recommended by the Pensions Commission would target extra spending on more well-off pensioners before pension income for less well-off pensioners is improved. More well-off pensioners are more likely to have a full BSP, and so benefit more from uprating the BSP with earnings. They are also not caught in Pension Credit and are less affected by the proposed reduction in the scope of Savings Credit. The improvements for less well-off pensioners, such as improving the qualification criteria for BSP and S2P, take longer to come into force. This effect, of paying benefits to more well-off pensioners first, is transitional, but would remain for decades rather than years.

The result is that, even in 2050 which is considered to be 'long term', in the Pensions Commission's preferred option:

- The most well-off 10% of pensioners could have around £35 a week more in state pensions and private income combined than they would do under the current pensions system: £325 a week rather than £290 a week (Table 4). In contrast, the least well-off 10% of pensioners could have only around £5 a week more.
- Because state spending remains unequal in the Pensions Commission's preferred option, the proportion of pensioner benefit units eligible for Pension Credit would be around 45%, which is only a slight reduction from today's 50% (Chart 6).

A single-tier system could better direct state pension expenditure than the Pensions Commission's preferred option towards those with low earnings and incomplete work histories. The long transition (Option 5) better targets the extra spending because it abolishes S2P accruals immediately.

<sup>58</sup> For example, Chart 15 in PPI (2006 SPSS) shows that the following two pensions systems cost broadly the same: i) a single-tier flat-rate pension set at £110 a week and ii) a flat-rate basic pension set at £90 a week, plus an earnings-related pension on top. Individuals with lifetime earnings of less than £10,000 a year would be better off under the first system.

<sup>59</sup> See Table 5 in Chapter 5

In this long transition to a single-tier (Option 5):

- The least well-off 10% of pensioners would gain by more in 2050 than under the Commission's option. They would have around £15 a week more than under the current system rather than the £5 a week more they would have under the Commission's preferred option (Table 4).
- The proportion of pensioner benefit units eligible for Pension Credit would be reduced to around 20%, which is much lower than the 45% under the Pensions Commission's preferred option (Chart 6).

As the next chapter shows, shorter transitions than Option 5 can be even more progressive.

**Table 4<sup>60</sup>: Illustrative weekly after tax income of people over SPA in 2050 by decile of the income distribution, £ per week in 2006/7 earnings terms**

	Current system	Pensions Commission's preferred approach	Option 5: Long transition to a single tier (same rate for couples)
<b>1<sup>st</sup></b>	100	105	115
<b>3<sup>rd</sup></b>	135	130	140
<b>Median</b>	160	170	170
<b>7<sup>th</sup></b>	200	210	205
<b>9<sup>th</sup></b>	290	325	300

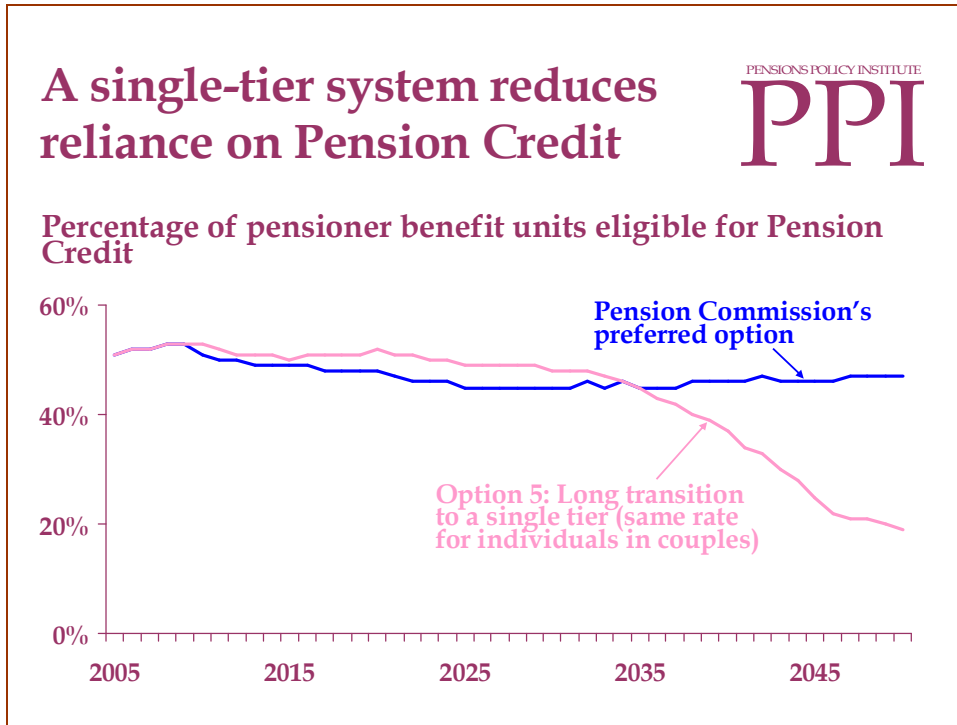
With a single-tier pension system, there is also much less need for Savings Credit (SC). If there were a better state pension that takes, say, 95% of people over the Guarantee Credit level, then the remaining 5% are not likely to be savers. Therefore, the problem of cliff-edge 100% withdrawal rates on any saving would be less acute. The role for Savings Credit would become unnecessary. Scrapping it (with suitable transition protection) would be a big simplification<sup>61</sup>.

The next chapter shows that the short transition to a single-tier pension could be even more effective at targeting spending on the least well-off and reducing the number of people eligible for Pension Credit. It could also be affordable within the cost range suggested by the Pensions Commission.

<sup>60</sup> PPI estimates using the Aggregate and Distributional Models. All figures have been rounded to the nearest £5.

<sup>61</sup> The Pensions Commission was concerned that abolishing Savings Credit would lead to cash losers. However, existing payments could be protected. This protection is assumed in this paper where appropriate, see Chapter 5 and Appendix 2.

Chart 6<sup>62</sup>



<sup>62</sup> Here, the single-tier option means more Pension Credit than the Pensions Commission's preferred option until around 2035. This is a consequence of the way the transition to a single-tier pension works in this example (with the single-tier pension introduced for new accruals and current awards of BSP remaining linked to prices). Once the single-tier pension is fully in place, there would be less Pension Credit than in the Pensions Commission's preferred option. Other, shorter transition mechanisms are explored in Chapter 5. PPI analysis based on the Aggregate Model and the Distributional Model. See Appendix 2 for further details.

## Chapter 5: Slow or fast transition?

This chapter addresses the fourth policy trade-off made by the Pensions Commission: Should the final system be in place in the near future, or should it be allowed to evolve gradually over a long period of time?

The Pensions Commission recommended a very slow transition, with the first individuals reaching SPA completely under the new system in 2058, though with some immediate improvements in the BSP, particularly for pensioners aged 75 and older.

A faster transition would be simpler and more transparent than a slower transition. It would limit the time available for 'political fiddling' and therefore could be more sustainable. A faster transition could be afforded within the cost range suggested by the Pensions Commission.

### **Lower rate for individuals in couples assumed**

The Pensions Commission were concerned that a fast transition to a single-tier pension could be expensive and lead to an increase in benefits for better-off, rather than worse-off, older people<sup>63</sup>.

Chapter 6 examines in detail the Commission's concerns about moving more quickly to a simpler end point. One way of making transition to a single-tier pension more affordable and no less progressive is to set the level of the new pension at a lower rate for each individual in a couple than for individuals who live alone.

The rationale behind this approach is that individuals in couples should in theory face lower living costs than individuals who live alone<sup>64</sup>. All individuals would still receive the new pension in their own right.

The rate for individuals in couples could be set at 80% of the rate for individuals living alone, in line with the current levels of Guarantee Credit. Another way to describe this option is to say that the amount individuals in couples would get is in fact the standard rate, but people living alone receive a 25% living alone supplement.

A lower rate for individuals in couples is considered in more detail in Appendix 3. Because it is more affordable and no less progressive, it has been assumed for the faster transitions analysed in this chapter (Options 6, 7 and 8).

<sup>63</sup> Pensions Commission (2005) page 212

<sup>64</sup> As implicit in the rates for state benefits, including Guarantee Credit

**A fast transition is simpler and more transparent than a slow transition**

If transition is slow, it takes a long time for the full effects of any reform to become apparent. This can lead uncertainty and difficulties in providing state pension forecasts.

Under the Commission’s preferred option, individuals retiring 25 years after the reforms were first started would still only have spent half of their life under the new system. The benefits of the reforms would build up over a long time, so that people of different ages would expect different pensions.

For example, a woman earning at female median earnings (around £18,000 a year) would receive around £124 a week in BSP and SERPS/S2P combined on reaching SPA in 2030 (Table 5). This is almost £10 lower than the ultimate value, which is not reached until the cohort reaching SPA at around 2050.

The pensions system would continue to have an earnings-related element for decades, so that people of different earnings would expect different pensions. For example, a man earning at the 9th decile of the male earnings distribution would receive around £159 a week in BSP and SERPS/S2P combined on reaching SPA in 2030, which is over £35 a week more than a man earning at the 1st decile would receive.

