

<b>Title:</b> The single-tier pension: a simple foundation for saving <b>IA No:</b> DWP0028 <b>Lead department or agency:</b> DWP <b>Other departments or agencies:</b> HMRC, HMT	<b>Impact Assessment (IA)</b>			
	<b>Date:</b> May 2014			
	<b>Stage:</b> Royal Assent			
	<b>Source of intervention:</b> Domestic			
	<b>Type of measure:</b> Primary legislation			
<b>Contact for enquiries:</b> Lewis Smith (0207 449 7069)				
<b>Summary: Intervention and Options</b>			<b>RPC Opinion:</b> Not in scope	

**What is the problem under consideration? Why is Government intervention necessary?**

The Government is concerned that the current State Pension will not provide a clear foundation to support people in taking greater personal responsibility for saving for their retirement. Levels of private saving are in decline and prior to reform of workplace and State Pensions it is estimated that around 13 million people are not saving enough for an adequate retirement income.

To address the challenge of under-saving, eligible workers are starting to be automatically enrolled into workplace pensions. However, there is still substantial complexity in the current State Pension system and reliance on means-testing results in less clear savings incentives. Within the context of automatic enrolment, a reformed State Pension would provide a clear foundation for individuals in making savings decisions. Reform is also needed to ensure the cost of the system remains sustainable.

**What are the policy objectives and the intended effects?**

To deliver a simpler and fairer State Pension that provides a better foundation for saving and is sustainable for future generations. The intended effects of State Pension reform are:

- individuals have a better understanding of the State Pension system, including how much they can expect to receive and, therefore, engage more actively with planning for retirement;
- inequalities of State Pension outcomes within the current system are reduced;
- individuals have reduced interaction with means-tested benefits in retirement;
- the State Pension system is more affordable and sustainable in the long-term.

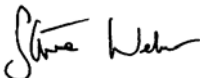
**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

A previous version of this Impact Assessment (January 2013) considered two alternative policy options (“Do nothing” and “Speeding up flat-rating of the State Second Pension”). This is available on the DWP website. This version of the Impact Assessment solely focuses on assessing the measures set out in the Pensions Bill 2013.

**Will the policy be reviewed?** It will be reviewed. **If applicable, set review date:** April 2021

Does implementation go beyond minimum EU requirements?	N/A				
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	<b>Micro</b> Yes	<b>&lt; 20</b> Yes	<b>Small</b> Yes	<b>Medium</b> Yes	<b>Large</b> Yes
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)	<b>Traded:</b> n/a			<b>Non-traded:</b> n/a	

*I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.*

Signed by the responsible Minister:  Date: 12/05/2014

# Single-tier pension: a simple foundation for saving

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## List of Abbreviations

ASHE	Annual Survey of Hours and Earnings
ASP/AP	Additional State Pension
bSP	Basic State Pension
COSR	Contracted-Out Salary Related
CTB	Council Tax Benefit
DB	Defined Benefit (pension)
DC	Defined Contribution (pension)
DWP	Department for Work and Pensions
GAD	Government Actuary's Department
GDP	Gross Domestic Product (a measure of the total size of the economy)
LEL	Lower Earnings Limit
MDR	Marginal Deduction Rate
NICs/NI	National Insurance contributions
NEST	National Employment Savings Trust (an automatic enrolment pension scheme for UK employers of any size).
ONS	Office for National Statistics
OPSS	Occupational Pension Schemes Survey
S2P	State Second Pension
SDAA	Severe Disability Additional Amount
SERPS	State Earnings-Related Pension Scheme
SMG	Standard Minimum Guarantee
SPa	State Pension age
UAP	Upper Accrual Point

## Executive Summary

1. Over the past few years the Government has announced and introduced radical reform of working-age benefits. Universal Credit will dramatically simplify the welfare system, bringing together a range of means-tested benefits into a single streamlined payment. These changes will help ensure that work pays and tackle the root causes of poverty and welfare dependency.
2. The introduction of **automatic enrolment** will ensure that around 11 million people will have access to a low cost, workplace pension scheme, many for the first time. This is expected to result in between six and nine million people newly saving, or saving more, in workplace pensions.
3. The Government now wants to reform the State Pension system so that it provides a **simpler, fairer foundation** that better supports pensioners in saving for their retirement and is sustainable for future generations.
4. Despite recent reform, a number of problems persist in our State Pension system:
  - Substantial **complexity and uncertainty** remain. This means that many do not know what they will get from the state when they retire and so do not have a clear starting point from which to plan and save for their retirement. Many people find the current system difficult to understand, which makes it harder to plan for retirement. A single-tier pension will provide a firmer foundation to support planning and saving for retirement by delivering a simpler, single flat-rate pension, the full level to be set above the basic level of the means-test (the Pension Credit ‘Standard Minimum Guarantee’);
  - A long-term decline in the relative value of the basic State Pension has led to an increasing **reliance on means-testing**, resulting in further complexity in the pension system and unclear saving incentives for many people. Currently 35 per cent of pensioners are eligible for Pension Credit, although around a third of those eligible do not claim it, missing out on an average of £34 a week<sup>1</sup>. The full level of the single-tier pension will be set at a rate that is above the basic level of means-tested support (the Pension Credit Standard Minimum Guarantee) and will therefore help to reduce the need for means-testing. By 2020, eligibility for Pension Credit for new pensioners is halved under the single-tier pension and ultimately falls to less than five per cent by 2060. This will simplify the pension system and reduce the interaction that any additional income may have with means-tested benefits for those with modest incomes. Those affected will get a greater benefit from retirement savings or working past State Pension age;
  - **Inequalities remain** in the system. Despite the reforms in the 2007 Pensions Act, the proportion of women in Great Britain qualifying for a full basic State Pension is not expected to equalise with men until around 2020, and, without further reform, it is expected to take a further 30 years for State Second Pension outcomes to equalise. The single-tier pension will help to address inequalities in the system for women and the low paid and bring the self-employed fully into the State Pension system for the first time since the 1960s;
  - There is an ongoing need to ensure that the State Pension system remains **affordable and sustainable** in the face of demographic change, while still treating people fairly. Life expectancy for both men and women, already at a record level, continues to increase - contributing to a rising dependency ratio. The costs of supporting a larger pensioner population are being mitigated by increases to the State Pension age. However, without further reform costs will rise substantially as a proportion of GDP over the longer-term. The single-tier pension will retain the contributory principle while reducing the rate of increase of spending on State Pensions.
5. On 4<sup>th</sup> 2011 the Government launched a public consultation on two options for reform to deliver a simpler, fairer State Pension that better supports saving for retirement:
  - The ‘faster flat-rating’ option would accelerate changes already underway to deliver a flat-rate, two-tier pension; and
  - The ‘single-tier’ option was a more radical reform to a single-tier pension, with the full level set above the basic level of means-tested support.

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<sup>1</sup> DWP Pensim2 modelling, and DWP, Income Related Benefits: Estimates of Take-up in 2009-10, 2012

6. Over 75 per cent of the organisations who responded to the consultation preferred the concept of the single-tier pension. The Government has decided to introduce a single flat-rate State Pension set above the basic level of means-tested support for future pensioners to simplify the State Pension and better support saving for retirement.
7. The White Paper stated that the single-tier pension would start in April 2017 at the earliest. However, in light of the positive response to the White Paper, the Government assessed if it would be possible to deliver reform sooner, to support the roll-out of automatic enrolment into workplace pensions and provide certainty for both individuals and their pension schemes at the earliest opportunity. On 18<sup>th</sup> March 2013 the Government announced that the single-tier pension would be implemented in April 2016.

### **Single-tier reform**

8. The core design principles of the single-tier pension are that it introduces a simple, flat-rate amount that ends the current two-tier system of basic and additional State Pension. The key features of the single-tier pension are:
  - A flat-rate payment, the full level of which will be set above the basic level of the means-test, allowing the closure of means-tested Savings Credit for single-tier pensioners;
  - The State Second Pension, contracting-out and outdated additions will end;
  - 35 qualifying years for the full amount, with transitional arrangements for those with pre-implementation qualifying years. Those with fewer than 35 years, but above a minimum qualifying period, will get a proportionally smaller amount;
  - Everyone will qualify individually, ending inheritance of, and derived entitlement to, a spouse or civil partner's pension. Limited transitional arrangements will be put in place;
  - Self-employed people are brought fully into the State Pension for the first time since the 1960s;
  - It will still be possible to defer claiming State Pension and receive an increased weekly pension in return. There will be no lump sum option, and no inheritance of a deferred single-tier pension.
9. The single-tier reforms will be of most benefit to individuals who have not built, or would not have been able to build up, as much entitlement to State Second Pension as under the current system. The reforms benefit women and equalise comparable State Pension outcomes with men more quickly than otherwise would have been the case. The median gross female State Pension equalises with the male median State Pension a decade earlier under the single-tier pension, compared with the current system.
10. The Government has made it clear that it will recognise National Insurance contributions and credits made prior to the implementation of the single-tier pension in managing the transition from the current system. A key challenge of reform is to recognise contributions that have already been made in a way that is fair, while also delivering the simplicity and clarity of the single-tier pension as quickly as possible as a basis to support planning and saving for retirement.
11. Since the Green Paper, the Government has developed an alternative approach to transition that delivers the simplicity and clarity of the single-tier pension more quickly but also recognises contributions made prior to the implementation of single-tier. These arrangements will mean that an individual's pre-implementation National Insurance records will be translated into a single-tier pension starting or 'foundation amount' as at 2016. This will be the higher of the values of an individual's pre-implementation National Insurance record assessed using the current and single-tier system rules. Valuing the National Insurance record as at 2016 increases the proportion of people qualifying for the full amount of single-tier pension in the early years of implementation and enables them to have a better picture from implementation of the value of their single-tier pension.
12. In a 'pay as you go' system, funding liabilities are borne by the working-age population. Future governments will want to consider the level of the single-tier pension and up-rating in light of the wider economic factors that are relevant at the time. The legislation will provide this flexibility, underpinned by a statutory requirement to up-rate by at least earnings. Decisions on these variables will be made by the Government shortly before implementation.

