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What could be the implications of the Government's proposed state pension reforms?

Introduction

The Coalition Government has launched a Green Paper to consult on possible reforms to state pensions that could significantly change the structure of the current pension system.[1]

The Government has stated four principles for the reform: enabling personal responsibility, ensuring that all groups are treated fairly, making the state pension system more simple and ensuring the affordability and sustainability of any reform option, meaning that any reform option must cost no more than maintaining the current system.

The Government has made clear that the reforms would only relate to the future state pension system. State pension entitlements that individuals have already built-up would be honoured.

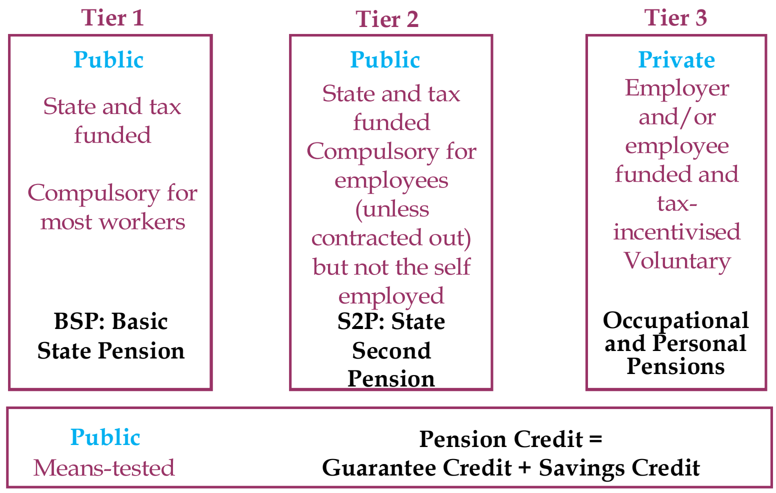
This briefing note examines the structure of the current state pension system, the implications of the Government's proposed reforms and sets out the trade-offs involved.

The current pension system

The structure of the UK pension system is complex. Its foundations were laid in the 1940s. Since the 1960s, successive governments have changed elements of both the state and private pension system.[2]

In its current form, the UK pension system can be divided into three tiers. The first two tiers are funded by the state through National Insurance Contributions (NIC's) and general taxation. The third tier is funded by the employee and/or the employer and with tax relief from the Government (Chart 1):

Chart 1: The current UK pension system



Tier 1 is represented by the Basic State Pension (BSP). Since 2010, a minimum of 30 years of NIC's or credits are necessary in order to qualify for the full BSP of £102.15 per week (in 2011/12). Currently, not everyone qualifies for a full BSP. It is estimated that 95% of people reaching SPA in 2025 will be entitled to a full BSP.[3]

From 2011, the BSP will be increased each year by the higher of earnings growth, growth in the Consumer Price Index (CPI), or 2.5%, a mechanism known as the 'triple lock'.

In addition to the BSP, pensioners can also qualify for a number of means-tested benefits such as Pension Credit, Housing Benefit, Council Tax Benefit (among others) and other benefits such as Winter Fuel Payments, to top up their weekly income.

Pension Credit tops up pensioners' income to make sure that they are above a certain minimum. Pension Credit has two elements, Guarantee Credit (GC) and Savings Credit (SC). From 6 April 2011, GC guarantees a minimum income of £137.35 per week for single pensioners and £209.70 for couples. Savings Credit aims to ensure that those who have made some private provision for retirement will be better-off than those who have made no provision. From 6 April 2011 the maximum SC is set at £20.52 per week for singles and £27.09 for couples until 2014.

Pension Credit has to be claimed and in 2008/09 between 27% and 38% of pensioners who were entitled to Pension Credit did not claim it.[4]

Tier 2 is represented by the State Second Pension (S2P), which replaced the State Earnings Related Pension Scheme (SERPS) in 2002. The original aim of SERPS was to provide a level of retirement income linked to employees' earnings. However, S2P is moving towards a flat-rate benefit. Employees with earnings above £5,304 and up to £14,400[5] accrue a S2P benefit of £1.60 per week for each year of NIC's. Employees with earnings between £14,400 and £40,040[6] accrue an extra S2P benefit up to around an extra £1 per week for each qualifying year of NIC's.[7] Following provisions in the Pensions Act 2007 the upper limit of £40,040 will effectively be reduced to £14,400 by around 2030, leaving a weekly flat-rate benefit of £1.60 per week for each qualifying year.

How much S2P people actually get at retirement depends on how many years they qualify for. S2P gives credits to certain groups who do not have earnings, such as disabled people and carers. The credits give entitlement to the flat-rate S2P benefit of £1.60 per week.