**Table 5<sup>65</sup>: Income from BSP and SERPS/S2P under the Pensions Commission’s preferred option for women and men earning at different deciles of the gender-specific earnings distributions, in £ per week, 2006/7 earnings terms**

	Reaching SPA (60/65) in 2010	Reaching SPA (66) in 2030	Reaching SPA (68) in 2050	Reaching SPA (68) in 2070
<b>Women</b>				
1st decile	91	112	132	132
3rd decile	98	119	133	133
Median	105	124	134	133
7th decile	117	130	135	133
9th decile	138	137	137	133
<b>Men</b>				
1st decile	119	123	134	132
3rd decile	136	132	136	133
Median	155	141	138	133
7th decile	180	151	139	133
9th decile	205	159	141	133

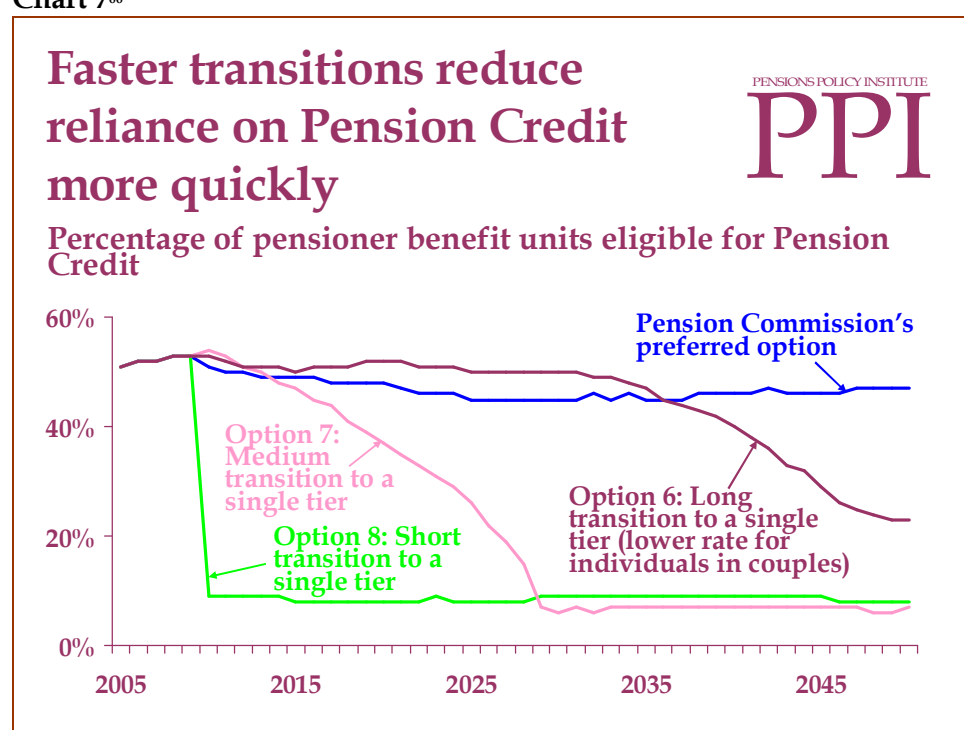
<sup>65</sup> PPI analysis using the Individual Model. Deciles divide the earnings distribution into ten groups each of which contain the same number of workers. So, for example, 30% of females earn below the 3rd decile of female earnings. The women illustrated all took time out of the labour market to care for a child in their late twenties, which is covered by credits in the current pensions system. In addition, they all take five years out of the labour market in their fifties to care for an elderly relative, which is assumed not to result in any credits in the current system, but to result in some under the Pensions Commission’s proposals. The men spend their entire working life in work, except for two years unemployment. See Appendix 2 for further details.

In effect two pension systems continue to run along side each other for decades. The state pension system would become more complex.

This long transition period, and the interaction between the two systems running alongside each other would make it difficult to provide meaningful state pension forecasts. Complexity and the risk of change would mean that individuals could not be certain about what pension the state would provide.

Importantly, a faster transition to a single-tier system can have an immediate impact on the number of people eligible for Pension Credit (Chart 7). This would send a very important signal to future pensioners that in future means-testing will be limited.

Chart 7<sup>66</sup>



<sup>66</sup> PPI analysis based on the Aggregate Model and the Distributional Model. In the short transition (Option 8), Savings Credit that is in payment when the reforms are introduced in 2010 would be protected. The amount in payment in 2010 would be paid for life, increasing with prices. The number receiving this protection is not shown in the chart because it would no longer be a means-tested amount and so would not be subject to the problems set out in Chapter 1. Around 25% of pensioner benefit units would receive the protection in 2010, reducing to around 5% by 2030. See Appendix 2 for further modelling details.

**A faster transition could be more sustainable**

A faster transition would limit the time available for ‘political fiddling’ and so could be more sustainable. In the same way that the complexity of having two tiers in the state pension system can make it easier to make changes (see Chapter 4), so can the complexity of having two systems running in parallel – one winding down and one building-up.

**A faster transition provides more help to today’s pensioners**

The slowest transitions concentrate on building-up rights in a new pension and so do not directly help those already over state pension age. For example, introducing a new single-tier pension to build up over a 40 year period (Option 6) would not help any individual already over state pension age (SPA). Those close to SPA would also not benefit by very much, as they have little time to build-up the new larger pension rights.

Introducing a single-tier, flat-rate pension that is fully uprated with earnings over a faster period, say 20 years (Option 7), can increase the incomes of people already receiving state pension by increasing the value of past entitlements as well as those built-up in future. It would gradually increase the amount that existing pensioners receive as well as help future pensioners build up larger state pension rights.

The short transition (Option 8), where the new higher pension becomes payable immediately, would obviously give the most help to current pensioners. It also targets extra spending at the bottom end of the income distribution, more quickly, and to a greater extent than the Pensions Commission’s preferred option does (Chart 8). This is because it uses the ‘offset’ transition (Box 9).

The extra spending under the Pensions Commission’s preferred option is likely to go to the most well-off pensioners rather than the least well off during transition. By 2030, the most well-off 10% of pensioners could be around £25 a week better off in 2030, compared to only around £5 a week for the least well-off 10% of pensioners (Table 6). The most well-off pensioners benefit more because they are not caught in Pension Credit, are less affected by reducing the scope of Savings Credit and because they are more likely to have a full BSP, so benefit more from uprating the BSP with earnings.

In contrast, with the short transition (Option 8), the least well-off 10% stand to gain around £15 a week by 2030, while stopping S2P accruals means that most well-off would have around £10 a week less than they would under the current system. The 20-year transition (Option 7) is more generous at all income levels as the offset method is not used, so higher earners benefit more from SERPS and S2P accrued before 2010.



Chart 8<sup>67</sup>

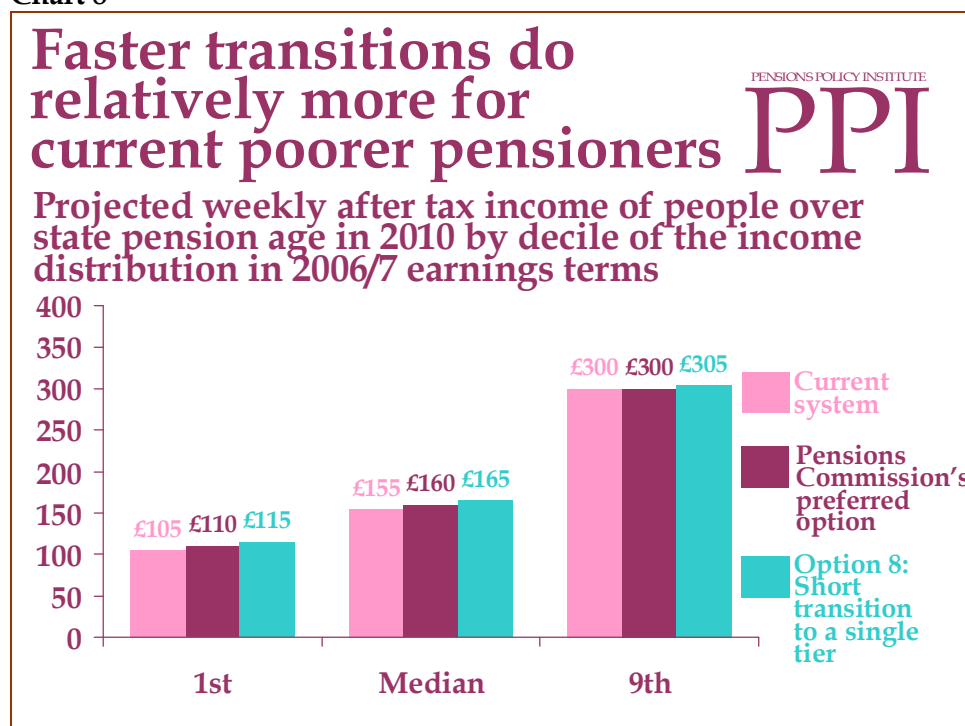


Table 6<sup>68</sup>: Illustrative weekly after tax income of people over SPA in 2030 by decile of the income distribution, £ per week in 2006/7 earnings terms

	Current system	Pensions Commission's preferred option	Single-tier options (with a lower rate for individuals in couples)		
			Option 6: Long transition	Option 7: Medium transition	Option 8: Short transition
1 <sup>st</sup>	105	110	105	120	120
3 <sup>rd</sup>	135	140	130	155	135
<b>Median</b>	165	180	170	190	170
7 <sup>th</sup>	215	230	215	240	210
9 <sup>th</sup>	340	365	345	375	330

<sup>67</sup> PPI analysis based on the Aggregate Model and the Distributional Model. See Appendix 2 for further details.