13. For illustrative purposes, this paper assumes that the single-tier starting level at implementation will be £144 per week (in 2012/13 earnings terms<sup>2</sup>) and that this will be up-rated by the triple-lock (the highest of growth in average earnings, CPI price inflation or 2.5 per cent) over the long-term. The basic State Pension in the current system is also assumed to be up-rated by the triple-lock. This is consistent with the assumptions used by the Office for Budget Responsibility in their Fiscal Sustainability Report. We present the impact that different assumptions about the start level and up-rating would make to the overall cost and impact of reform in Annex B.

### **Main impacts of single-tier reform**

14. The single-tier pension will deliver greater certainty of income in retirement. By the mid 2030s the large majority of people reaching State Pension age (over 80 per cent) will receive the full single-tier pension. This will make it much easier to provide those of working-age with a clear idea about what their State Pension will be worth when they reach State Pension age and over their retirement, providing a firm foundation to support people in saving for retirement.
15. The single-tier pension will simplify the system and reduce the interaction that any additional income may have with means-tested benefits for those with modest incomes. The proportion of single pensioners on a marginal deduction rate of 20 per cent or less will improve significantly, particularly among the poorest fifth of pensioners, so that they can keep more of any additional savings or earnings. To be conservative, we have not modelled any behavioural change in saving for retirement arising from the policy.
16. Reform will help to reduce the number of people within the scope of means-testing, with eligibility for Pension Credit for new pensioners halved by 2020 and ultimately falling to less than five per cent by 2060. In the long-term the impact of the reforms is to reduce eligibility to any means-tested benefit by around 350,000 pensioner benefit units (households) by the 2040s.
17. The single-tier pension will be fairer by delivering parity for women's State Pension outcomes a decade sooner than under the current system. Around 650,000 women who reach State Pension age in the first ten years after the single-tier pension is introduced will receive an average of £8 per week more in State Pension due to the single-tier valuation (in 2013/14 earnings terms).
18. Furthermore, the single-tier qualification criteria will bring self-employed people fully into the State Pension, treating the National Insurance contributions of the self-employed in the same way as employee contributions for State Pension purposes.
19. It will also help to ensure that the pensions system remains affordable in the longer-term, as under single-tier the rate of increase in spending on pensioner benefits will be slowed down. The single-tier system is projected to cost broadly the same as the current system until the late 2030s. From the 2040s the growth in spending as a proportion of GDP is slower than under the current system. By 2060 spending will be 8.4% of GDP, down from 9.0% under the current system<sup>3</sup>.
20. In 2016, most people will receive the same level of State Pension income as they would have done had the current system continued. Around 25% of people will get a higher outcome. By 2020, around 75% of new pensioners have higher outcomes under the single-tier pension. This proportion gradually diminishes over time: by 2050 around 50% of pensioners have higher outcomes. People who would have qualified for large amounts of additional State Pension had the current system rolled forward without future reform are the main group who have notionally lower outcomes.<sup>4</sup>
21. The end of 'contracting-out' will mean that people in Defined Benefit (DB) schemes will cease to receive the 'contracted-out rebate' and will start to pay full National Insurance contributions (NICs). However, under the single-tier pension the vast majority of these people will be able get extra State Pension for years worked or credited after 2016. Furthermore, around 85 per cent of affected individuals who reach State Pension age in the first two decades after implementation will gain enough extra State Pension to offset the extra NICs and any adjustments to their workplace pension scheme.

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<sup>2</sup> See Annex A for more details.

<sup>3</sup> These figures are based on DWP projections. These differ in some respects from projections in the OBR Fiscal Sustainability Report. See Chapter 7 for further details.

<sup>4</sup> References to notional gains and losses are to comparing the single-tier pension to what would have been the case had the current system continued.

## Comparison with the October 2013 Impact Assessment

This edition of the Impact Assessment is consistent with the previous version of the Impact Assessment published in October 2013 as it uses economic assumptions consistent with those used in the Office for Budget Responsibility's 2013 Fiscal Sustainability Report. This is an annual publication which looks at longer term trends in public expenditure and, as such, it is appropriate that our Impact Assessment is consistent with the most recent version of this document.

Measures which were added to the Pensions Bill 2013 since its introduction to the House of Lords which are now enacted in the Pensions Act 2014 have been described in this document. However, any impacts on overall results will be small due to the small number of individuals concerned and, as we cannot identify these individuals separately within our modelling, we are not in a position to update the main results in our impact analysis.

Other developments since introduction to the House of Lords which could affect the impact of the single-tier pension which have not been captured in this analysis in order to maintain consistency with the 2013 Fiscal Sustainability Report are:

**Future State Pension age changes** – The Government announced at the Autumn Statement 2013 its intention that individuals should, on average, spend no more than a third of adult life in retirement. Any changes to the State Pension age implicit on this announcement have not been included as this announcement is not part of the single-tier reforms.

**Population projections** – The Office for National Statistics has published its 2012 population projections. We do not expect there to be significant incremental costs or impacts on the single-tier pension as a consequence of these.

The Office for Budget Responsibility will publish its latest forecasts for long-term expenditure on pensions in its Fiscal Sustainability Report 2014.

# Chapter 1) The problem and rationale for intervention

## 1.1 Overview

22. In 2002, the Government established an independent Pensions Commission to consider the long-term challenges facing the UK pension system and whether the existing voluntary pension saving regime represented an adequate response. The Commission concluded that the existing system would have to be reformed to ensure it would meet several long-term challenges<sup>5</sup>:
- Demographic and social change: the proportion of the population aged 65 or over is rising rapidly because of increasing life expectancy and lower fertility rates.
  - Under-saving for retirement: millions of people are not saving enough to deliver the income they are likely to want or expect in retirement.
  - Complexity: the complexity of the State Pension system stopped people from making informed decisions about whether, when and how much to save.
  - Inequalities in the pension system: concerns that some groups, in particular women, have reduced opportunities to save for a decent income in retirement.
23. In order to address these concerns, a range of reforms improved State Pension coverage and provided a simpler and fairer State Pension system, as well as setting a timetable for future increases in State Pension age.
24. Last year saw the introduction of automatic enrolment into workplace pension schemes. This should result in between six and nine million people newly saving or saving more in workplace pensions. The Government considers that further reform is needed to the State Pension system in order to provide a clear and simple foundation to encourage current generations of workers to save for their retirement. It is also an opportunity to make further progress in tackling inequality.

## 1.2 The challenge of the ageing population

### Demographic change

25. The population is projected to rise most quickly for the oldest age groups. The pensioner population is projected to increase from an estimated 12.2 million in 2010 to 15.3 million in 2035, and 18.3 million in 2060. Cohort life expectancy at age 65 is projected to increase from 21.0 in 2010 to 24.0 in 2035 for men and from 23.7 in 2010 to 26.6 in 2035 for women<sup>6</sup>.
26. Life expectancy in the UK has reached its highest level on record for both men and women, and is projected to continue to increase. In 2007, for the first time, the number of pensioners exceeded the number of children under 16 in the UK<sup>7</sup>.
27. The rate at which life expectancy is increasing has accelerated. It took 70 years, between 1920 and 1990, for male life expectancy at 65 to increase by 5 years. The next five year increase took just 20 years, between 1990 and 2010. Each set of life expectancy projections has shown a greater increase than its predecessor (see Chart 1.1). Since the original timetable to increase State Pension age to 67 was agreed in the 2007 Act, projections of life expectancy have continued to rise. To illustrate the extent that this has happened, the most recent 2010 life expectancy forecasts now predict a man retiring in 2013 to spend more than an extra year in retirement than the projections that were used in the 2007 Act.

