PENSIONS POLICY INSTITUTE

PPI

# The long-term cost and spending implications of the single-tier pension

**The impact of the Government's single-tier state pension reform is a research project funded by the Nuffield Foundation**

The PPI is publishing a series of briefings to provide a detailed, comprehensive and independent analysis of the impact of introducing the single-tier state pension.

The first briefing (June 2013) described the main components of the Government's state reform plans and an initial analysis of the possible impact of the reforms on individuals. The second and third briefings (published in October 2013) considered the management of the transition from the current system to the new single-tier pension and the impact of a switch away from the triple-lock back to uprating by earnings. The fourth and fifth briefings (both published in February 2014) addressed the abolition of contracting-out and the impact of changes to State Pension Age.

This final briefing in the series considers the long-term cost and spending implications of the single-tier reforms and a range of alternative assumptions about the setting of the level, uprating, and State Pension Age changes. For more information, please contact the PPI.

## The Government's proposals

The Pensions Bill proposes to implement a new single-tier state pension from April 2016 that will replace the current Basic State Pension (BSP) and the State Second Pension (S2P). The White Paper[1] illustrates the new pension as being set just above the current Guarantee Credit level, at £144 per week (in 2012/13 prices), although the actual level will not be set out in primary legislation, but will be announced by the Government of the day closer to the implementation date of April 2016. The changes will not apply to people who are over State Pension Age (SPA) in April 2016, including those people who reach SPA between now and then. The introduction of the single-tier pension will mean the end of new accruals of S2P, and consequently contracting out from S2P, and will see the removal of the Savings Credit element of the Pension Credit.

## Background

The Department for Work and Pensions (DWP) published an Impact Assessment on the single-tier pension in October 2013.[2] This included an analysis of the long-term spending impacts of the single-tier pension on contributory benefits, means-tested benefits and other pensioner benefits compared to the current system. It also highlighted the expected gains to the Exchequer from the increases in National Insurance (NI) revenues as a result of ending new accruals to S2P and the contracted-out NI rebates from April 2016. This briefing note uses the PPI's Aggregate and Distributional models to expand on the DWP analysis and to illustrate the likely impacts of the single-tier reforms on long-term costs and spending on state pensions under a range of alternative assumptions.

## Government projections

The DWP projections suggest that, assuming the triple -lock is used to uprate the single-tier state pension from 2016 onwards, the single-tier policy and "total state support for pensioners" will remain broadly cost-neutral until around 2040 (Chart 1). Total state support for pensioners includes the costs of contributory state pensions, Pension Credit, Housing Benefit (HB), Council Tax Support (CTS), and other pensioner benefits such as Winter Fuel Payments and Disability Benefits.

Beyond 2040, whilst the cost of both systems is increasing as a percentage of GDP, the DWP projects that the single-tier system will cost less than the current system. Most of the reduction in expenditure is due to the lower costs of contributory benefits and the new single-tier pension compared to the costs of rolling the BSP and S2P forward. The Government estimates it will be spending around £1bn less on the

**Chart 1: DWP projected expenditure on total state support for pensioners under current system and single-tier, £m GB and overseas**

| | 2016 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|
| Current System | £115,500 | £122,200 | £169,000 | £247,900 | £316,300 | £447,700 |
| Single –Tier | £115,500 | £122,100 | £168,800 | £245,000 | £306,300 | £418,200 |
| Change in expenditure | 0% | 0% | 0% | -1% | -3% | -7% |

Pensions Bill Impact Assessment, October 2013
£ figures are in 2013/14 prices

single-tier pension than it would have done on BSP and S2P by 2040, around £10bn less by 2050, and around £30bn less by 2060, in today's prices. In GDP terms, expenditure on "total state support for pensioners" is expected to fall from 9.0% of GDP by 2060 to 8.4% of GDP by 2060. This is primarily because, without the single-tier reforms, some individuals (particularly median to higher earners and those with long contribution histories) would have been building up significant entitlements to S2P. There are also savings in expenditure on Pension Credit, HB and CTS projected in future years.