<sup>68</sup> PPI estimates using the Aggregate and Distributional Models. All figures have been rounded to the nearest £5.

**Box 9: The ‘offset’ transition**

The ‘offset’ is designed to enable an overnight transition to a single state pension to be both distributionally efficient (poorer pensioners gain, not richer) and affordable. The offset means in practice:

- Those with state pension income (BSP+S2P or contracted-out equivalent) of less than £114 a week are brought up to that level.
- Those with more state pension income than £114 do not gain immediately, but lose nothing.
- All accrued rights are honoured.

The offset works by introducing a new pension that replaces BSP and S2P. Individuals receive the higher of the new pension or the combined amount of BSP + S2P (where S2P includes contracted-out pensions) (see Table 7).

**Table 7: Illustrative state pension amounts for the average newly retired woman and average newly retired man under the current system and after transition to a single-tier flat-rate state pension using the offset method**

	Current system			After offset
	BSP and SERPS/S2P	Guarantee Credit	Total state pension	New state pension
Newly retired woman	£77	£37 (if claimed)	£114	£114
Newly retired man	£136	£0	£136	£136

The offset therefore avoids the perennial problem of higher income pensioners gaining more than lower income pensioners from incremental improvements to the current system. Without the offset, gains are proportional to existing pension.

Higher income pensioners would gain from a new single state pension, but over time, as the new pension is increased each year in line with earnings; a faster uprating than they would expect from existing pensions (which are uprated in line with prices). This helps prevent the income of older pensioners falling too far behind the income of those younger.

The offset could be perceived as giving people who did not contribute fully an increase in pension income, while not giving anything extra to those who have contributed in full. This is not totally correct if the new pension is set at the level of the Guarantee Credit which is already available irrespective of contributions; the only difference is automatic payment rather than needing to claim. But there could be an issue for people who chose to pay voluntary additional NI contributions which could be solved by a special reward.

The offset is administratively feasible. Interviews with NISPI led the PPI to conclude that it would simplify state and private pension administration<sup>69</sup>. The Pensions Commission interviewed officials in the Pensions Service, and came to the conclusion that the offset would be possible, but complex<sup>70</sup>.

The offset could require an initial burst of administrative activity but after it had been introduced, it could simplify state and private pension administration. The state pension built-up in BSP and S2P (including the contracted-out equivalent) would be calculated only once, at the time of the transition. It could then be stored and, when in payment, uprated in exactly the same way as today in order to be compared with the new pension level.

### **A faster transition need not have higher costs**

A faster transition is possible within the cost range suggested by the Pensions Commission as being acceptable<sup>71</sup>. In the short term (up to 2020), transition could be kept not only within the Commission's cost range, but also within the expected future cost of the current pensions system<sup>72</sup>. This is an advantage, because the short-term cost is likely to be constrained, since policy tools like raising the state pension age cannot be implemented at short notice.

In general, the slower the transition, the lower the short-term cost, but options 6, 7 and 8 could all be afforded within the expected future cost of the current state pension system by a mixture of:

- Using the offset method (described in Box 9) for the short transition (Option 8).
- Spending some of the savings from abolishing contracted-out rebates on current pensions (considered in Box 10).
- Modest increases in National Insurance contributions (NICs).
- Diverting state spending from elsewhere.

The Pensions Commission's preferred option, with the BSP made universal for the over 75s, would require extra spending on top of the expected future cost of the current state pension system: £1 billion on introduction in 2010, increasing to £10 billion by 2020.

<sup>69</sup> NAPF (2004) page 37

<sup>70</sup> Pensions Commission (2005) Second Report page 248

<sup>71</sup> This was to maintain spending on pensioners at current levels until 2020 and then increase it to between 7.5% and 8% of GDP by 2050, Pensions Commission (2005) page 13. Note that the estimates in this paper use a different definition of cost, of spending on pensions rather than pensioners (Box 4).

<sup>72</sup> Assuming that the Guarantee Credit continues to be increased in line with earnings. The future cost of the current pensions system is expected to reduce between 2010 and 2020, so the Pensions Commission's proposed cost range of keeping state spending level before 2020 would involve some extra cost on top of current spending plans.

If both the offset method and contracted-out rebates were used, then the fastest transition (Option 8) is possible with only an extra £1 billion to fund on introduction in 2010 and an extra £7 billion by 2020 on top of the expected future cost of the current state pension system (Table 8). This is less than the Pensions Commission's preferred option requires. The extra amount could be found either by small increases in NICs or diverting spending from elsewhere. As a rough indication of the size of the cuts needed, Winter Fuel Allowances, other age-related payments, Over 75s TV licences and Christmas Bonus together cost around £2 billion a year<sup>73</sup>.

**Table 8<sup>74</sup>: Estimated state expenditure on state pensions (BSP, SERPS/S2P, contracted-out rebates, Pension Credit and other pension benefit such as Winter Fuel Allowances), state pension age increases gradually to 68 by 2050, as a percentage of GDP and in £ billion, 2006/7 prices**

	Single-tier options (with a lower rate for individuals in couples)				
	Current system	Pensions Commission's preferred option	Option 6: Long transition	Option 7: Medium transition	Option 8: Short transition
<b>2010</b>	5.6%	5.8%	4.9%	5.1%	5.6%
<b>2020</b>	5.2%	5.8%	4.6%	5.3%	5.5%
<b>2030</b>	6.0%	6.7%	5.4%	6.7%	6.4%
<b>2040</b>	6.5%	7.4%	5.8%	7.1%	6.9%
<b>2050</b>	6.6%	7.2%	5.9%	6.6%	6.6%
<b>2010</b>	82	85	71	75	83
<b>2020</b>	95	110	85	100	105
<b>2030</b>	135	155	120	155	145
<b>2040</b>	175	200	160	195	190
<b>2050</b>	215	245	200	220	220

If neither the offset nor contracted-out rebates are used, the significant extra cost of the short transition (Option 8) may mean that a slower transition is preferred, to stay within current spending plans.

<sup>73</sup> DWP expenditure projections for the 2005 Pre-Budget Report

<sup>74</sup> PPI estimates using the Aggregate and Distributional Models. See Steventon (2005) for a technical description of the models. Costs for the single-tier options are on the basis that contracted-out rebates are spent on current pensions. The offset is assumed to be used for Option 8. Figures in £ billion are rounded to the nearest £1 billion for 2010 and to the nearest £5 billion for the later years.

**Box 10: Using contracted-out rebates to fund current pensions**

A number of options in this paper would abolish contracting-out (including the Pensions Commission's preferred approach, although it would take 20 years to be completely removed). The additional revenue raised would be available to the Government to use as it wishes. It could be used to:

- Increase spending on current pensions.
- Reshape National Insurance contributions.
- Increase general revenues and be spent in non-pension areas.
- Reduce Government borrowing.

For the single-tiers, it is assumed in this paper that this additional revenue is used for transition, that is, to increase spending on current pensions.

Using contracted-out rebates to fund the transition to a better state pension system has a number of advantages:

- It avoids increased taxation or reduced spending in other areas.
- It helps the problems of today's poorer pensioners.
- By improving the state pension, a better platform is provided for voluntary saving<sup>75</sup>.

Despite retaining S2P, the Pensions Commission recommends abolishing contracting-out only over a 20-year period. Contracting-out would at first be retained for Defined Benefit (DB) schemes. But the Commission also stated explicitly that *Additional government cash flow generated from these changes [to contracting-out] should be used to increase government's contribution to national saving*. In the third report, this assertion was qualified by saying the rebates should only *ideally* be used in this way<sup>76</sup>.

The Pensions Commission's rationale is that abolishing contracting-out:

- Is more likely to stimulate DB scheme closure than new provision.
- Would involve a reduction in the national savings rate and a reduction in pre-funding of pensions.
- Increases future pay-as-you-go (PAYG) liabilities.

However:

- There is no evidence on what impact the removal of contracting-out would have on DB provision. Views are mixed with many involved in the provision of DB schemes taking the opposite view to that of the Commission (see Chapter 6 for more details).
- Any impact on national saving has to be considered in light of recent and likely future declines in DB provision, the impact of other parts of the Pensions Commission recommendations (for example the introduction of the NPSS) and the positive impact on savings incentives of moving to single-tier flat-rate pension system<sup>77</sup>.
- The higher PAYG liabilities are already counted fully in the projected costs of state pension reform, so there is no 'hidden' future cost.