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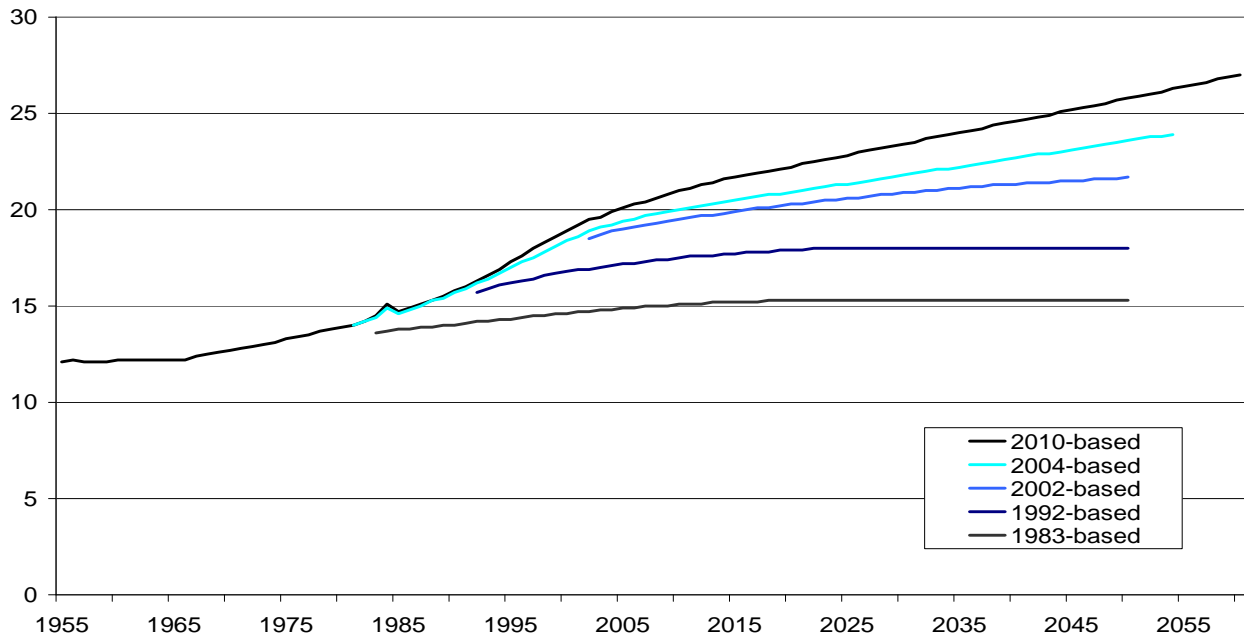
<sup>5</sup> The Pensions Commission, 2004, *Pensions: Challenges and Choices: The First Report of the Pensions Commission* and 2005, *A New Pension Settlement for the Twenty First Century: The Second report of the Pensions Commission*.

<sup>6</sup> Office for National Statistics 2011, 2010 principal population estimates. Includes the announced increase to SPa 67 between 2026 and 2028, and the SPa equalisation to 65 (for women), and rises to 66 and 68 as set out in legislation.

<sup>7</sup> Office for National Statistics, 2009, 2008-based national population projections.



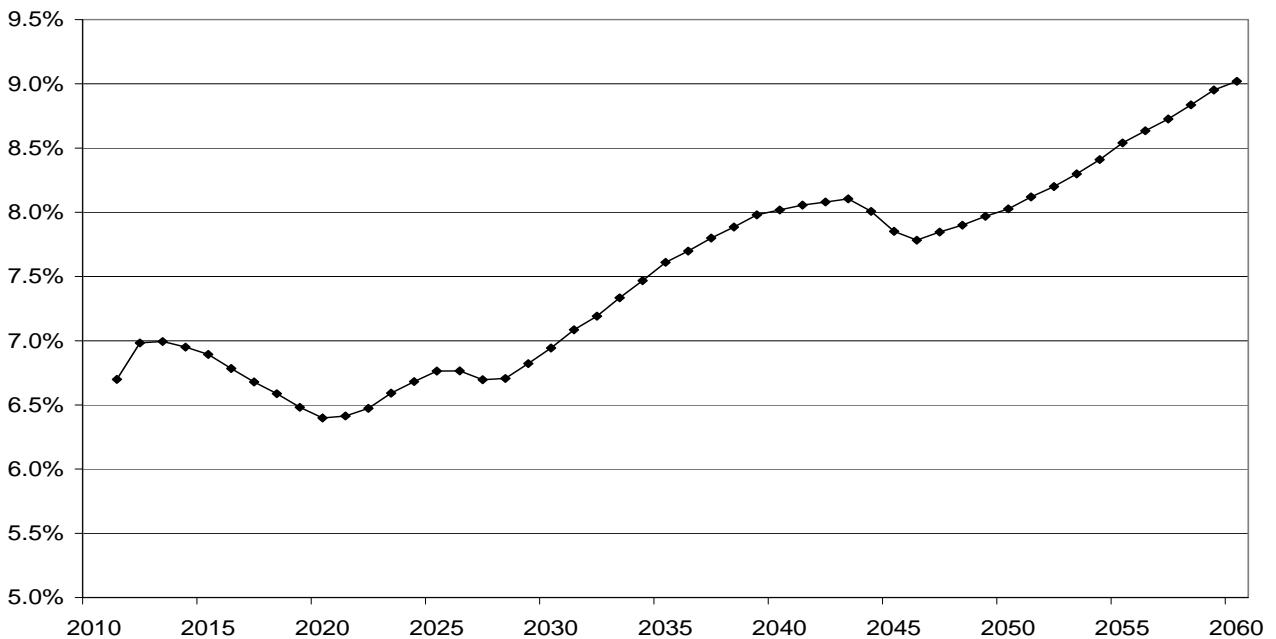
**Chart 1.1: Cohort life expectancy for a 65 year old male, 1955-2060**



Source: ONS, Period and cohort expectation of life tables (various releases) and GAD, Period and cohort expectation of life tables (various releases)

28. Given these increases in longevity, the Government has already acted, legislating to increase the State Pension age to 66 by October 2020 and proposing to increase the State Pension age to 67 by April 2028 to ensure that the State Pension remains sustainable and affordable over the long-term. The Government is also proposing a regular review process to ensure that further increases in State Pension age reflect increases in life expectancy. Nevertheless, despite the increases to the State Pension age already announced and, without further reform, spending on pensioner benefits as a proportion of GDP is forecast to rise significantly (Chart 1.2).

**Chart 1.2: Pensioner benefit expenditure as a proportion of GDP under current system**

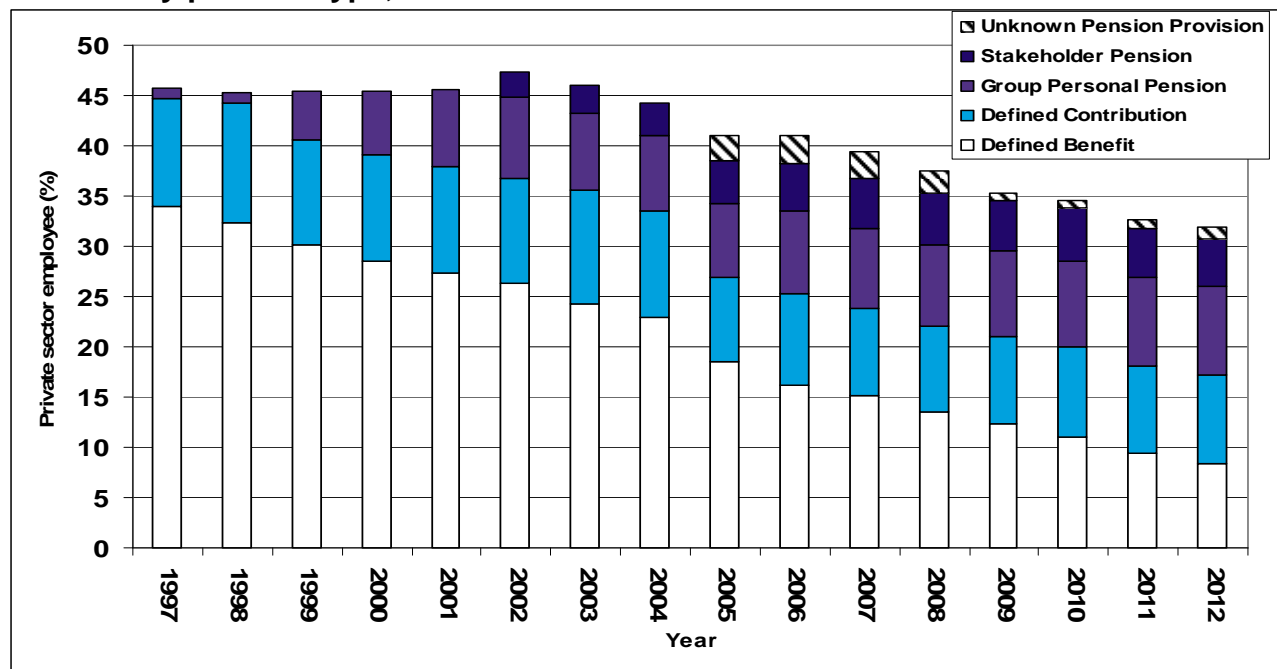


Source: DWP expenditure projections. Includes the announced increase to SPa 67 between 2026 and 2028, and the SPa equalisation to 65 (for women), and rises to 66 and 68 as set out in legislation. The dips in the series occur in periods when State Pension age is rising.