Currently, the maximum S2P benefit that someone can receive is £159.52 per week, on top of a maximum basic state pension of £102.15, giving a total possible state pension in the current system of £261.67 per week in 2011.

At present, the self-employed are not eligible for S2P and they pay lower NIC's. Overall, approximately 70% of the working-age population qualify for S2P each year, based on earnings and credits.[8]

Pensions in payment from S2P are increased annually by the rise in the CPI.

Tier 3 consists of private pensions and it includes all voluntary pension arrangements. This includes defined benefit (DB) and defined contribution (DC) occupational, stakeholder and personal pensions.

It is possible for members of occupational, stakeholder and personal pension schemes to contract-out of S2P if certain criteria are met, which broadly mean that scheme members will not, on average, be worse-off by giving up the benefit than if they had remained in S2P.[9]

Employers and employees in DB contracted-out schemes pay lower NIC's, sometimes known as the National Insurance Rebate. Members of DC schemes receive an additional rebate based on their age and earnings.[10]

The Government Proposals and the trade-offs involved

The Green Paper consults on two possible reforms:

1) an acceleration of the existing reforms so that the state pension evolves into a two-tier flat-rate structure more quickly.

2) a more radical reform towards a single-tier flat-rate pension set above the current level of the Guarantee Credit element of Pension Credit (for example £140 per week).

Option 1 would accelerate the pace of the reforms legislated for in the Pensions Act 2007, with the State Second Pension becoming flat-rate by 2020, instead of 2030. This would imply that the current upper limit for additional S2P accrual (£40,040) would be brought down to £14,400 by 2020, leaving a flat-rate S2P benefit of £1.60 per week for each qualifying year. For an individual with a full working life under this system (with 52 years of contributions from age 16 to SPA at age 68 in 2072), this would mean a S2P benefit of £83.20 (52 x £1.60) per week (2011 earnings terms). On top of a full BSP this would give total state pension of around £203 a week in 2072 (in 2011 earnings terms). This compares to a possible maximum of £207 a week under the current system (in 2011 earnings terms).[11]

But there would be a range of outcomes, depending on how many years of S2P an individual qualified for. A self-employed person with the same earnings history would just get the BSP of £120 a week (in 2011 earnings terms), as the self-employed do not accrue rights to S2P and pay lower NICs. The Government is consulting to extend coverage of S2P to the self-employed within option 1.

The transition to a fully flat S2P benefit for all pensioners would be slow. People retiring after 2020 would receive some of their S2P under the current rules and some under the new rules. It would not be until people who started working in 2020 reach SPA, around 2072, that everyone would start to receive a fully flat rate S2P.

Under this option, it would still be possible to contract out of S2P, albeit with lower rebates paid to DB schemes than today due to the flat-rating of S2P. At retirement, contracted out workers would receive a BSP and a private pension that would compensate for not receiving S2P.

The uprating of pensions in payment would follow the current rules. The BSP would be uprated by the 'triple lock' while the S2P would be uprated by CPI growth. The Green Paper also highlights that under this option the Savings Credit element of Pension Credit would be retained.

Compared to the current system, Option 1 would retain the structure of the current system composed by the BSP and the S2P but it would accelerate the flat-rating of S2P.

However, long transition rules would be necessary to account for past State Second Pension entitlement and the system would not pay fully flat rate benefits until around 2070. In addition, the different uprating mechanism for the BSP and the S2P may retain complexity.

If no other rules are changed, this option would lead to lower Government spending on state pensions from 2020. This is due to the elimination of extra S2P accrual by 2020, instead of by 2030. As a consequence, people earning between £14,400 and £40,040 would lose some extra entitlement to S2P from 2020.

Maintaining contracting out would allow scheme sponsors to keep receiving National Insurance rebates, albeit lower than today. This may be important for sponsors of DB schemes, who have faced rising costs in the last decade, partly due to increased longevity. However, this would also prevent progressing towards a single National Insurance rate for all employees.

Retaining Savings Credit would imply no significant savings to Government in means-testing administration. Calculating eligibility for and paying means-tested benefits is expensive.

Finally, keeping the current means-tested system would not improve the incentives to save in a private pension.

Option 2 entails the introduction of a single-tier pension for new pensioners with at least 30 years of National Insurance Contributions, estimated at around £140 per week in the Green Paper when it is introduced. The Government has indicated that this could be in 2015 or 2016. People would qualify for the new pension on an individual basis and the self-employed would be eligible. People with less than 7 years of NIC's would not qualify for the new single-tier pension.

However, the new single-tier pension would not apply to individuals who had already reached their SPA before the implementation date.

The single-tier pension would replace the current BSP and S2P and it would be uprated by the 'triple lock.'