<sup>75</sup> NAPF (2005) and PPI (2006 SSPS)

<sup>76</sup> Pensions Commission (2006) page 26

The offset used in Option 8 saves £12 billion in 2010 and abolishing contracted-out rebates saves £11 billion<sup>78</sup>. If neither were used, then the total of £23 billion to be found could be raised by a combination of increasing NICs and cuts to other areas of state spending:

- If the total was to be found only by NICs, then NICs would have to be increased by around 2% for each of workers and employers on earnings above the Primary Threshold (£97 a week in 2006/7). This is twice the recent increase for NHS reforms.
- If the total were to be found by only cutting spending, then, as an indication, the health budget would be reduced by around 20% or the education budget by around 25%<sup>79</sup>.

The slower transitions (Option 6 and Option 7) do not need to use the offset method. The medium transition (Option 7) would require only partial use of contracted-out rebates or higher NICs, while the long transition (Option 6) would require only very little on top of the expected future cost of the current state pension system before 2020.

The medium transition (Option 7) would only require around £4 billion out of the £11 billion saving in contracted-out rebates in 2010, in order to be afforded within the expected future cost of the current state pension system. By 2020, as benefit improvements become larger, either all of the contracted-out rebates would be needed, or money would have to be found elsewhere, such as from higher NICs or diverting other state spending. If NICs were the only method used, then they would have to increase by around 1% for both workers and employers.

The long transition (Option 6) would cost only a little more than the expected future cost of the current state pension system before 2020. The accruals to the new BSP take time to work through before a significant amount is in payment. A small amount of money from contracted-out rebates might be needed, but the Government would have the choice about how to spend most of it.

As discussed in the previous section, the short transition (Option 8) is the most progressive of all the options. However, Option 7 is still more progressive than the Pensions Commission's preferred option. Option 6 would also be more progressive than the Pensions Commission's preferred option in the long term.

<sup>77</sup> Sefton, Van de Ven and Weale (2005) show that replacing the current PC system with a single-tier flat-rate pension would encourage saving and longer working among low and middle income households. Although the paper also suggests that high income households would save and work less, this is based on the premise that a flat-rate system would deliver a higher pension to these households than they would receive if the current system continued. In fact, the current system gives more to higher earners (either directly or through contracting-out) than assumed in the paper. So moving to a flat-rate pension at the Guarantee Credit level would give high earners less state pension in future than a continuation of the current system would. This would further encourage saving and working longer.

<sup>78</sup> DWP expenditure projections for the 2005 Pre-Budget Report. Includes rebates in respect of the public sector pension schemes.

<sup>79</sup> HMT (2005) page 45

The short, medium and long transitions (Options 8, 7 and 6) all target a lower level of state benefit than the Pensions Commission's preferred option (although are more evenly distributed). In the long term, this means that the state could spend less on pensions than envisaged by the Commission, the pension could be set at a higher level than the Guarantee Credit, or state pension age could increase to less than age 68.

The analysis in this paper therefore shows that a simpler solution than the Pensions Commission proposal is affordable within the cost range suggested by the Pensions Commission and is likely to meet the Government's tests for reform more effectively. A fast transition to a single-tier pension, with earnings uprating and improved coverage, is both possible and affordable, could have a better distributional outcome, and could reduce reliance on means-testing still further. The next chapter examines in detail the Pensions Commission's concerns about this approach – and shows that all of their concerns can be overcome.

## Chapter 6: What are the barriers to a simple solution?

This chapter considers the reasons given by the Pensions Commission for deciding against moving quickly to a single-tier state pension.

The Pensions Commission recognised the significant benefits of moving quickly a single-tier pension system. They decided against recommending this approach for a variety of reasons based on their initial analysis, views and judgement. Alternative analysis and interpretation suggests that the disadvantages the Pensions Commission saw in the simpler approach are less significant than feared and can be overcome.

The Commission recognised the significant attractions of moving quickly to a single-tier, flat-rate state pension system: *The obvious benefit of a [single-tier flat-rate pension] is that it would be simple and easy to understand. ... it would make it possible to promise people a flat-rate state pension equal to or at least close to the Guarantee Credit poverty line, rising in line with earnings over time, but affordable within the range for public expenditure in 2050 ... it would eliminate or at least minimise the role of means-testing. People would have a clear understandable promise of what the state will deliver, and clear incentives to save on top<sup>80</sup>.*

The Commission raised a number of possible disadvantages with this approach, concluding that these outweighed the advantages:

1. Unifying BSP and S2P reduces future flexibility in policymaking.
2. Abolishing contracting-out could adversely impact Defined Benefit (DB) occupational pension provision
3. Abolishing contracting-out could adversely impact national savings.
4. There would be high immediate costs.
5. There would be undesirable distributional effects.
6. Transition would be complex.
7. The offset transition may be perceived as unfair.

However, the analysis in this chapter shows that:

1. Flexibility adds complexity and makes it hard to understand future entitlements.
2. There is no evidence for the abolition of contracting-out to have an adverse impact on DB provision; many think it could be positive.
3. A reform package including abolition of contracting-out could have a positive impact on national savings.
4. Transition is affordable.
5. A single-tier flat-rate state pension system is progressive.
6. Transition to a single-tier state pension system is feasible and not necessarily complex.
7. The offset transition only exposes unfairness that already exists in the current system.

<sup>80</sup> Pensions Commission (2005) page 212



### 1. Unifying BSP and S2P reduces flexibility

The Pensions Commission suggested that retaining the two-tier approach would *allow 3 potentially useful forms of flexibility in the overall design of the system*<sup>81</sup>. It would be possible to have different pension ages, different qualification criteria and different uprating rules for BSP and S2P in a two-tier system.

Chapter 4 of this report shows that added flexibility also adds complexity. It increases uncertainty about the potential impact of any future changes. It becomes harder to understand what the state will provide for each individual, and when, and how much the combined state pensions will be worth later in retirement.

### 2. Abolishing contracting-out could adversely impact Defined Benefit occupational pension provision<sup>82</sup>

The Commission recommends that contracting-out is abolished in the long term (by 2030) for Defined Benefit (DB) schemes, but does not want to exacerbate the closure of DB schemes in the short term: *The Pensions Commission believes that immediate abolition [of contracted-out rebates] is more likely to spur further DB scheme closure than to stimulate new provision*<sup>83</sup>.

Contracting-out would be abolished for Defined Contribution (DC) schemes from 2010.

As described in Box 10, and acknowledged by the Pensions Commission, there is no evidence for how the removal of contracting-out would impact on DB provision. Views are mixed:

- All of the organisations involved in the running and administration of DB schemes listed by the Pensions Commission as having expressed a preference about the future of contracting-out<sup>84</sup> actively support the abolition of contracting-out: the National Association of Pension Funds, the Association of Consulting Actuaries, and Watson Wyatt.
- All of the organisations involved in the contracting-out of DC arrangements listed by the Pensions Commission as having expressed a preference about the future of contracting-out<sup>85</sup> are in favour of retaining contracting-out: the ABI, Prudential, Standard Life, Aegon and HSBC.

<sup>81</sup> Pensions Commission (2005) page 214

<sup>82</sup> NAPF (2005) Chapter 4 discusses this objection in more detail

<sup>83</sup> Pensions Commission (2005) page 220

<sup>84</sup> Pensions Commission (2005b) page 42. See also NAPF (2005) page 36

<sup>85</sup> Pensions Commission (2005b) page 42

DB provision is already falling, and this trend is expected to continue<sup>86</sup>. The removal of contracting-out would be only one factor in the employer's decision on whether or not to continue with DB provision, alongside others including:

- The level of the contracted-out rebate.
- Funding levels and the cost of closing or freezing a scheme.
- Required levels of continuing contributions.
- Regulatory requirements, including the PPF levy.
- Future investment returns.
- Future improvements in longevity.
- The potential impact of the NPSS and auto-enrolment for all employees.

The existence or not of contracting-out may therefore not be the overriding influence on future levels of DB provision.

### **3. Abolishing contracting-out could adversely impact national savings**

*Obviously if contracting-out rebates were abolished, government cash flow would improve (by about £8 billion in 2005/06). Some submissions to the Commission argued that this cash flow benefit can be used to fund a rapid move to a more generous and less means-tested, flat-rate pension. We are however wary of this approach, which would involve accepting a reduction in the national savings rate, and thus a reduction in pension pre-fundings<sup>87</sup>.*

Box 10 in Chapter 5 also describes how, as with the impact on DB provision, the impact of abolishing contracting-out on the national saving rate should be considered as part of the overall reforms in pension saving rather than in isolation. For example:

- Employer contributions to DB schemes are currently running at high levels to help fund deficits. They may reduce anyway.
- The introduction of compulsory auto-enrolment and the NPSS is designed to increase voluntary saving.
- A move to a simpler single-tier flat-rate state pension system with much lower levels of means-testing could increase levels of voluntary pension saving<sup>88</sup>.
- By 2010 the amount spent in contracted-out rebates may already be lower than planned if current trends continue or accelerate, so even with no changes other than abolishing contracting-out the impact on national saving may be less than expected.