### 1.3 The challenge of under-saving for retirement

29. Despite the fact we are living longer, fewer people are saving for their retirement. The numbers contributing to or having contributions paid into a scheme (active members) continues to fall. In 2012 there were 7.8 million active (employee) members of occupational pension schemes compared with 12.2 million at the peak in 1967<sup>8</sup>.
30. Within that overall decline there has been a move away from Defined Benefit schemes. Chart 1.3 shows the proportion of private sector employees in GB who belong to an employer-sponsored pension scheme. The chart shows that the proportion of employees in a DB scheme has fallen from 34% in 1997 to less than 10% in 2012. However, this has been partly offset by a rise in Group Personal Pensions and Stakeholder schemes. This means that the risk associated with ensuring that pensions deliver a particular level of income in retirement is being increasingly borne by individuals rather than employers.

**Chart 1.3: Employee membership of a private sector employer-sponsored pension scheme: by pension type, 1997 to 2012**



Source: ASHE Pensions Statistics, ONS. (Note: 2012 figures are provisional).

31. As a consequence of under-saving for retirement, there are around 13.2 million people of working-age in Great Britain who could have inadequate retirement incomes<sup>9</sup>. Just under a third of 45-64 year olds have no private pension wealth and this number rises to over half of 25-34 year olds<sup>10</sup>. The high number with no private pension provision, against a backdrop of increasing longevity, is a concern, as evidence suggests that on its own the State Pension will not provide the retirement income that many people want.
32. Accessible forms of tax-relieved saving have become more popular: an estimated 14.6 million people saved into an Individual Savings Account (ISA) in 2012/13. But around half of ISA owners approaching State Pension age (aged 45-64) had less than £9,000 saved in their ISA in 2010/11, an amount which is unlikely to go far in covering retirement expenditure<sup>11</sup>.
33. To help tackle these problems the Government is introducing Workplace Pension Reform. A central feature is that employers will be required to automatically enrol their eligible employees into a qualifying workplace pension and make a minimum contribution. The reforms are expected to offset the decline in private pension membership and to increase the number of people newly saving or saving more in all forms of workplace pensions by between six and nine million. Private

<sup>8</sup> Office for National Statistics, 2013, *Occupational Pension Schemes Survey 2012*. ONS

<sup>9</sup> DWP Sep 2013 - Framework for the analysis of future pensioner incomes

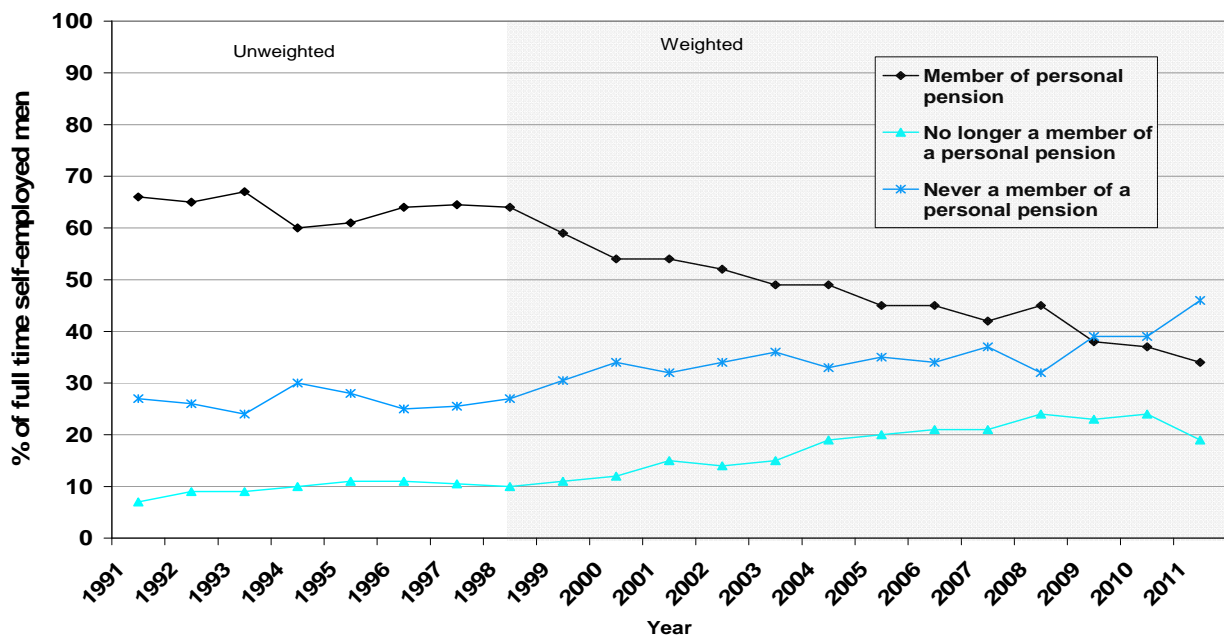
<sup>10</sup> Office for National Statistics, *Wealth in Great Britain Wave 2: Wealth and Assets Survey 2008/10 Chapter 4 ; Table 10*.

<sup>11</sup> HMRC ISA Statistics July 2013 , Tables 9.4 and 9.11

pension savings are estimated to increase by around £11 billion a year (2012/13 earnings terms) once the reforms have been fully implemented in 2018<sup>12</sup>.

34. With this context of a changing pensions' landscape brought about by Workplace Pension Reform, individuals will be able to build up private pension savings themselves through enrolment into workplace pension schemes, so the earnings-related component of the State Pension can end.
35. Chart 1.4 shows that the proportion of self-employed men that have a personal pension has also been deteriorating, to the point where nearly half of full-time self-employed men have never had a personal pension.

**Chart 1.4: Membership of a personal pension scheme for self-employed men working full-time, 1991 to 2011, Great Britain**



Source: ONS General Lifestyle Survey 2011, figure 6.4.

Notes: Data from 1998 is weighted; weighted data are not available before this. A personal pension is defined to include personal pensions, stakeholder pensions and retirement annuities.

36. The self-employed make an important contribution to the economy and constitute a significant share of the labour market. The number of self-employed people was 4.1 million in mid 2013, around 13 per cent of total employment<sup>13</sup>. Treating Class 1, 2 and 3 National Insurance contributions (as well as credits) equally for the first time in around 40 years (since the end of Graduated Retirement Benefit) gives the self-employed access to the same State Pension as employees. This is consistent with the objective of giving people certainty about their State Pension income in an increasingly diverse labour market, providing a clearer foundation for pension saving.

## 1.4 Complexity and uncertainty in the current State Pension

37. Whilst the Pensions Act 2007 reforms provided improvements to the State Pension system, the following problems remain:

### Complexity and uncertainty

38. There is still substantial complexity and uncertainty in the system. Many people are unsure what their State Pension will be worth when they retire. Two in three people interviewed for the DWP Attitudes to Pensions Survey agreed that “sometimes pensions seem so complicated that I cannot really understand the best thing to do” and only 21% said that they knew enough about pensions to decide with confidence what to do.<sup>14</sup> The current complex system means it is very difficult for

<sup>12</sup> “Workplace pension reform: digest of key analysis”, DWP 2012,

<sup>13</sup> *Labour Market Statistics* October 2013, ONS.

<sup>14</sup> *Attitudes to Pensions 2012*, DWP

working-age people to know how much income they will get from the state in retirement and understand how best to prepare for retirement.

### **Poor incentives to save for some groups**

39. The uncertainty in State Pension outcomes in the current system feeds directly through to savings incentives. The amount of State Pension that someone receives will determine both whether, and the extent to which, other sources of income are subject to withdrawal due to interaction with the means-tested system. Someone in receipt of just Housing Benefit in retirement will keep 35p for every additional £1 of pension income, and a person in receipt of Pension Credit (both Guarantee Credit and Savings Credit) would keep 60p for every extra £1 of pension income.
40. Interaction with means-tested benefits can also reduce the perceived reward for any saving and add to confusion around what income an individual can expect to have in retirement. Pension Credit, Housing Benefit and Council Tax Benefit all have different rules and withdrawal rates and it can be difficult for an individual to know how much income they might have in retirement.
41. Means-tested benefits may not always be the most effective way to ensure that all poorer pensioners receive a minimum level of support because some do not take up benefits to which they are entitled. Around a third of those entitled to Pension Credit do not claim, each missing out on an average of £34 a week.<sup>15</sup>

## **1.5 Inequality in the current State Pension system**

42. As part of the Pensions Act 2007, reforms were introduced to help reduce inequalities for women in the current State Pension system. However, it will take time for these measures to translate into improved State Pension entitlement. Both state and private pension outcomes are lower for women than for men. The proportion of women reaching State Pension age entitled to a full basic State Pension is not expected to catch up with men until around 2020 and the overall State Pension outcomes of men and women are not expected to equalise until after 2050<sup>16</sup>.
43. In the current system, the self-employed pay National Insurance contributions on a different basis from employees, and some low earners can pay more in National Insurance than if they received the equivalent sum as a wage. National Insurance contributions paid by the self-employed do not count towards the additional State Pension.