In addition to changes to contributory, mean-tested and other pensioner benefits, the introduction of the single-tier will coincide with the ending of new accruals to S2P and contracting-out. Based on current DWP and Government Actuary's Department (GAD) assumptions about the future levels of the contracted-out rebates, earnings/accrual bands for S2P, and the falling numbers who are expected to be members of contracted-out Defined Benefit (DB) schemes over time, the Exchequer is expected to be saving a further £5.0bn in 2016, £4.6bn in 2020 and £3.7bn in 2030.[3] As the contracted-out rebates currently pre-fund future S2P payments foregone (by funding benefits in contracted-out DB pension schemes), these savings represent a transfer away from state spending on future pensioners. The savings are realised in the form of higher NI revenues.

At Budget 2013 the Chancellor announced that some of the savings from the NI rebates, including the additional savings from bringing forward the assumed implementation date from April 2017 to April 2016, would be earmarked to help fund the Dilnot package of social care reforms (costing £1.0bn per year in 2016) and additional childcare support (costing £750m in 2016). There will be different distributional consequences depending on how these savings are reallocated and these are discussed later in this note.

**Entitlement to the single-tier pension**
Those reaching SPA from April 2016 will be entitled to the new single-tier pension. The single-tier pension is expected to be set at £144 per week in 2012/13 prices and will require 35 qualifying years for full entitlement. Those with fewer than 35 years but above a minimum qualifying period (to be set in regulations at 10 years as announced during the Pensions Bill) will receive a proportionately smaller weekly amount.

The arrangements for the single-tier pension set out in the Government's January 2013 White Paper included a faster transition to the single-tier compared to the initial Green Paper proposals published in April 2011[4]. Individuals' pre-implementation NI records will be used to provide them with two valuations in April 2016:

- A 'current scheme' valuation—which uses the same rules as if someone had reached SPA at that point; and
- A 'single-tier' valuation— which calculates what entitlement someone would have had if the single-tier pension had been in place over the course of their working life.

Those who have spent time during their working life contracted-out of SERPS and/or S2P will then have an amount deducted from each valuation to reflect the fact that part of their future state pension entitlement will be delivered through a private pension scheme instead[5].

For the 'current scheme' an amount is subtracted from the valuation to reflect contracted-out deductions from SERPS and S2P. For the 'single-tier' an amount is subtracted from the valuation to reflect a 'Rebate Derived Amount' and to ensure that individuals do not benefit from the increase to their state pension entitlement and any private pension they built up as a result of being contracted-out.

The individual's final 'foundation amount' will reflect the higher of the two valuations as at April 2016 once those subtractions have been made.

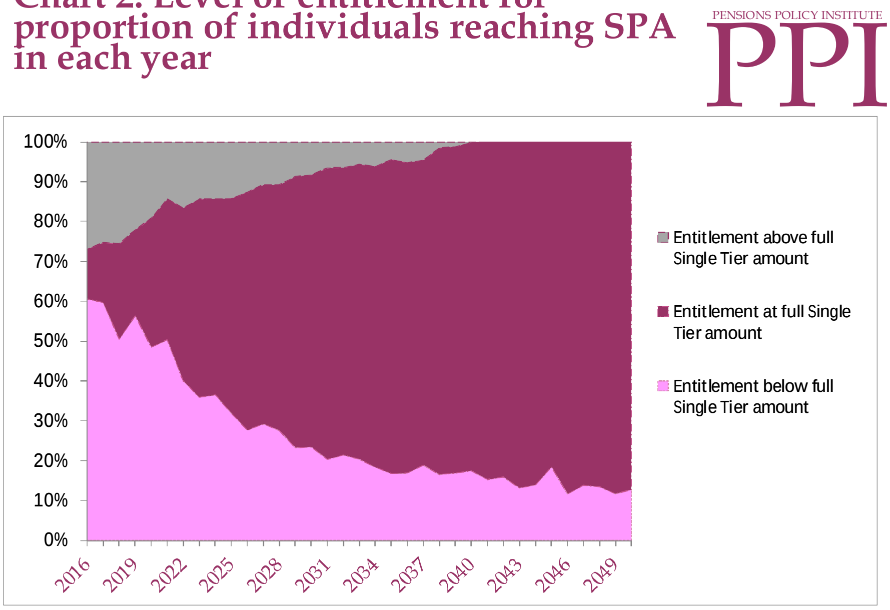
Those individuals below SPA who have a foundation amount of less than £144 per week will then be able to build up new entitlement under the single-tier system from April 2016, up to a maximum entitlement of £144 per week. That will include some individuals who already have contracted-out rights that would otherwise take them over the £144 per week but who are now in a position to build up new entitlement to the single-tier pension.