While there is broad consensus that a mixture of funded and unfunded provision is desirable<sup>89</sup>, there is nothing to say that the current level of funded provision is 'correct'.

<sup>86</sup> Pensions Commission (2005) page 222

<sup>87</sup> Pensions Commission (2005) page 222

<sup>88</sup> See footnote 77

<sup>89</sup> PPI (2006 SSPS)

In reality any decision on the use of contracted-out rebates would be a political decision. Using them to fund transition to a better state pension system is one possibility that could also help improve national saving.

#### **4. Moving to a single-tier flat-rate pension system would have high immediate costs**

The Pensions Commission argued that moving to a single-tier state pension system *would still leave the need for a significant and immediate increase in public expenditure*<sup>90</sup>.

Chapter 5 demonstrates that this need not be the case. Depending on the speed of transition, transition to a single-tier flat-rate state pension system could:

- Have no immediate additional cost (as in Option 6, the long transition to a single tier with a reduced rate for couples)
- Have the immediate additional cost covered by the additional revenue from abolishing contracted-out rebates (as in Option 7, the medium transition to a single tier)
- Have the immediate additional cost covered by the additional revenue from abolishing contracted-out rebates and the offset transition (as in Option 8, the short transition to a single tier).

#### **5. Moving to a single-tier flat-rate pension system would have undesirable distributional effects**

The Pensions Commission argued that: *At the lowest earnings levels it [moving quickly to a single-tier flat-rate state pension system] would enable people to enjoy benefits as of right rather than on means-tested basis, but would not actually increase their total potential income. Instead many of the benefits would flow to people somewhat higher up the income distribution. Indeed due to a counter-intuitive effect deriving from the complexities of the Savings Credit system, some low-income pensioners could actually be made worse off if [a single-tier flat-rate pension] were introduced in place of the existing BSP and S2P system, and if the lower Savings Credit threshold were increased in line with the now unified basic pension*<sup>91</sup>.

*.. the distributional impact would still include significant undesirable effects. Some high income individuals with large private pension rights but limited SERPS/S2P rights (e.g. higher income older pensioners who retired before significant SERPS rights could be built up) would be significant gainers.*<sup>92</sup>

<sup>90</sup> Pensions Commission (2005) page 248

<sup>91</sup> Pensions Commission (2005) page 212

<sup>92</sup> Pensions Commission (2005) page 248

Chapter 4 (Table 4) shows that these distributional concerns are unfounded. Analysis of the distribution of pensioners' incomes rather than the Pensions Commission's individual examples, shows that a single-tier state pension system is ultimately more redistributive and progressive than both the current system and the Pensions Commission preferred option.

Similarly, Chapter 5 (Table 6) highlights how a short transition targets gains in state pension income on lower income pensioners, resulting in a more progressive use of state resources than the current system or the Pensions Commission's preferred option, through use of the offset transition.

The costs of a short transition (Option 8) include the cost of protecting existing payments of Savings Credit in transition, so that no individual sees a reduction in the amount of state pension income they receive. The Pensions Commission analysed the immediate abolition of Savings Credit with no transitional protection, which exacerbated their concerns on the distributional impact<sup>93</sup>.

Depending on the generosity of transitional protection for Savings Credit, some individuals reaching SPA after 2010 may receive less state pension income than they would have if the current system (and the continued increase in the coverage of Savings Credit) had remained in place. But this is the case in any system that reduced the extent of Savings Credit, including the Pensions Commission's proposals.

## **6. Moving to a single-tier flat-rate pension system would be complex**

*The possible (though complex) offset arrangements....<sup>94</sup>*

*This calculation [of the offset] is complex and administratively burdensome particularly because the different benefits have different indexation regimes .... requiring the calculation to be done separately each year for each individual<sup>95</sup>.*

The offset is not complex for either the individual to understand or the Government to operate. After an initial calculation (which is possible without requiring information from individuals as the Government already records all the information required) the administration of private pensions is simplified.

Box 9 in Chapter 5 describes how for those under state pension age at the time of the transition it is only necessary to record – or 'crystallise' – the accrued rights to that point. No further calculation of benefits is needed until state pension age is reached.

<sup>93</sup> Pensions Commission (2005) pages 212-3, Figure 5.34

<sup>94</sup> Pensions Commission (2005) page 248

<sup>95</sup> Pensions Commission (2005) page 246

After pension age, the calculation is very similar to the calculation needed to be made today for every pensioner at each annual uprating. The only additional calculation would be a comparison of the amounts in each benefit with the level of the single-tier flat-rate pension, and this would be automated.

Overall, especially as the extent of Pension Credit has been reduced, the administrative burden on Government should be less, and cheaper, than under the current system.

### **7. The offset transition may be perceived as unfair**

*this logically and theoretically fair system [a short transition to a single-tier flat-rate state pension system] may not be thought such, particularly if, as is possible, some people have achieved a lower return on the contracted-out additional pensions than is assumed...<sup>96</sup>.*

*In addition the introduction of [a single-tier flat-rate state pension] would be seen by some as creating unfairness since it would in some circumstances fail to give people a higher pension in return for higher contributions<sup>97</sup>.*

Both of these criticisms expose unfairness that exists within the current system, rather than introduce new unfairness.

The problem of poor value from contracting-out already exists. Some people will receive less from their contracted-out pension than they would have got from SERPS/S2P had they remained contracted-in. This feature simply becomes more transparent in a single-tier system. Low income individuals would be protected by Guarantee Credit.

Individuals who had made 'more' contributions (people making 'full' NI contributions as opposed to lower contributions for the self-employed or the reduced rate for married women, or people making voluntary NI contributions) would still benefit from the change, so any consideration of fairness would need to consider their own overall level of pension as well as their position relative to others.

The situation already arises (though to a lesser extent) in the current system as contributions are not considered for Pension Credit, so in some cases additional contributions or paying full rate NI does not lead to higher income (particularly for those who would still receive less than a full BSP).

<sup>96</sup> Pensions Commission (2005) page 246

<sup>97</sup> Pensions Commission (2005) page 247

It may be possible to reward voluntary contributions (at an additional cost) through additional payments (either one-off or ongoing). To size the extent of this problem, approximately 250,000 individuals make voluntary contributions each year, with around two-thirds of them contributing for a full year on a voluntary basis<sup>98</sup>.

Although there may be a perception of unfairness from the offset transition, overall the system would become fairer. It is a political judgement whether to allow these perceptions to decide overall policy. If so, a slower transition to a single-tier flat-rate state pension system would avoid these perceptions.

<sup>98</sup> DWP (2006 CQY) Table 6.0

## Appendix 1: The Government's tests

**Extract from John Hutton MP Speech, *Securing our Future: The Pensions Challenge*, ippr, Thursday 24th November 2005**

If we are to achieve a lasting pensions settlement for the 21st century, I believe that ultimately our long-term package of measures has got to meet five key tests.

First, does it promote personal responsibility?

Second, is it fair?

Third, is it affordable?

Fourth, is it simple?

And fifth, is it sustainable?

Let me spend a moment on each of these in turn.

Firstly – does it promote personal responsibility? As my predecessors have made clear, the primary responsibility for security in old age has to rest with the individual and their families. An active welfare state must provide a floor below which no-one should be allowed to fall but its primary role must be to enable people to provide for themselves, giving everyone the opportunity to build a decent retirement income that meets their needs and expectations.

Secondly – is it fair? The system must protect the poorest so that we never again see the pensioner poverty that blighted the lives of millions of pensioners at the end of the last century. It must be fair to women and carers correcting past inequalities and reflecting their changing role in today's society. And it must be fair to those who have saved – rewarding those who have contributed and incentivising those who can save to do so.

Thirdly – is it affordable? Clearly any system needs to be affordable to taxpayers and the economy as a whole. As the country ages we will face pressures to spend more on pensions. Already since 1997 we are spending £11 billion a year more on pensioners. We have an obligation to continue to manage public expenditure prudently and responsibly. As Gordon Brown will say this evening, in his speech to the Institute of Directors, there will be no relaxation in our fiscal discipline. We will not put the long term stability of public finances at risk. And we should assess how re-prioritising welfare spending can make a contribution to supporting pension reform.

Fourthly – is it simple? There needs to be a clear deal between citizens and the state. People need to know what the Government will do for them and they need to be clear about what is expected of themselves.

Finally - is it sustainable? Any package of reform must form the basis of an enduring national consensus – and one on which people can make decisions about their retirement planning with confidence that it won't be pulled apart by successive Governments fiddling with the system.