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<sup>15</sup> Department for Work and Pensions, 2012, *Income Related Benefits: Estimates of Take-up in 2009-10*.

<sup>16</sup> DWP Pensim2 modelling. Equalisation defined on basis of comparison of median gross pensions.

# Chapter 2) Policy objectives and options considered

## 2.1 Consultation and State Pension reform objectives

44. In April 2011 the Government launched a consultation on State Pension reform entitled “*A State Pension for the 21<sup>st</sup> century*”, which set out the guiding principles for reform:
- **Personal responsibility** – enabling individuals to take responsibility for meeting their retirement aspirations in the context of increased longevity.
  - **Simplicity** – simplifying the State Pension so that it is easier for people to plan and save for retirement (particularly within the context of Workplace Pension Reform).
  - **Fairness** – ensuring an adequate level of support for the most vulnerable; ensuring everyone with a full contribution record should be entitled to a State Pension above the basic level of means-tested support<sup>17</sup>; and treating all groups more fairly.
  - **Affordability and sustainability** – given the longer-term pressures on the public finances, State Pension reform must be affordable. Furthermore, as longevity projections continue to increase, Government has a responsibility to ensure the costs are shared fairly between generations. In addition, State Pension reforms need to retain trust and confidence in a sustainable deal for the long-term.
45. The consultation on State Pension reform ran from 4<sup>th</sup> April 2011 to 24<sup>th</sup> June 2011. In total DWP received 101 responses from stakeholder organisations and approximately 1,600 from individuals. The Minister for Pensions hosted four round-table discussions on specific aspects of the proposed reform and officials met thirty-five stakeholder organisations during the consultation period.
46. In general, the consultation demonstrated broad support among stakeholder organisations for the single-tier option, with around three quarters of organisations who responded saying they support the single-tier in principle. There was widespread consensus among stakeholders, whether or not they supported the single-tier option itself, that the current State Pension system is not fit for purpose, largely because of its complexity.

## 2.2 Description of options considered

47. Three options were considered:

### Option 1: ‘Do nothing’ - the baseline

48. The Government’s Green Paper set out the rationale for why doing nothing is not an option. Without reform:
- complexity in the State Pension system will remain and add to uncertainty for individuals about their retirement income;
  - inequality between different groups, for example men and women, will remain;
  - concern around sustainability of the pension system given increased life expectancy projections will remain; and
  - the introduction of Workplace Pension Reform will not be supported if the State Pension does not provide a clear foundation for private saving.

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<sup>17</sup> This is defined as the level of income provided by the Pension Credit standard minimum guarantee (SMG) which in 2012/13 topped up pensioners’ income to £142.70 per week for singles and £217.90 per week for couples. In April 2013 the thresholds rose to £145.40 for singles and £222.05 for couples.

## Option 2: Preferred option - single-tier pension package of reform

49. The single-tier reforms aim to provide a clear and simple foundation to encourage current generations of workers to save for their retirement, thus making the pensions system more sustainable in the long-term. It also makes further progress in tackling inequality, while retaining the contributory principle.
50. The key features of the single-tier pension when fully implemented are:
- **A flat-rate payment set above the basic level of means-tested support**  
The full rate of the single-tier pension will be above the level of the basic means-test (the Pension Credit 'Standard Minimum Guarantee'). The current legislative requirement to increase the basic State Pension at least in line with average growth in earnings will also apply to the single-tier. An individual with a full contribution record of 35 years could expect to retire on a State Pension that lifts them clear of the basic level of means-tested support and keeps them above it throughout their retirement. This is because the full single-tier pension amount would be uprated at least in line with earnings, so would hold its value relative to the means-test (which is also uprated by earnings). The precise starting value and approach to uprating for single-tier will be set shortly before implementation, taking account of the fiscal context at the time.
  - **The State Second Pension, contracting-out and other additions will end**  
The State Second Pension and contracting-out for Defined Benefit schemes will end when the single-tier pension is implemented. The Savings Credit element of Pension Credit will be removed and the Category D pension and the 25p Age Addition will also end for single-tier pensioners. This will rationalise the different sources of pensioner income from the state into a simpler, single payment. It will make it much easier for people to understand how much they need to save to get the income in retirement they want.
  - **35 qualifying years for the full amount, those with fewer than 35 years, but above a minimum qualifying period, will get a proportionally smaller amount**  
In order to get the full amount of single-tier pension, an individual will need 35 qualifying years. Crediting arrangements will be brought forward to protect the single-tier pension position of those who cannot work for certain specific reasons, for example due to caring commitments. People reaching State Pension age under the single-tier pension will need to have a minimum number of qualifying years to become eligible for State Pension. The Government has announced its intention that this minimum period will be 10 qualifying years, and the Pensions Bill provides that it cannot exceed this length.
  - **Everyone will qualify individually, ending inheritance of, and derived entitlement to, a spouse's or civil partner's pension**  
Current provisions in the existing pension system for the inheritance or derivation of the pension and contribution records of a spouse or civil partner are out of step with changes that have taken place in society. For a person reaching State Pension age under the single-tier pension, there is no longer any rationale for carrying forward provision for using the National Insurance contribution record of their spouse or civil partner to get a basic State Pension or higher rate of basic State Pension. This will end under the single-tier pension, with limited transitional arrangements put in place.
  - **Self-employed people will be brought fully into the State Pension**  
Under the current system, National Insurance contributions paid by the self-employed do not count towards additional State Pension. The Government believes that we should treat all forms of National Insurance contributions equally in the calculation of State Pension and not disadvantage those who work on their own account often in entrepreneurial activities. The rate of National Insurance that is payable by the self-employed will be a matter for the Government to decide closer to implementation.

- **Individuals will still be able to defer claiming their State Pension and receive a higher weekly State Pension in return**

The ability to defer claiming the State Pension will be retained under the single-tier pension, but the deferral reward will change to more closely reflect the value of the income foregone by the delay in drawing a single-tier pension, and it will no longer be possible to receive a lump-sum payment. In the analysis we assume that State Pension will increase by 1 per cent for every 10 weeks that it is deferred. The decision on the rate will be informed by the latest actuarial factors, such as life expectancy, considering advice from the Government Actuary's Department (GAD), and the fit with the Government's agenda for supporting people who wish to work longer. It will not be possible to inherit the increments built up from deferring a single-tier pension.

51. A single-tier pension would therefore be a substantial simplification of the system. Many complex and outdated elements of the current system would be abolished. A single flat-rate State Pension, i.e. without an additional earnings-related component, would give people much greater certainty and clarity over what their State Pension will be worth, providing a much firmer foundation on which to base decisions around saving for retirement.
52. Ending contracting-out from Defined Benefit occupational pension schemes is another aspect of moving to the single-tier pension system and will contribute to simplifying the State Pension system. The Government will continue to work closely with stakeholders to understand the likely impacts that ending contracting-out will have on individuals, employers and pension schemes. Chapter 5 provides further analysis.
53. The single-tier pension will commence on 6<sup>th</sup> April 2016:
  - Those who reach State Pension age prior to this date will continue to receive their State Pension in line with current rules.
  - For people who reach working-age or enter the labour market for the first time after 6<sup>th</sup> April 2016, all their National Insurance contributions or credits will be dealt with under the single-tier rules.
  - People who reach State Pension age on or after 6<sup>th</sup> April 2016, and who satisfy the qualification criteria, will be able to receive a single-tier pension upon reaching State Pension age, based on pre- and post-implementation National Insurance contributions or credits.
54. A key challenge of reform is to do this in a way that is fair, while also delivering the simplicity and clarity of the single-tier pension as quickly as possible, as a basis to support planning and saving for retirement. In the consultation paper on reform, the Government outlined an approach to transition that would have meant that even by 2050 around half of pensioners would still not receive the full single-tier pension amount despite, for the most part, having 35 or more qualifying years. Such a lengthy transition period would undermine the key objective of providing people with clarity over what their State Pension will be when they retire.
55. The Government has therefore developed an alternative approach to transition that delivers the simplicity and clarity of single-tier more quickly but also recognises contributions people may have prior to commencement. The majority of people of working-age will have made National Insurance contributions prior to the implementation of the single-tier pension. Each record will be different, depending on the person's history of work or credits. These records will be translated into a single-tier start valuation or 'foundation amount' – at the date of the introduction of the new scheme.