If the 'foundation amount' is more than £144 per week, the amount above the single-tier level will be protected (and uprated by prices using the Consumer Price Index (CPI) over time) and paid on top of the single-tier pension from SPA. As the single-tier is assumed to be uprated by the triple-lock (the higher of CPI, earnings and 2.5%) the protected amount is expected to gradually lose value over time compared to the single-tier.

# The long-term cost and spending implications of the single-tier pension

In April 2016 there will therefore be individuals reaching SPA with 'foundation amounts' and state pension entitlements at, above, or below the full single-tier amount. DWP's estimates of entitlement to the single-tier (Chart 2) show that in 2016 61% of those reaching SPA have below full entitlement to the single-tier, whilst 13% qualify for the full amount and 27% have above full entitlement. Men reaching SPA are more likely to have above full entitlement than women reaching SPA in 2016.

**Chart 2: Level of entitlement for proportion of individuals reaching SPA in each year**




Source: DWP estimates of level of entitlement to single-tier *(based on the modelling and economic assumptions in the October 2013 Pensions Bill Impact Assessment)*

The transition to the single-tier occurs over the next two to three decades, and, as Chart 2 shows, virtually no individuals are reaching SPA with entitlement above the full amount of the single-tier by 2040. Meanwhile 15-20% are still reaching SPA each year with entitlement below the full amount due to having less than the maximum of 35 qualifying years, or through having years previously contracted-out but not having enough years post April 2016 to build up the full amount. By 2040, over 80% are reaching SPA entitled to the full single-tier amount of £144 per week.

There is limited analysis available on those groups who do not receive any entitlement at all to the single -tier pension in future years because of the 'Minimum Qualifying Period' (MQP). The DWP Impact Assessment models a MQP of 10 years and concludes that around 2% of the total caseload for GB residents and 20% of the caseload for overseas residents will be affected, saving the Government around £650m per year by 2040.

**Entitlement to Pension Credit and other means-tested benefits under the single-tier**

With the introduction of the new single-tier pension, eligibility for Pension Credit for those reaching SPA from April 2016 is expected to fall significantly. This is because:

- the higher level of the single-tier pension (at £144 per week in 2012/13, set just above the level of the Guarantee Credit) will lift more pensioners above the level of the Standard Minimum Guarantee; and
- the abolition of the Savings Credit element of Pension Credit means that very few pensioners reaching SPA from April 2016 are eligible for Savings Credit in future years (a small number may be who were part of a couple where one member reached the qualifying age before it was removed).

As a transitional measure, for the first five years, there will be additional support with rent and council tax for those who would have received higher support with these costs had Savings Credit remained in place. The details of this transitional measure have not yet been announced.

Guarantee Credit, HB and CTS, and other pensioner benefits will continue to provide a safety net for those with low incomes from their state and private pensions. The DWP's Impact Assessment projected small reductions in spending on HB and CTS under the single-tier compared to the current system, whilst the cost of other pensioner benefits remained unchanged.

**PPI modelling approach used to estimate the costs of the single-tier reforms**

The projected expenditure on the BSP, S2P and the single-tier pension is calculated using the PPI's Aggregate Model. The Aggregate Model projects forward state pension spending taking into account future economic conditions, changes in population size and the labour market, and changes in policy.

# The long-term cost and spending implications of the single-tier pension

The PPI modelling of the single-tier pension uses the latest ONS 2012-based population projections and mortality rates. The economic assumptions used are in line with the OBR's 2013 fiscal sustainability report, and assume long-term earnings growth of 4.4%, long-term CPI of 2.0% and long-term triple-lock indexation of 4 .7%. Over the long-term the triple-lock is assumed to exceed average earnings growth by 0.3%, in line with the DWP's assumptions for the triple-lock.

Pension Credit expenditure is estimated using the PPI's distributional model, a static micro-simulation model which uses the income data from a sample of around 8,000 UK pensioners projected forward, with consideration for demographic and policy changes and alterations in spending. All figures presented in the following charts are expressed as a percentage of GDP (in 2014 terms).