Our task now is to lay the foundations for a lasting pensions settlement. This means new arrangements that stand the test of time; that won't be uprooted by successive Governments; that will allow people to plan ahead and make decisions with confidence – whilst being sufficiently flexible to allow it to adapt to unknown challenges in the future and the changing needs of tomorrow's society.



## Appendix 2: Modelling details

This paper contains quantitative analysis of the effect of different reform options, using economic modelling. The main body of this paper contains boxes which highlight important aspects of the modelling methodology and uncertainty that should be borne in mind when interpreting the results.

This appendix contains further, more technical details. It is structured by the main types of quantitative analysis included in this paper:

1. The proportion of pensioner benefit units eligible for Pension Credit.
2. The costs of the reform options.
3. The distributional impact on the pensioner population as a whole.
4. The impact on specific individuals of the Pensions Commission's proposals.
5. The number of people who would be eligible for transitional Savings Credit protection in the short transition to a single-tier pension (Option 8).

The quantitative analysis is based on the PPI's suite of economic models. For consistency, the three models in the suite all use the same set of assumptions, which are described in the final section of this appendix.

### **1. The proportion of pensioner benefit units eligible for Pension Credit**

Box 2 in Chapter 1 explains that there are uncertainties in how many people will be eligible for Pension Credit in future. The uncertainty is caused by data limitations concerning the current distribution of pensioner income and uncertainty in how the distribution will change in future.

- A. **Data limitations:** The Distributional Model uses estimates of the current distribution of pensioner incomes as a starting point. But the most appropriate available estimates, from the Family Resources Survey (FRS), are known to include misreporting. This means that all state pension is reported as one number but Guarantee Credit is sometimes mistakenly reported as BSP/S2P. This misreporting will lead to over-estimates of the amounts of BSP and S2P for low income pensioners.

To compensate for this misreporting, the Distributional Model adjusts the estimates of the amounts of BSP and S2P received (which are derived from splitting up the single number for state pension income in the FRS). The adjustment works so that the total amount received across the population in each matches the total amount projected by the Aggregate Model. In practice, as the adjustment is applied across all individuals, this leads to some individuals being counted in the

calculations as if they receive more than 100% of the full rate of BSP. This will result in an over-estimate of the amount of BSP for individuals with full basic state pension entitlement, and an under-estimate for those with less than a full BSP.

Data limitations can create some distortions in the distributional results, but they tend to work in opposite directions and so cancel each other out. Credibility is added to the results by the Distributional Model estimates for the percentage of pensioner benefit units eligible for Pension Credit 2005 being within the range of official estimates<sup>99</sup>. These official estimates also use the FRS and an alternative method of correcting for misreporting.

- B. *What will happen in future:* More importantly, there is uncertainty as to how the distribution of pensioner incomes will change in future. These uncertainties relate to average future growth and relative changes within the distribution.

*i) Average growth:* The base case estimates in this paper assume that the average amount received in different types of pension income – including BSP, S2P and private pensions – will grow at the rate implied by detailed aggregate expenditure projections. This is a relatively sophisticated methodology. However, all modelling analysis relies ultimately on the assumptions made. In this case, assumptions are made on inflation and earnings growth, which drive state benefit levels, and private pension contributions and investment returns. These are all uncertain and a range of different assumptions can be justified.

*ii) Changes in the distribution:* A necessary simplification made in the Distributional Model is that income across the whole income distribution will grow at the same rate. This simplification still allows for the possible flattening in the income distribution that is expected as women's entitlements to BSP improve<sup>100</sup>, because the growth rates are applied separately for men and women and for people of different ages. It also allows partly for the introduction of S2P, which improves state pension for lower earners and carers, because lower earners and carers are more likely to be women than men.

<sup>99</sup> The Distributional Model estimates that, in the PPI base case scenario for the current system used in this paper, 50% of pensioner benefit units are eligible for Pension Credit in 2005. This lies within the range of recent official estimates, of between 44% and 51% for 2003/4. House of Lords *Hansard* 25 April 2006 Column WA15.

<sup>100</sup> DWP (2005 WP) paragraph 25, page 73

However, the introduction of S2P would also be expected to flatten state pension income amongst people of the same sex and age but different earnings, and this is not taken into account in the current version of the Distributional Model. Because income could grow faster than assumed for lower income pensioners, Box 2 in Chapter 1 contains sensitivity analysis which shows the possible effect of the assumptions made.

The 'pessimistic' scenario in Box 2 reflects the possibility that the actual average growth in pensioner incomes will be slower than assumed in the base case. In this scenario, the proportion of pensioner benefit units on Pension Credit is therefore higher than in the base case. It assumes that state pensions grow as expected but that average income from private pensions grows with prices (rather than with the PPI projection used in the base case which is faster than earnings in the short term, but then declining). It also assumes that the approach of 'no distributional change within sex and age groups', as outlined in ii) above, is reasonable. In this scenario, the proportion eligible for Pension Credit is estimated to be around 95% in 2050, rather than 85% as in the base case.

The 'optimistic' scenario allows for possible income growth that is faster than assumed in the base case. It assumes that all income – state and private, throughout the whole income distribution – grows with average earnings. By applying this assumption throughout the whole income distribution, it addresses the possibility that the approach of 'no distributional change within sex and age groups' is optimistic. PPI analysis has shown it is unlikely that state pension income will grow as fast as average earnings at the bottom end of the income distribution in the current system<sup>101</sup>, so this scenario involves an upper estimate on how quickly the bottom end of the income distribution improves. In this scenario, the proportion eligible for Pension Credit is estimated to be around 80% in 2050, rather than 85% as in the base case.

There is therefore a funnel of doubt for the future proportion of pensioner benefit units on Pension Credit. Making different assumptions could lead to an answer that is lower than 80% or higher than 95%. Other organisations have produced estimates that are slightly lower. Possible reasons for this are explained in Box 2.

All projections are ultimately driven by the data and assumptions they use and are subject to considerable uncertainty, even in the short term. The modelling is best interpreted as an illustration of the possible differences between the different reform options considered, rather than as what the numbers would be under each individual option.

<sup>101</sup> Steventon (2005) page 6

## 2. The costs of the reform options

This paper also contains estimates of the cost of the different reform options.

In this paper, 'cost' or 'state expenditure on pensions' means the annual cost to the public purse of paying Basic State Pension, SERPS/S2P, Pension Credit, other pension benefits such as Winter Fuel Allowances, and contracted-out rebates. As explained in Box 3 in Chapter 1, including contracted-out rebates is important, as changes in spending on contracted-out rebates now can have an impact on future spending on pension benefits.

Box 4 explains how the definition of spending on pensions used in this paper differs from the definition the Pensions Commission used, which was spending on pensioners.

## 3. The distributional impact on the pensioner population as a whole

This paper includes estimates for the distributional impact of the reforms on the pensioner population as a whole. As Box 5 in Chapter 1 explains, this distributional modelling avoids the disadvantage inherent in analysing only specific individuals, namely, exaggerating the importance of specific types of individuals by disproportionate prominence.

The distributional impacts have been produced using the PPI's Distributional Model, the same model used to produce the estimates of the proportion of pensioner benefit units on Pension Credit. The same uncertainties as listed in section 1 above therefore need to be borne in mind when interpreting the distributional results.

In addition to these uncertainties, it is important to bear in mind that it is unrealistic for any model to pick up every possible type of change that could happen to the pensioner income distribution in future. The modelling is therefore not intended to be a prediction of what the distribution could be under each option, but to allow comparisons between options on a consistent basis. For example, the analysis shows which reform options are most likely to result in more progressive (i.e. flatter) income distributions.

Some other relevant points are:

- When comparing the income distribution under different options, individuals will change positions in the income distribution. For example, the people with the lowest incomes in the current system may not be in the lowest income group after a reform.
- Distributional estimates cover all pensioners, comparing singles and couples on a comparable basis. This means that a high income couple (towards the top of the income distribution) can receive an increase as a result of reform in income if one of the partners currently has a low individual income, which is increased as a result of the reform.

- Receipt of disability benefits moves individuals up the income distribution. As Pension Credit has more generous income limits for disabled people, it is possible to be in receipt of Pension Credit even though income is relatively high and individuals are in the top part of the income distribution.

#### **4. The impact of the Pensions Commission's option on specific individuals**

Table 5 in Chapter 5 contains estimates for the amount that successive cohorts of women and men would receive in BSP and SERPS/S2P on reaching state pension age under the Pensions Commission's preferred option. The table shows how the amounts received depend on earnings during the working life. It therefore uses individual modelling based on hypothetical individuals, rather than distributional modelling.

Distributional modelling would analyse income in retirement rather than earnings during the working life.