56. The Government will recognise contributions that have been made prior to implementation in managing the transition from the current system to the single-tier pension through the 'foundation amount'. Subject to an individual satisfying the minimum qualifying period, the 'foundation amount' will be the minimum weekly amount of State Pension an individual will receive when they reach State Pension age. This applies in the following ways:
- Where an individual's National Insurance contributions record leads to a foundation amount which is **greater than the full level of the single-tier pension** weekly amount, the amount above the single-tier pension will be protected and added to the full single-tier pension weekly amount;
  - Where this foundation amount is **lower than the full level of the single-tier pension** weekly amount, individuals will be able to increase their single-tier pension up to their State Pension age to the full rate by gaining further qualifying years; and
  - Where an individual has **previously been contracted-out** of the additional State Pension a deduction will be made to reflect private pension benefit accrued through contracting-out.
57. Under this approach, the contributions people have made prior to commencement, including during periods of contracted-out employment, are consolidated as the starting point for a much simpler single-tier system. By the mid 2030s around four out of five people reaching State Pension age will receive the full single-tier pension weekly amount.
58. As the single-tier pension will be set at a rate that is above the basic level of means-tested support there will no longer be a need for a complex savings reward: removing Savings Credit for single-tier pensioners will simplify means-tested support and help to ensure Pension Credit is re-focused on providing a safety net targeted at the poorest and most vulnerable. As a consequence, eligibility for Pension Credit among new pensioners would be halved by 2020. Support will be retained for a period of 5 years for those people who may have received more help with housing costs by virtue of the availability of the Savings Credit. Chapter 4 of this Impact Assessment provides further analysis of the impact on means-tested benefits.
59. The Government would also change additional State Pension inheritance rules from the point of implementation, with transitional arrangements for couples in specific circumstances (details are in the White Paper).

### **Option 3: Faster flat rating of additional State Pension**

60. In the White Paper we also considered an alternative State Pension reform option which would incrementally build upon reforms legislated in the Pensions Act 2007 as outlined within the Green Paper '*A State Pension for the 21<sup>st</sup> century*'. Currently, the basic State Pension is a flat-rate payment worth £110.15 per week and the State Second Pension is partly flat-rate and partly linked to earnings.
61. Under current legislation, the earnings-related element of the State Second Pension is set to be phased out in the late 2030s, at which point the State Second Pension will be valued at around £1.75 a week for each qualifying year. This leaves the State Pension system to consist of two flat-rate tiers. The transition to a flat-rate State Second Pension could be speeded up by phasing out the earnings-related component of the State Second Pension more quickly.
62. However, the Government does not believe that faster flat-rating would provide the clear foundation that is needed to support current generations in taking greater personal responsibility for saving for their retirement. Most significantly, it would retain a much greater variation in outcomes than the single-tier pension and retain much of the complex architecture of the current system. The Government believes that a single-tier pension is the only option that would meet the principles for reform and provide the foundation that is needed to support saving for retirement. The Government therefore intends to introduce a single-tier pension in April 2016.
63. Further discussion and analysis to explain why we have rejected this option can be found in Annex C of the January 2013 Impact Assessment and also in Annex 2 of the White Paper.



## Chapter 3) Impact on individuals

64. This chapter looks at the effect of the single-tier pension reform package on the various types of income that pensioners receive from the state, compared to the current system. The impact analysis presented throughout this report uses as a baseline the current benefit system, including changes enacted in the Pensions Act 2007 and the Welfare Reform Act 2012. It includes the planned rise in State Pension age to 67 by 2028 and assumes the basic State Pension is uprated by the triple-lock.
65. We consider how outcomes change under the single-tier pension, assuming a starting level of £144 per week, in 2012/13 earnings terms, and uprating by the triple-lock. As the final value of these variables will be set by the Government of the day, analysis of the proportions with notionally higher or lower outcomes from the single-tier pension under different starting levels, economic assumptions and uprating assumptions are given in Annex B. The analysis in this chapter is mainly based on the Department's Pensim2 dynamic micro-simulation model, details of which can be found in Annex A.
66. Unless otherwise stated, the analysis in this chapter only includes people who reach State Pension age after the reforms have been implemented and only covers Great Britain<sup>18</sup>. Those who reach State Pension age before implementation will continue to receive their State Pension in line with existing rules, though some whose spouse receives the single-tier pension may not stand to inherit or derive as much as could have been the case had the current system remained in place.
67. For people reaching State Pension age after implementation, contributions under the current system will be recognised in the single-tier system. Subject to the minimum qualifying period, at the point of implementation nobody will have a foundation amount that is lower than the pension they could have become entitled to based on their own pre-implementation contributions under the current system's rules. This means that the impacts discussed in this chapter are notional. Outcomes for individuals under the current system would remain uncertain until near the point they reach State Pension age (for example due to the impact of their unknown future earnings on their entitlement to additional State Pension - hence we have to model these outcomes) and also as future changes to outcomes are assessed on the assumption that the pension system would otherwise have remain unchanged over the coming decades.
68. Notional impacts also arise because **total net income** received from the state and National Insurance paid under the single-tier pension might be different from income that would notionally have been received under the current system. For example, some people may pay higher National Insurance contributions due to the end of contracting-out yet they may also receive more State Pension than they would have done otherwise. In this chapter, we consider only the impact on pensioner incomes. The effect of changes to National Insurance is discussed in chapter 5.
69. The transition to the new system means that different cohorts of single-tier pensioners will be affected in different ways.
- Older individuals are more likely to be (or have been) in a Defined Benefit scheme and are therefore more likely to be affected by the ending of contracting-out. However, under the single-tier pension they will also have an opportunity to gain additional entitlement to State Pension up to the full amount of the single-tier pension.
  - Younger people (particularly median and higher earners) will be less able to become entitled to large notional amounts of additional State Pension, which will be protected for those older people that have already made National Insurance contributions. However, as they will retire in the later years of the single-tier pension, they will have had the chance to build up a significant private pension income by this point, due to the operation of automatic enrolment.
  - The majority of people reaching State Pension age after the single-tier pension is implemented but before 2040 will have a higher net income over the course of their retirement.
70. Pensioners living overseas may receive less State Pension than they would have done under the current system because of the introduction of the 10-year minimum qualifying period. They may

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<sup>18</sup> Pensim2 only models Great Britain but under the 'parity principle' we have anticipated that Northern Ireland will introduce equivalent measures.

also experience a notional change in outcomes as a result of other aspects of single-tier reform, in common with pensioners in Great Britain.

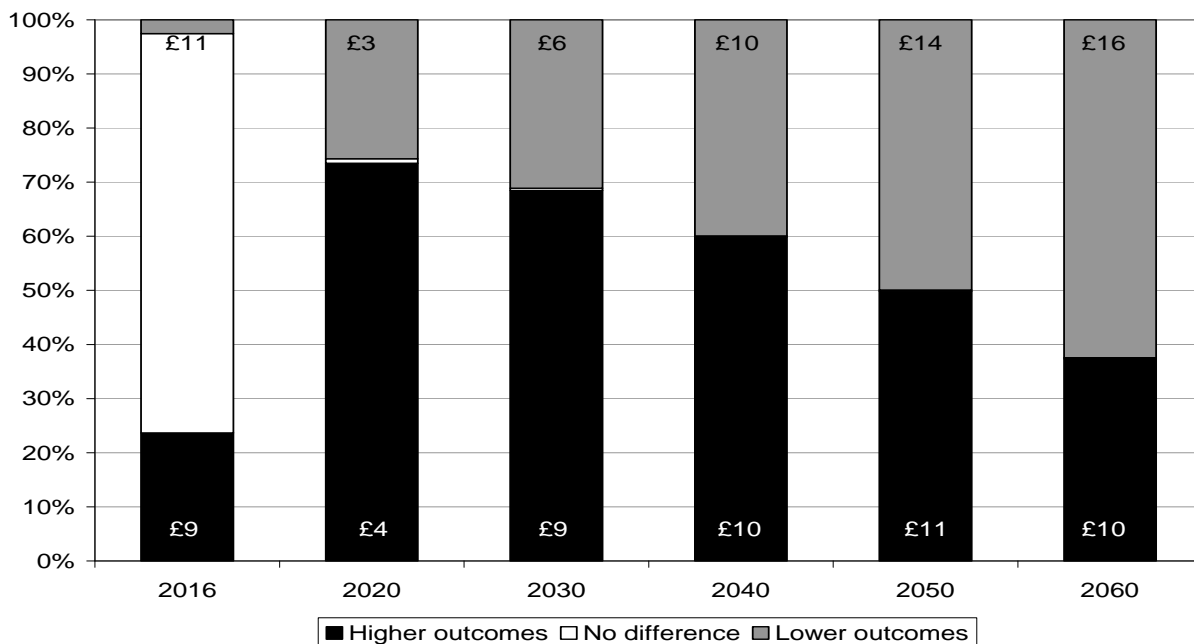
### 3.1 Difference in outcomes under the single-tier pension compared with the current system

- 71. This section compares outcomes under the single-tier pension to a baseline in which the current system is rolled forward. As is the case throughout this Impact Assessment, the impacts presented are notional.
- 72. We first look at State Pension outcomes for individuals, before considering overall state support including income-related benefits at benefit unit (household) level. This is because State Pension is an individual award, whereas income related benefits are assessed at household level.
- 73. In the charts that follow, the ‘proportion with changed notional outcomes’ represent both a 5p increase and a £10 increase equally as ‘one person with a higher notional outcome’. For this reason we also display the median changes to show the size of the average impact.