**Comparing the DWP and PPI expenditure projections**

The figures presented in this briefing note are not directly comparable with the figures from the DWP's Impact Assessment on the single-tier. Some important differences include:

- The exclusion of non-UK resident recipients of the BSP or single-tier pension in the PPI modelling;
- The exclusion of HB, CTS and other pensioner benefits from the PPI modelling; and
- The use of 2012-based population projections in the PPI modelling (the DWP Impact Assessment used the earlier 2010-based population projections).

The projections for expenditure on the single-tier are based on the PPI's Aggregate Model outputs, using the DWP's projected proportions of those reaching SPA in each year above, below and at the full single-tier. The projections for expenditure on the current-system, in particular the projected expenditure on S2P, are complicated by incremental changes to entitlements over time, including changes to credit entitlements and derived rights. To ensure comparability between the DWP and PPI estimates of future spending under the current system the PPI's projections for S2P spending from 2030 onwards have been calibrated to the DWP's projections.

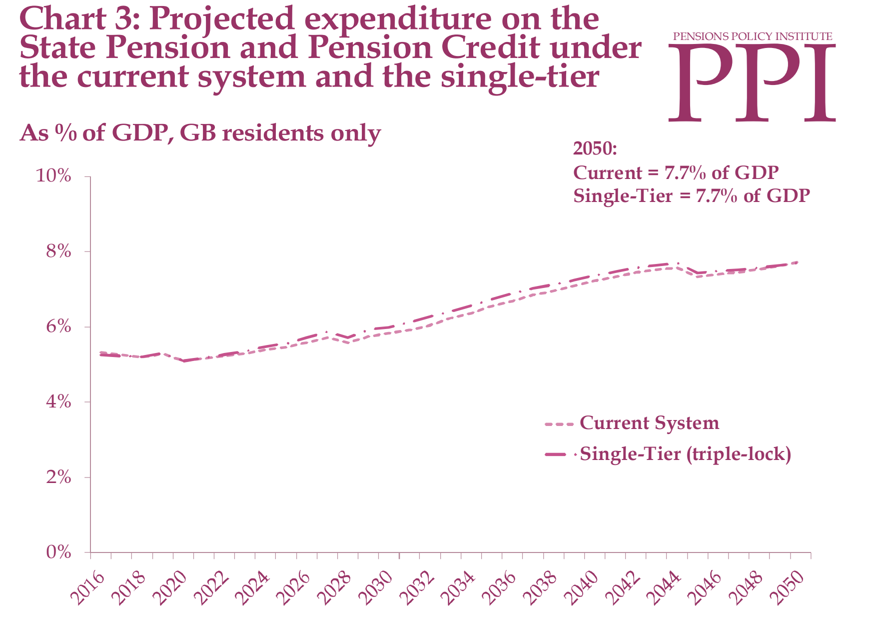
**PPI projections of spending under the current system and the single-tier**

To compare the projected costs of the new single-tier system with the current system a starting assumption must be made about the level at which the single-tier pension is set in April 2016 when it is first introduced.

Whilst this is not set out in primary legislation, we have assumed that the starting level is set at £156.90 per week in April 2016, consistent with the DWP's own assumptions and based on the £144 per week in 2012/13 being uprated by earnings increases to April 2016/17 to reflect the expected increases in the level of the Guarantee Credit.

Chart 3 shows that the total expected spending on State Pensions and Pension Credit is very similar under both systems, with the single-tier costing only slightly more than the current system in the early years (as the cohort reaching SPA each year becomes eligible) then rising to an increase of 0.2% of GDP by the early 2030s (reflecting the build of early gainers who are now pensioners). The in-year differences in spending then start to fall until the two systems appear to break-even in around 2050, as beyond 2030 many mid-high earners reaching SPA begin to see losses compared to the current system as they would have built up significant entitlements to S2P.

**Chart 3: Projected expenditure on the State Pension and Pension Credit under the current system and the single-tier**



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# The long-term cost and spending implications of the single-tier pension

**PPI projections of spending under different variants of the single-tier**

To illustrate the flexibility within the primary legislation and the potential paths for future spending under the single-tier we have modelled a series of alternatives to the core single-tier assumptions, based on setting different assumptions about the future uprating of the single-tier pension, the starting level at which the single-tier is set in April 2016, and the further anticipated changes to State Pension Age which were announced by the Chancellor in his 2013 Autumn Statement[6].

These projections are relevant as neither the future indexation of the single-tier by the triple-lock, or the starting level of the single-tier, are included within the Pensions Bill. It is therefore within the gift of future governments to set an alternative spending path for the single-tier pension without the need for changes to primary legislation.