Under option 2, the flat-rate single pension would be worth £165 a week (2011 earnings terms) by 2072, broadly the same as someone with 30 years of flat-rate S2P.[12] This compares to a maximum possible total

Chart 2: The trade-offs of the different reform options

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	Pros	Cons
Option 1: accelerate reforms set out in the Pensions Act 2007	• Current rules broadly maintained. • Retains contracting out, which may help employers to keep DB schemes. • Lower state spending from 2020, if no other rules are changed.	• Workers with earnings between £14,400 and £40,040 would get less S2P from 2020 to 2030. • Long transition rules. • Pensions in payment not flat-rate until 2070. • Retains a means-testing element.
Option 2: introduction of a Single-Tier Pension of £140 a week	• Simpler system in the long term and clearer what pension the state will provide. • People with incomplete NIC records may get a higher pension than under the current system. • The self-employed may get higher pensions, but they may need to pay higher NIC's. • Immediate increase in Government revenue from ending contracting-out. • People who are entitled but fail to claim Pension Credit would get a higher pension.	• Transition rules necessary to recognize past S2P entitlement and contracted-out pensions. • Scheme sponsors would lose NIC's rebates, which could accelerate the closure of DB Schemes. • Some people who would have been entitled to Savings Credit could lose income. • People who would have accrued high S2P in the current system could get a lower pension. • People with less than 7 years of NIC's could be worse-off.

pension in 2072 of £207 a week under the current system, or £203 a week under option 1 (both in 2011 earnings terms).

The Savings Credit element of Pension Credit would be abolished. However, it is not clear what would happen to pensioners who are currently automatically entitled to Housing and Council Tax Benefit because of receiving Guarantee Credit if they are no longer able to qualify for this benefit because of receiving a higher single-tier pension.

The elimination of S2P would end contracting out and all employees would pay the same rate of NIC's, irrespective of the type of pension scheme offered by their employer. Scheme sponsors would no longer receive NIC rebates for contracted-out employees.

To ensure a fair transition to the new system, people receiving the single-tier pension who had been contracted-out would receive a reduced pension (lower than the estimated £140 a week) to compensate for the fact that they would receive a private pension that would replace the S2P given up.

In a similar vein, past entitlements to S2P which, according to the current rules, would result in a total state pension above £140 a week would need to be recognised. So until large past entitlements to S2P have declined, some pensioners would get a higher state pension than others. In addition, some pensioners would lose entitlement to the abolished Savings Credit.

Compared to the current system, option 2 would make the state pension system more simple and transparent with a single uprating mechanism.

In addition, people with incomplete NIC's may be better-off than under the current rules and the self-employed would get a higher pension, although they may need to pay higher NIC's. By contrast, individuals with less than 7 years of NIC's could be worse-off as they would not qualify for the new pension.

Transition rules would still be necessary to recognise existing entitlements to S2P that would take the total state pension above the £140 level.

The ending of S2P and contracting out would lead to a single NI rate, and there would be an immediate increase in Government revenue due to the removal of the NIC's rebate. In 2010/11 the Government spent almost £7bn in contracted out rebates.[13] Yet, losing the rebates may put further pressure on DB schemes' sponsors.

The reduction in means-testing could lead to administrative savings, and could also help to make clearer the benefits of saving for some people.

People who are entitled to but do not claim PC would be better-off under this option as the new single tier pension would provide a higher state pension than they currently receive. Meanwhile, some who would have accrued high entitlements to S2P or who would have been able to claim SC could be worse-off.

Conclusions

Both reform options would imply a significant reform of the current state pension system and they would both create winners and losers. The PPI will be producing a full assessment of both reform options to feed into the Government's consultation.

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1 DWP (2010) *A State Pension for the 21st Century*
2 PPI (2011) *The Pensions Primer*.
3 DWP (2007) *Gender Impact Assessment of Pension Reform* p.18
4 DWP (2010), *Income Related Benefits Estimates of Take-up in 2008-09*.
5 Lower Earnings Limit (LEL) and Lower Earnings Threshold (LET), respectively.
6 Upper Accrual Point (UAP).
7 This is assuming 49 years of contributions for an employee earning above the UAP during all his working life.
8 PPI (2010) *Pensions Facts*, Table 10.
9 From April 2012 contracting out of S2P for members of occupational, group, stakeholder and personal DC schemes will be abolished. Only members of DB schemes will be able to contract out of S2P.
10 See: www.hmrc.gov.uk/ni/reducedrate/contractedout.htm
11 All 2072 figures are PPI estimates, assuming that the triple lock increases by approximately 0.25% a year in excess of average earnings (based on analysis of historical data)
12 Although in the years after retirement, the whole pension would be increased by the triple lock in option 2
13 HMRC (2010) *Tax expenditures and structural reliefs, 2007-08 and 2008-09* . Table 1.5.

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