Typical policy analysis assumes that individuals remain in full-time work at the same earnings level from the day they leave education to the day they reach 65. Rather than use these artificial assumptions, the individuals analysed here illustrate some of the range of characteristics that exist in the working population that affect current and future pension income. They are similar to individuals analysed in previous PPI studies:

- The women all started work at the age of 21, and worked full-time until age 28. They then had a career break to care for a child for six years, but the break did not coincide with the financial year, so they lost two credits to BSP and S2P. They returned to part-time work for five years. They then worked full-time until they returned to part-time work for five years in their fifties, and then took another career break for 5 years in their 50s to care for an elderly relative, for which they received no carer benefits or credits. They returned to full-time work again, until reaching state pension age.
- The men all worked mainly full-time from age 21, but were unemployed for two years in their twenties and worked part-time between age 55 and age 60.

Each individual is modelled assuming different levels of earnings, based on decile points<sup>102</sup> of the male and female earnings distributions.

Typical policy analysis also tends to assume that individuals stay on a percentage of the median or average earnings of all workers throughout his or her working life. The earnings levels used here are instead 'age-specific', that is, based on the earnings received at different ages. For example, the median earning woman is assumed to have the median

<sup>102</sup> Decile points divide the earnings distribution into ten groups each of which contain the same number of workers. So, for example, 30% of females earn below the 3rd decile of the female earnings distribution and 60% of females earn below the 6th decile.

earnings of all full-time employed 21 year-old women when she is aged 21, and the median of all full-time employed 22 year-old women when she is aged 22. As earnings tend to be higher in the middle of working life than at younger and older ages, using age-specific earnings in this way should give a more realistic picture.

The level of earnings assumed in different ages are shown in Table 9.

**Table 9<sup>103</sup>: Annual earnings assumed for the hypothetical individuals analysed in Table 5 in Chapter 5 at different ages, if in full-time work, in 2006/7 earnings terms**

	Age 25	Age 50	Age 64
<b>Women</b>			
1st decile	10,900	10,800	9,400
3rd decile	14,300	14,700	11,300
Median	17,600	18,300	14,100
7th decile	21,400	25,400	18,400
9th decile	28,100	36,300	25,800
<b>Men</b>			
1st decile	12,000	14,400	12,200
3rd decile	15,800	20,400	16,900
Median	19,200	26,300	22,300
7th decile	24,300	34,100	27,100
9th decile	33,900	52,500	52,500

### **5. The number of people who would be eligible for transitional Savings Credit protection in the short transition to a single-tier pension**

Finally, additional analysis has been produced for the short transition to a single-tier pension (Option 8).

Chapter 6 shows that the Pensions Commission's concerns about the distributional effect of moving to a single-tier, flat rate pension system are unfounded. One of the concerns was that *due to a counter-intuitive effect deriving from the complexities of the Savings Credit system, some low-income pensioners could actually be made worse off if [a single-tier flat rate pension] were introduced in place of the existing BSP and S2P system, and if the lower Savings Credit threshold were increased in line with the now unified basic pension*<sup>104</sup>.

The costs of the short transition shown in Table 8 in Chapter 5 include the cost of protecting existing payments of Savings Credit in transition, so that no individual sees a reduction in the amount of state pension income they receive.

<sup>103</sup> ONS (2004). The PPI updates its modelling assumptions annually to allow different pieces of modelling work to be compared during the year. All figures rounded to the nearest £100.

<sup>104</sup> Pensions Commission (2005) page 212

The amount in payment is assumed to be increased with prices each year and be payable for life. When the first partner of a couple dies, the surviving spouse is assumed to continue to receive half of the original amount.

The cost of this transitional protection is estimated using Distributional Model estimates of the amounts of Savings Credit that would be in payment immediately before the reforms are introduced in 2010. The cost after this date is estimated conservatively in this paper, by assuming that Savings Credit recipients have the same mortality as assumed for the population as a whole. In fact, if Savings Credit recipients currently have lower incomes than the population as a whole, then they are likely to have higher mortality rates.

The cost of this transitional protection is projected to decline quickly (Table 10).

**Table 10<sup>105</sup>: The estimated cost of transitional protection for existing Savings Credit payments in Option 8, in £ billion, 2006/7 prices, and the estimated percentage of pensioner benefit units receiving the protection**

	<b>Cost of the transitional protection</b>	<b>Percentage of pensioner benefit units in receipt of the transitional protection</b>
<b>2010</b>	2	25%
<b>2015</b>	1	20%
<b>2020</b>	1	15%
<b>2025</b>	1	10%
<b>2030</b>	*	5%

The percentage of pensioner benefit units estimated to be in receipt of the transitional protection would also decline quickly, from around 25% in 2010 to around 5% by 2030, as shown in Table 10 above. As explained in the footnote to Chart 7 in Chapter 5, this percentage is not included in the estimates for the percentage of pensioner benefit units eligible for Pension Credit in Option 8. This is because the transitional protection would no longer be means-tested and would only effect people already over age 60 in 2010 and not most people of working age. It is therefore not subject to the disadvantages which Chapter 1 cited as the rationale for focusing on the number of people eligible for Pension Credit as the key measure of the success of reform.

<sup>105</sup> PPI analysis using the Distributional Model. £ bn figures have been rounded to the nearest £1 bn. \* means less than £0.5 bn. % figures have been rounded to the nearest 5%.

### **The PPI's suite of economic models**

The projections in this paper have been produced using the PPI Aggregate Model, Distributional Model and Individual Model. These models have been developed by the PPI to assess the impact of long-term policy options. The Nuffield Foundation has funded the development of the models.

The PPI has published a full description of the technical details of the models<sup>106</sup>. This final section of this appendix describes the common set of assumptions used in the base case modelling presented in this paper.

Assumptions have been made in this paper on future pensions policy, on the UK economy as a whole and on the National Pensions Savings Scheme (NPSS).

### ***Future pensions policy***

Details of the alternative reform options tested are in Chapter 1.

The projections for the current system in this paper assume that the current state pension system continues, with the same uprating conventions as are used today<sup>107</sup>:

- The Basic State Pension (BSP) and State Second Pension when in payment are increased in line with prices. The BSP remains the minimum level of entitlement to Savings Credit.
- The Guarantee Credit continues to be increased in line with average earnings.
- The Lower and Upper earnings limits for State Second Pension increase in line with prices. The Lower Earnings Threshold (the LET – the ‘flat-rate’ part of State Second Pension) continues to be increased in line with average earnings. The Upper Earnings Threshold continues to increase to reflect the changes in the LET, ensuring that higher earners receive the same in State Second Pension as they would have received in SERPS. However, when the Upper Earnings Threshold overtakes the Upper Earnings Limit, it is assumed to be uprated in line with prices.
- The base case scenario assumes that Pension Credit take-up<sup>108</sup>:
  - Remains at 85% for people who are entitled to both the Guarantee Credit and Savings Credit components.
  - Remains at 74% for people who are only entitled to the Guarantee Credit component.
  - Increases from the current level of 35% to around 60% for people who are only entitled to the Savings Credit component, as Savings Credit becomes a more significant part of older people’s income.

<sup>106</sup> See Curry (2003) and Steventon (2005)

<sup>107</sup> For more details, see PPI (2005 PP)

<sup>108</sup> PPI (2004) PPI submission to the Work and Pensions Select Committee. The PPI updates its modelling assumptions annually to allow different pieces of modelling work to be compared during the year. These take up rates are similar to the latest official estimates in DWP (2006 IRB).



### *Macroeconomic assumptions*

This paper uses the same macroeconomic assumptions as previous PPI modelling work, for consistency<sup>109</sup>:

- Prices are assumed to grow by 2.5% each year.
- Earnings are assumed to grow by 2.0% each year in excess of prices.
- The age, sex and marital structure of the population is assumed to follow the Government Actuary's Department's (GAD's) 2003-based population projections<sup>110</sup>.
- Employment rates are assumed to increase for women over age 50 as state pension age increases between 2010 and 2020 to be more in-line with today's employment rates for younger women.
- Contracting-out in the private sector is assumed to halve between now and 2035 as defined benefit schemes are closed down but to remain at current levels in the public sector<sup>111</sup>.
- Contracted-out rebate rates are calculated as being actuarially neutral assuming the same investment returns, earnings growth and inflation as elsewhere in the models.
- Private pension funds earn nominal investment returns of 7% a year for equities and 4% a year for bonds, before expenses.

### *National Pensions Savings Scheme*

All of the reform options modelled in this paper include the National Pensions Savings Scheme (NPSS) proposed by the Pensions Commission from 2010. The specific assumptions made on the NPSS are similar to those the Pensions Commission made in their modelling<sup>112</sup>:

- 6.6 million employees and 0.4 million self-employed people, who are not already saving in existing occupational and personal pension policies, join the NPSS.
- The average contribution rate is 10% of band earnings (i.e. 10% of earnings between the Primary Threshold and the Upper Earnings Limit for NPSS contributions). This is based on employee, employer and state contributions totalling 8% of band earnings, plus on average additional voluntary employee contributions of 2% of band earnings.
- NPSS pensions are taken at state pension age.
- Annual charges are 0.3% of the assets under management.
- For simplicity and consistency with the other modelling in this paper, investment returns in NPSS are assumed to be the same as for other pensions.