**Chart 4: Projected expenditure on the State Pension and Pension Credit under the single-tier with different uprating assumptions**

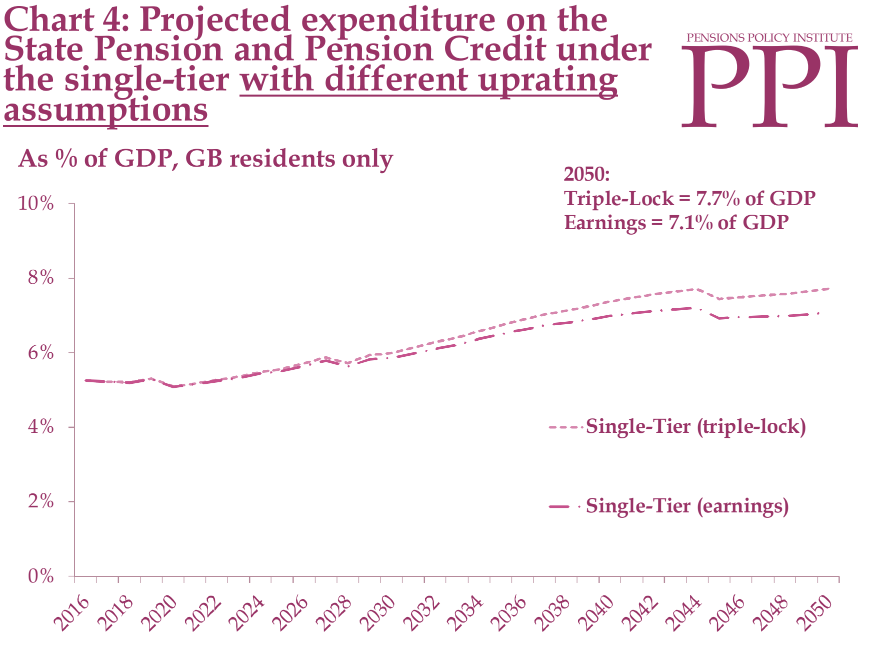


Chart 4 shows the change in future spending were the single-tier set at £156.90 in April 2016 but then uprated by earnings instead of the triple-lock. With the triple-lock uprating assumption 0.3% higher than average earnings growth over the longer-term, we find that the single-tier (the costs of delivering the State Pension and Pension Credit) would cost 0.6% of GDP less by 2050 than under the triple-lock. Put another way, the State Pension and Pension Credit would cost around 92% of the costs under the single-tier with the triple-lock. There is therefore scope for future spending on pensioners to be reduced under the single-tier as being legislated for in the Pensions Bill. Indeed, the current legislative requirement within the Pensions Act 2007 is for the state pension to be uprated by average earnings growth over time.

**Chart 5: Projected expenditure on the State Pension and Pension Credit under the single-tier with a higher starting level and the earnings link**

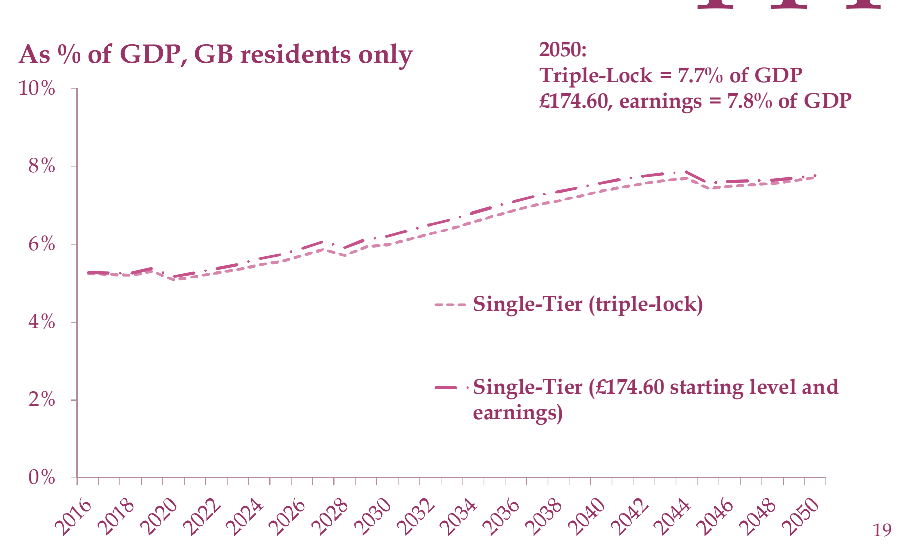


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Chart 5 goes on to illustrate an alternative single-tier system where the starting rate is set at a higher level, of £174.60 per week in April 2016 rather than £156.90, and the single-tier pension is then uprated by earnings rather than the triple-lock over time. The higher starting level of £174.60 roughly breaks even with £156.90 triple-locked in 2050.