#### a) Impact on State Pension outcomes (individuals)

- 74. Chart 3.1 shows that within a few years of implementation, single-tier pension reform leads to most single-tier pensioners having a higher State Pension than under the baseline of the current system. For each year the chart shows all living pensioners who have reached State Pension age since the implementation of the single-tier pension.

**Chart 3.1: Proportion of pensioners with changed notional State Pension outcomes under single-tier; median weekly amounts (2013/14 earnings terms)**



- 75. In 2016, the first year of reform, most people receive the same level of State Pension income as they would have done had the current system continued. Around 25 per cent of people will have a better outcome as a result of the single-tier transition valuation. Even in 2050 approximately half of single-tier pensioners will have an outcome that is higher than under the current system.
- 76. Four case studies on the following pages illustrate how individuals in a range of different circumstances are affected by the introduction of the single-tier pension. These have been chosen to be broadly illustrative of what happens to individuals reaching State Pension age both early and

later into the single-tier system and, as such, are highly stylised. Further case studies can be found in various places elsewhere in the Impact Assessment (see pages 25, 32 and 36).<sup>19</sup>

### Case Study 1) Linda – Low earner, aged 59 in 2013

Linda was born in 1954 and reaches State Pension age in 2020. She works from the age of 20 in a relatively low paid public sector job, earning a salary equivalent to around £17,000 (2012/13 earnings terms). She gains 46 qualifying years of National Insurance contributions by the time she reaches State Pension age (SPa) in 2020. She has a life expectancy after SPa of 24 years.

Linda receives a higher State Pension under the single-tier system than she would have done under the current system, as each qualifying year is worth more. However, even though she has a full record of qualifying years, she does not get the full single-tier amount. This is because she was contracted-out of the additional State Pension during her working life and so a deduction will be applied during the calculation of her State Pension. However, for each additional qualifying year Linda gains between 2016 and her State Pension age, she will increase her State Pension amount by 1/35th of the full single-tier pension (capped at the maximum level).

2012/13 earnings terms	Current State Pension	Single-tier Pension
Weekly pension in first year after reaching State Pension age	£120	£134
Average weekly pension over the rest of her life (for stated life expectancy)	£124	£138
Total pension over the rest of her life	£154,000	£172,000

### Case Study 2) Julie - Median earner, aged 59 in 2013

Julie was born in 1954 and reaches State Pension age at 66 in 2020. She worked from the age of 20 in the private sector, earning a salary equivalent to around £24,000 (2012/13 earnings terms). She gains 46 qualifying years of National Insurance contributions by the time she reaches State Pension age in 2020. She has a life expectancy after State Pension age of 24 years.

Although she does not get as much pension income in the first year of her retirement as she would have done if the current system was rolled forward, she does receive more than the full single-tier pension, because she receives a protected payment (uprated by prices). Due to the more generous uprating of the single-tier pension she receives a very similar amount of income over retirement.

2012/13 earnings terms	Current State Pension	Single-tier Pension
Weekly pension in first year after reaching State Pension age	£193	£182
Average weekly pension over the rest of her life (for stated life expectancy)	£178	£177
Total pension over the rest of her life	£222,000	£221,000

<sup>19</sup> All of the case studies were modelled by DWP using the Department's iPen model v8.3. We have rebased the case studies to express them in equivalent 2012/13 prices terms, in order that 35 qualifying years shows a single-tier pension of £144 per week, consistent with the White Paper.

### Case Study 3) Thomas – High Earner, aged 31 in 2013

Thomas was born in 1982 and reaches State Pension age at 68 in 2050. He worked as an accountant from the age of 20 with a salary equivalent to around £40,000 (2012/13 earnings terms), and gains 48 qualifying years of National Insurance contributions. He is enrolled in a DC pension scheme from age 30. He has a life expectancy after State Pension age of 23 years.

Thomas notionally loses out due to the ending of the facility to build up significant amounts of additional State Pension over the coming decades. However, some of his notional loss will be mitigated by the fact that the whole single-tier pension will be uprated by at least the growth in earnings whereas, currently, only the basic State Pension is uprated in this manner.

2012/13 earnings terms	Current State Pension	Single-tier Pension	Private Pension
Weekly pension in first year after reaching State Pension age	£224	£156	£194
Average weekly pension over the rest of his life (for stated life expectancy)	£194	£162	£125
Total pension over the rest of his life	£247,000	£193,000	£150,000

### Case Study 4) Sam - Median earner, 40 year period of self-employment, aged 59 in 2013

Sam was born in 1954 and reaches State Pension age at 66 in 2020. He worked for a firm from the age of 23 to the age of 26 earning a salary equivalent to around £29,000 (2012/13 earnings terms). He was then self-employed from age 27 until State Pension age. Sam did not contribute to a private pension over the course of his working life.

Sam is much better off under single-tier, getting the full amount. Under the current system the National Insurance contributions paid by the self-employed do not result in any additional State Pension entitlement. However, in the single-tier system these contributions will be treated in the same way as employee contributions for State Pension purposes.

2012/13 earnings terms	Current State Pension	Single-tier Pension
Weekly pension in first year after reaching State Pension age	£119	£144
Average weekly pension over the rest of his life (for stated life expectancy)	£121	£148
Total pension over the rest of his life	£138,000	£169,000

Some ethnic minority groups are more likely to be self-employed, and this aspect of the policy will benefit communities for which this is a more common career option.

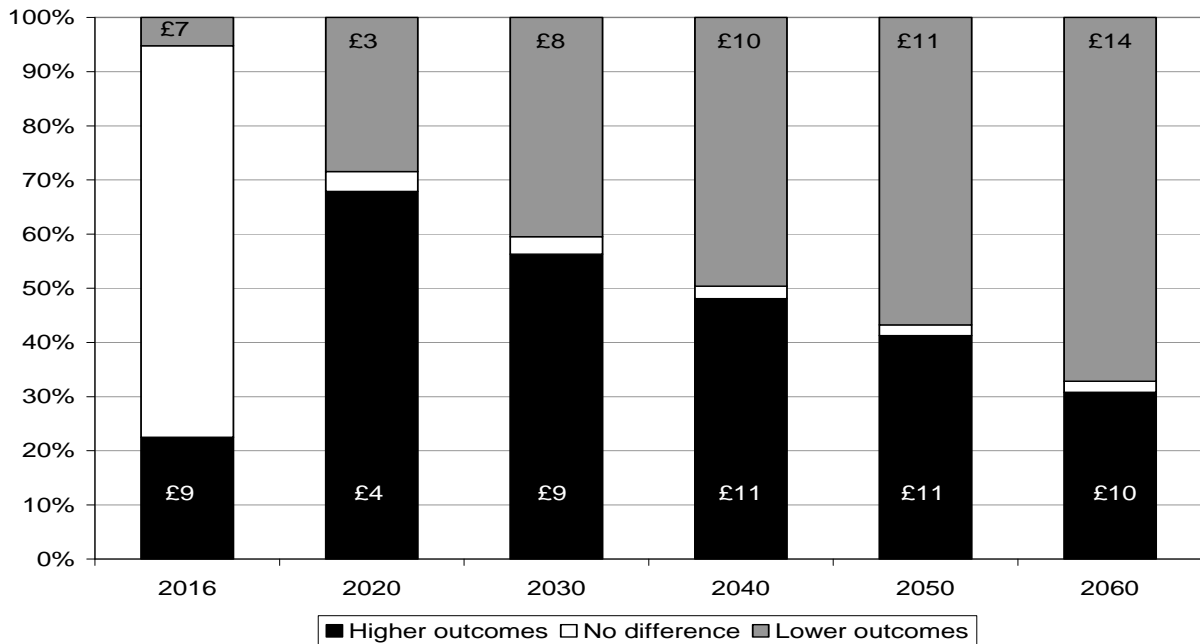
#### b) Impact on overall state support for pensioners (households)

77. We now widen the picture to include the impact of means-tested benefits (MTBs). As eligibility for means-tested benefits is assessed at benefit unit level, this means that the unit of analysis is now households rather than individuals<sup>20</sup>.
78. Chart 3.2 below shows that a majority of households reaching State Pension age under the single-tier pension (the cumulative number of pensioner benefit units who have reached State Pension age since 6<sup>th</sup> April 2016) have the same or notionally higher outcomes than in the baseline of the