<sup>109</sup> For the full set of assumptions used, see Steventon (2005) Appendix 2

<sup>110</sup> The PPI updates its modelling assumptions annually to allow different pieces of modelling work to be compared during the year. In October 2005 GAD released a new set of population projections based on estimates of the UK population in 2004. These showed a slight increase in the projected number of people over state pension age. As the increase is slight for all years up to 2050, the new projections are unlikely to have a large impact on the costs presented in this paper.

<sup>111</sup> This is the assumption used by GAD to project the cost of SERPS/S2P and contracted-out rebates. GAD (2004). Other organisations have suggested that Defined Benefit schemes might close more quickly, including the Pensions Commission, which would increase the costs of S2P in the long term and reduce the costs of contracted-out rebates in the short term Pensions Commission (2005) page 57.

<sup>112</sup> Pensions Commission (2005) page 287

### Appendix 3: The impact of setting a single-tier pension at a lower rate for individuals in couples

The Pensions Commission were concerned that a fast transition to a single-tier pension could be expensive and lead to an increase in benefits for better-off, rather than worse-off, older people<sup>113</sup>. Chapter 6 examines in detail why the Pensions Commission did not recommend moving more quickly to a simpler end point.

This appendix considers one way of making transition to a single-tier pension more affordable and more progressive. This is to set the level of the pension at a lower rate for each individual in a couple than for individuals who live alone. The rationale behind this approach is that individuals in couples should in theory face lower living costs than individuals who live alone<sup>114</sup>.

Each individual in a couple would receive a pension in his or her own right, based on his or her own eligibility. If the individual is living as part of a couple, his or her amount would be set at 80% of the amount for a single individual. If the individual becomes single, say after divorce or becoming widowed, he or she would receive 100% of the amount for a single individual.

Another way to describe this option is to say that the amount individuals in couples would get is in fact the standard rate, but people living alone receive a 25% living alone supplement.

Because a lower rate for individuals is more affordable and more progressive, it has been assumed for the single-tier options analysed in Chapter 5.

#### **A lower rate for each partner in a couple is less expensive and no less progressive**

If the pension were set at the same rate for individuals in a couple as single individuals, then the total amount received by each a couple (twice the Guarantee Credit level for single pensioners, so £228 a week) would be much higher than the current couples rate of Guarantee Credit (£174 a week). This has led to concerns that such a system could be expensive, and regressive as couples are less likely to have low income and be at risk of poverty than single pensioners<sup>115</sup>.

Paying each partner in a couple 80% of the rate for a single person would align the amount received by a couple with the Guarantee Credit level. This approach risks losing some of the simplicity and transparency of the single level approach, though the system would still be very simple, and much simpler the Pensions Commission's very long transition approach.

<sup>113</sup> Pensions Commission (2005) page 212

<sup>114</sup> As implicit in the rates for state benefits, including Guarantee Credit

<sup>115</sup> DWP (2006 PI) page 47

Options 5 and 6 are both long transitions to a single-tier, flat-rate pension. Option 5 sets the pension at the same rate for all individuals, regardless of whether they are in a couple or live alone, whereas Option 6 has the reduced rate for couples.

Option 6, with the lower rate for individuals in couples, gives less to higher income pensioners (Chart 9) and means only slightly more pensioners are eligible for Pension Credit (Chart 10). It is less expensive than paying everybody the same rate, as in Option 5 (Table 11).

Because a lower rate for individuals is more affordable and no less progressive, it has been assumed for the single-tier options analysed in Chapter 5.

**Table 11<sup>116</sup>: Projected state expenditure on pensions, as a percentage of GDP and in £ billion, 2006/7 prices**

	<b>Option 5: Long transition to a single tier (same rate for individuals in couples)</b>	<b>Option 6: Long transition to a single tier (lower rate for individuals in couples)</b>
2010	4.9%	4.9%
2020	4.6%	4.6%
2030	5.5%	5.4%
2040	6.1%	5.8%
2050	6.3%	5.9%
2010	71	71
2020	85	85
2030	125	120
2040	165	160
2050	210	200

<sup>116</sup> PPI estimates based on the Aggregate Model and the Distributional Model. See Box 3 for a description of what is included in the total of state expenditure on pensions. £ billion figures are rounded to the nearest £1 billion for 2010 and to the nearest £5 billion for subsequent years.

Chart 9<sup>117</sup>

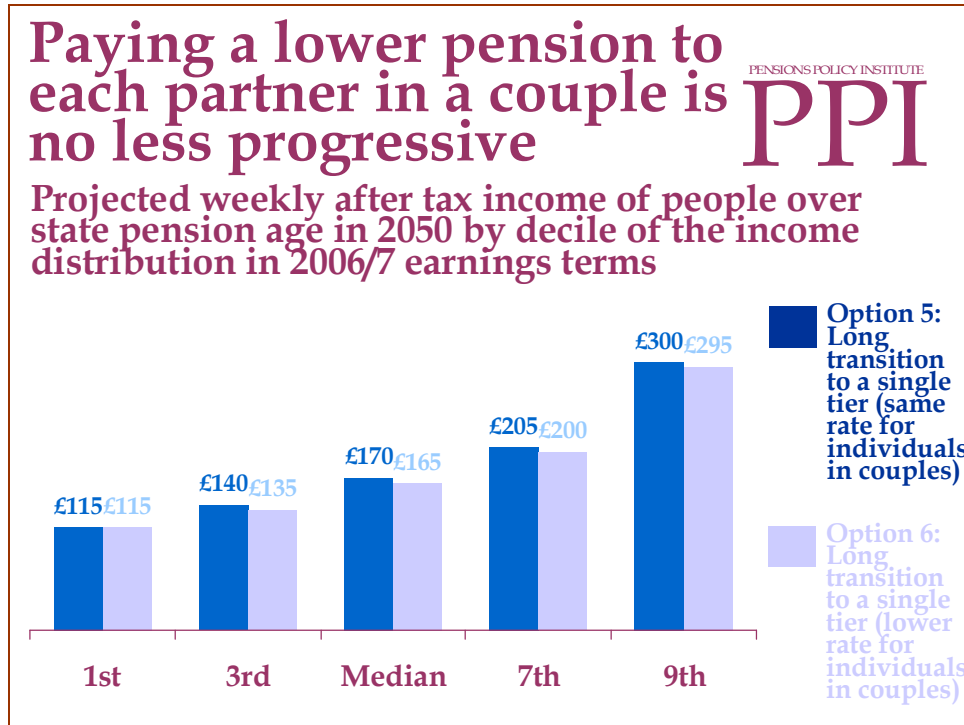
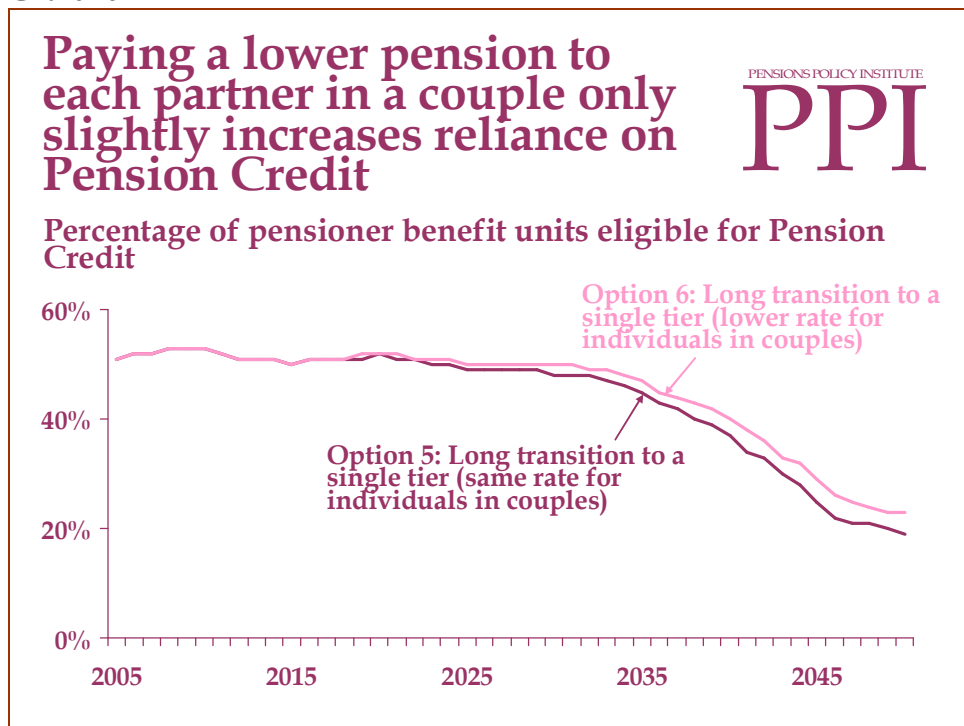


Chart 10<sup>118</sup>



<sup>117</sup> PPI estimates based on the Aggregate Model and the Distributional Model

<sup>118</sup> PPI analysis based on the Aggregate Model and the Distributional Model. See Appendix 2 for further details.

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