Under this approach we find that the evolution of future spending looks similar to under the core single-tier assumptions, though with total expenditure on the State Pension and Pension Credit around 0.2% of GDP higher each year throughout the 2030s (these are likely to be slight over-estimates as some individuals who previously had protected payments above £144 per week would now be at or below the higher level of the single-tier). The difference between the two systems then falls as the higher starting value of the single-tier pension is eroded by the lower uprating over time, with the two systems costing a similar amount by 2050.

If a future government wanted to pay a higher single-tier pension to those currently approaching SPA this would be one route to do so. However such a policy would be likely to increase political pressure for the new single-tier pension to also be extended to existing pensioners. Beyond 2050, it would be expected that the value of the single-tier pension would fall below the triple-locked £156.90 in April 2016, and so the alternative system would start to cost less in every year.

Two further alternatives are now considered, one illustrating the impact of potential further changes to SPA, and one illustrating the combined impact of those SPA changes and the earnings uprating of the single-tier pension.

The Pensions Minister, Steve Webb MP, announced in 2013 that the review process for setting the SPA in future will be informed by the principle that on average an individual should spend 'up to a third of their adult life in retirement'. For this purpose adult life is defined as starting at age 20. In the Autumn Statement 2013, the Chancellor reiterated this principle and suggested that, accordingly, the UK's SPA would increase to 68 by the mid 2030s and to 69 by the late 2040s.

Chart 6 demonstrates the impact of implementing these SPA changes on the future path of spending in the single-tier system. The increase in the SPA to 68 is assumed to be brought in in 2034, and the increase to 69 is assumed to be brought in in 2044. The SPA increases to 68 and 69 being accelerated reduces the cost of the single-tier system by between 0.3% and 0.4% of GDP from the mid-2030s onwards as there would be fewer pensioners in each year eligible to claim the single-tier pension and Pension Credit.

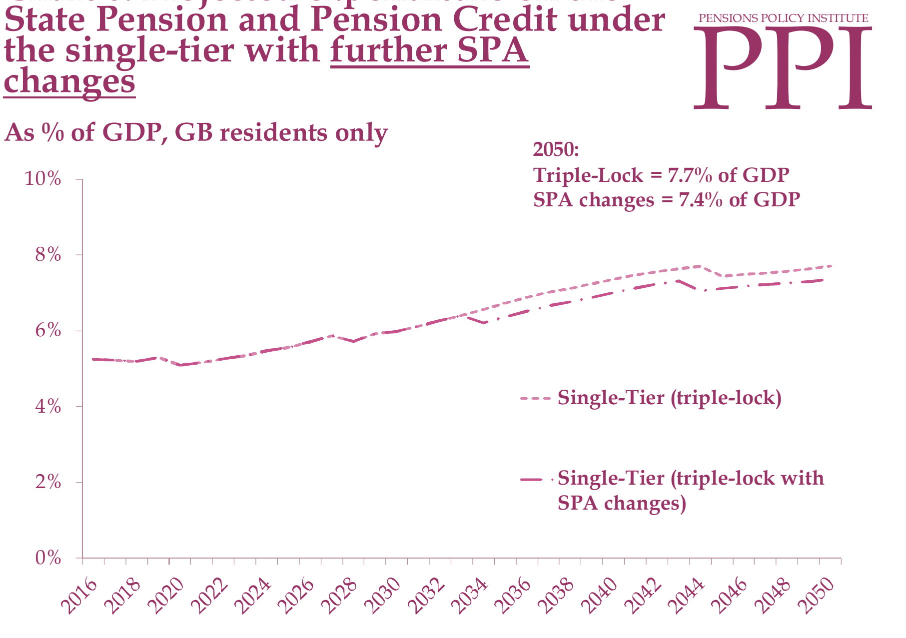
This is significant as the DWP's Impact Assessment for the Pensions Bill did not assume these further increases to the SPA would apply, and so the Impact Assessment is likely to over-estimate the true cost of both the current system and the single-tier system.

However, the potential savings in future spending on pensioners are also likely to be partly offset by higher working-age benefit costs for those just below SPA who are unable to work (which would reduce overall savings). Set against this, higher numbers of working-age people working and paying tax would be expected to increase GDP reducing the relative cost of supporting pensioners.

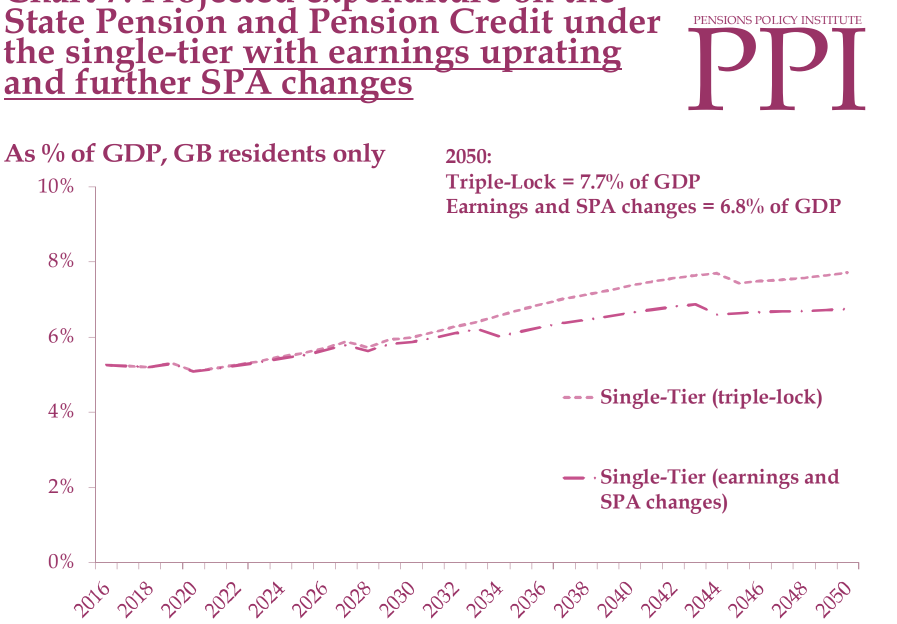
Finally, we consider an alternative where both measures to reduce future spending on pensions are deployed, with earnings uprating adopted from April 2016 onwards and with the expected SPA increases implemented in the 2030s and 2040s. Chart 7 shows the potential reductions in spending from this approach. By 2050, the changes combined reduce the total cost of providing the State Pension and Pension Credit by 1.0% of GDP, with the total spending less than 90% of spending under the core single-tier approach.

**Chart 6: Projected expenditure on the State Pension and Pension Credit under the single-tier with <u>further SPA changes</u>**

**As % of GDP, GB residents only**



## Chart 7: Projected expenditure on the State Pension and Pension Credit under the single-tier with earnings uprating and further SPA changes




Again, as the legislative requirement for uprating the state pension over time remains the link to average earnings growth, and as the further SPA increases are now expected given the latest projections of life expectancy and the principle for setting the future SPA set out by the Pensions Minister and the Chancellor, this is a plausible alternative scenario for the path of future spending.

**Further savings to the Exchequer from abolition of the contracted-out rebates**

The ending of new accruals to S2P in April 2016 and the associated abolition of contracting-out into DB schemes in both the private and public sector will generate significant savings for the Exchequer from 2016 onwards. These savings will arise through increased NI revenues once the NI rebate is abolished. The annual 'savings' compared to the current system will depend on the baseline assumptions about the numbers of schemes and members expected to still be contracted-out in April 2016 and beyond.

Whilst the DWP's Impact Assessment included projections of the increases in NI revenue as a result of the single-tier reforms, it did not include these in it's overall assessment of the cost-neutrality. As the increases reflect revenues that were previously being used as rebates to cover the costs of future pension provision in DB pension schemes they reflect a transfer away from funding future pensioners' state pension rights.

Depending on how those revenues are redeployed it could be argued that they reflect a transfer away from those of working age now (i.e. future pensioners) to other groups. For example, the announcement at Budget 2013 that part of the savings from the contracted-out rebates would be used to fund the cost of the Dilnot long-term care reform package suggests that current pensioners are expected to significantly benefit from the rebate savings, at least in the early years of the transition.

However, changes in the costs of pensions tax relief (for example, from increased numbers saving through automatic enrolment), or increases in housing wealth and other forms of inheritance passed down to younger relatives of those benefiting from the Dilnot long-term care reforms, could be argued to be recycling at least some of the rebates back to the same groups affected.

And if some of the savings are used to reduce the annual deficit, which in turn reduces future interest payments on national debt, and implies lower taxes or borrowing in future years, then those of working age are again likely to benefit.

The behavioural response from employers to the abolition of contracting-out is also difficult to predict. If some employers do not change the structure of their DB schemes, or do not increase employee contributions, some employees may benefit from higher state pension entitlements under the single-tier and maintain their level of DB scheme accruals. For example, the Government recently announced that for schemes covered by the Protected Persons Regulations employers would not be able to use the statutory override to change the schemes' benefit structures, and would have to negotiate any changes with trustees and scheme members instead.

Public sector employers with funded pensions, most notably Local Authorities using the Local Government Pension Scheme (LGPS), are also restricted in the changes they can make to their scheme structures and contribution rates by the 25-year deal agreed at the time of the public sector pension reforms.[7] So while members of these schemes will be paying higher NI contributions from April 2016 onwards, their employers will not be making any changes to reduce their own employer contributions to offset the loss of the employer NI rebates. Part of the NI rebate savings could therefore be recycled in the next Spending Review to directly compensate those public sector employers with funded schemes who are prevented from making any changes. However, this would leave less of the savings available to fund other reforms, including the Dilnot proposals.

**Conclusion**

The single-tier reforms to the state pension system represent a radical shift in pensions policy towards a flat-rate pension. The PPI's estimates, like the DWP's estimates, suggest that the single-tier will start to cost less than the current system over the longer-term.

However, one aspect of the changes that has not been explicitly considered in the DWP's cost-neutrality assessment is the removal of contracting-out from April 2016. If this was incorporated in the DWP's Impact Assessment, for example by comparing the single-tier system against the current system without contracting-out from April 2016, it is expected that the single-tier reforms would generate more substantial savings, and earlier savings, than has currently been described.

In addition, the PPI's own modelling demonstrates that, under the reforms contained within the current Pensions Bill, there is still significant scope for future governments to alter the path of state pension spending, Changes could be made to the level of the single-tier pension, and to the uprating of the single-tier pension, (returning to the earnings link) without recourse to primary legislation. Similarly, further changes to the SPA, that more than offset the impact of changes in longevity, could also reduce costs (though arguably, these changes would apply equally to the single-tier and the current system).

The single-tier reforms are likely to bring new challenges for future governments in due course.

The unavoidably complex transition to the single-tier will mean that it is not until 2025 that the majority of those reaching SPA receive exactly £144 state pension per week in state pension. This raises questions about how the reforms can be clearly communicated and explained to the general public.

The length of the run-off of the current system (for all those reaching SPA before April 2016) could also create pressure on future governments to speed up the transition and move older pensioners onto the single-tier.

Finally, the levers that future governments have to change the path of future spending will be far more transparent in future - with a simpler, flat-rate pension in place instead of a combination in BSP, S2P and Pension Credit entitlements. This could make changes to the single-tier more politically attractive if they can be easily explained to the electorate, but could also make it more difficult for future governments to make savings by tinkering with aspects of the state pension system.

The PPI will continue to monitor the development of the single-tier reforms as the Pensions Bill receives Royal Assent and as the reforms are implemented.

1 DWP (2013) *The single–tier pension: a simple foundation for saving*
2 DWP (2013) *Impact Assessment: The single-tier pension: a simple foundation for saving.*
3 DWP (2013) *Impact Assessment: The single-tier pension: a simple foundation for saving*
4 DWP (2011) *A state pension for the 21st century*
5 DWP (2013) Technical Note: The Single-Tier Transition and Contracting Out
6 HM Treasury (2013) *Autumn Statement*
7 HM Treasury (2011) *Statement by the Chief Secretary to the Treasury, Rt Hon Danny Alexander MP on Public Service Pensions*

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