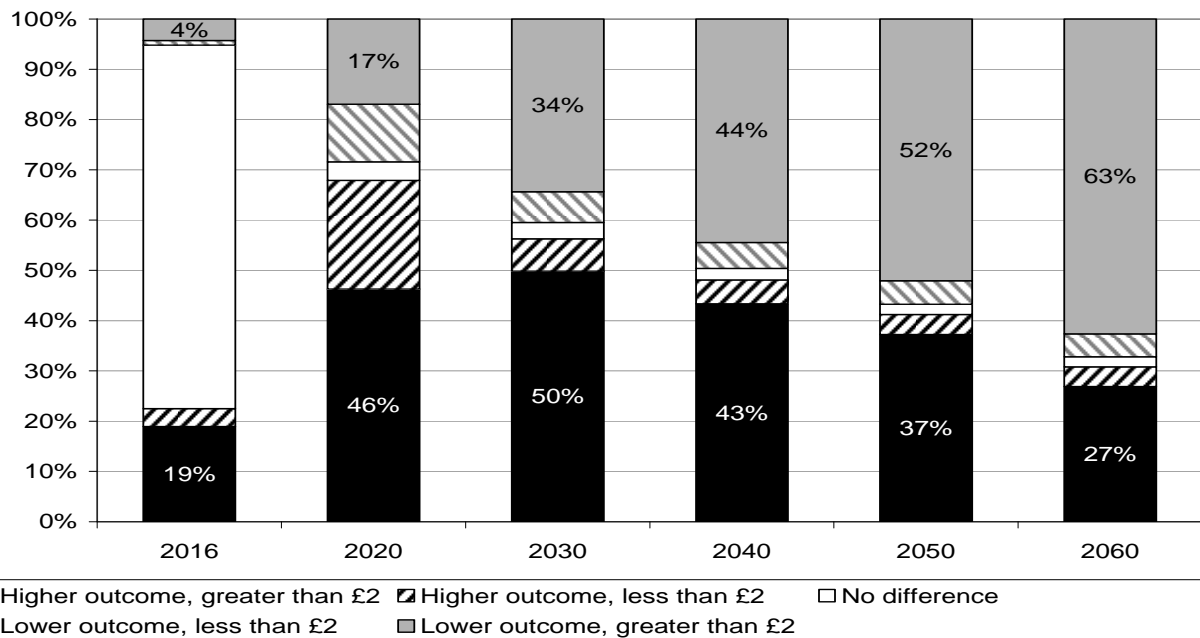
<sup>20</sup> 'Benefit unit' is a standard DWP term and can be defined as a single adult or a married or cohabiting couple and any dependent children; and since January 2006 same-sex partners (civil partners or cohabitantes)

current system rolled forwards, until the 2040s. The median changes to outcomes are relatively modest; for example an £11 per week higher outcome in 2040 represents a three per cent rise in household income. Chart 3.3 shows additional detail on the size of impact on those with higher and lower outcomes.

**Chart 3.2: Proportion of benefit units with changed notional outcomes (net household income), median weekly difference (2013/14 earnings terms)**

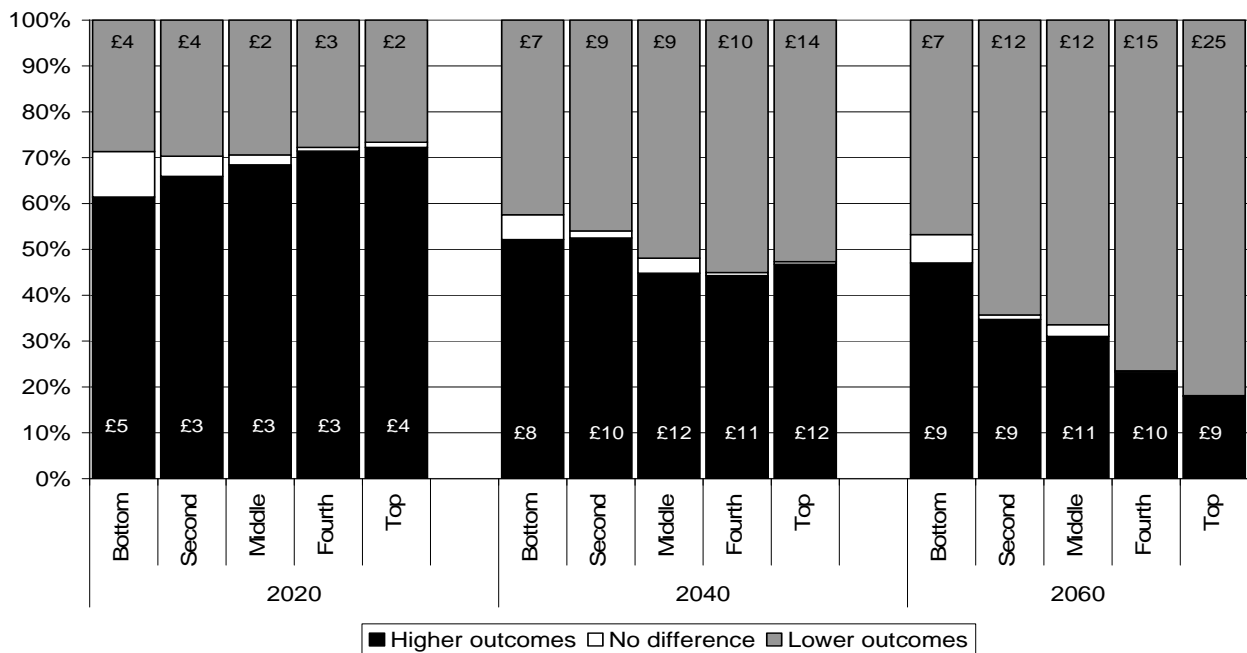


**Chart 3.3: Proportion of benefit units with changed notional outcomes, impacts of more than or less than £2 per week (net incomes, 2013/14 earnings terms)**



79. Chart 3.4 below shows the proportion of households (the cumulative stock) with notionally changed outcomes by income quintile; the reform has a progressive impact in later years. Section 4.2 shows how single-tier reform also supports lower income quintiles by significantly increasing the proportion of any additional pension saving that they keep.

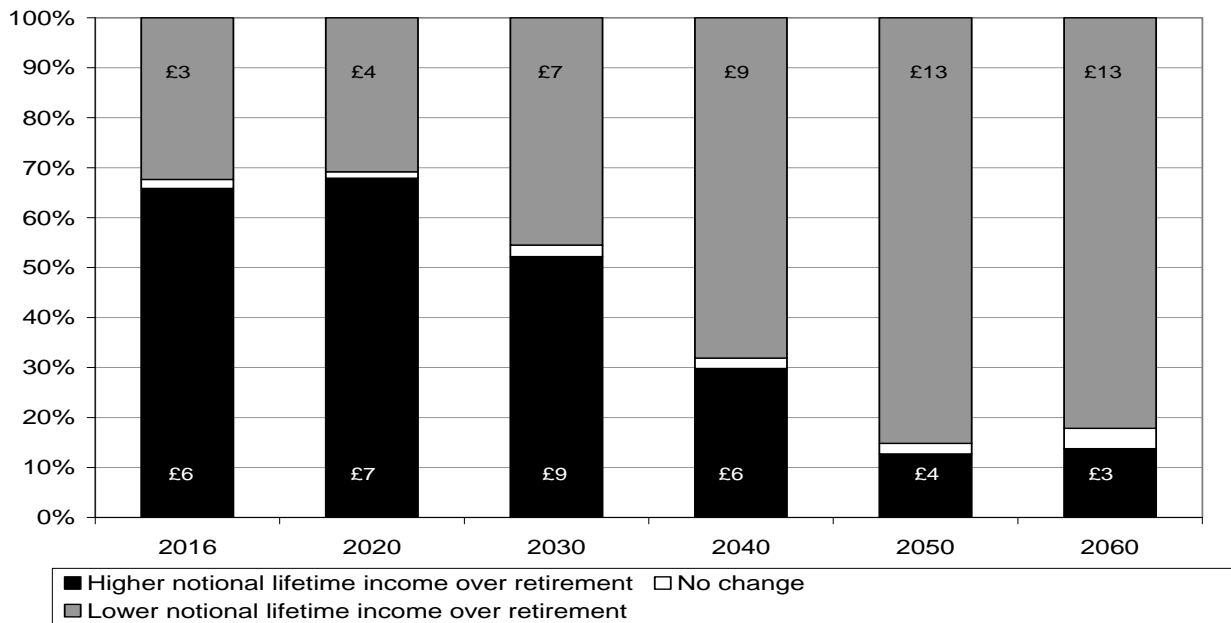
**Chart 3.4: Proportion of benefit units with changed notional outcomes due to single-tier reform compared to the baseline, by income quintile. Median weekly change (net incomes, 2013/14 earnings terms)**



80. Chart 3.5 below shows the proportion of benefit units that receive higher and lower notional incomes over the whole of their retirement under the single-tier pension than they would have received under the current system.
81. The majority of households in each cohort reaching State Pension age up to 2030 receive higher incomes over the whole of their retirement under the single-tier system. Initially the majority of households gain over retirement because of the single-tier valuation and the triple-lock, but for cohorts reaching State Pension age after 2030 the proportion that have higher income over retirement falls below 50%. This is because if the current system was rolled forward they would have been able to become entitled to large amounts of State Second Pension<sup>21</sup> which will not be possible under the single-tier pension. This increases the probability that they will have a notionally lower State Pension after the reforms.
82. On a cumulative basis, more than half of those reaching State Pension age before 2040 will have higher total retirement income under the single-tier pension.

<sup>21</sup> For a cohort reaching State Pension age this year, the maximum amount payable by way of SERPS + S2P is around £160 per week, on top of the Basic State Pension of £110.15 per week.

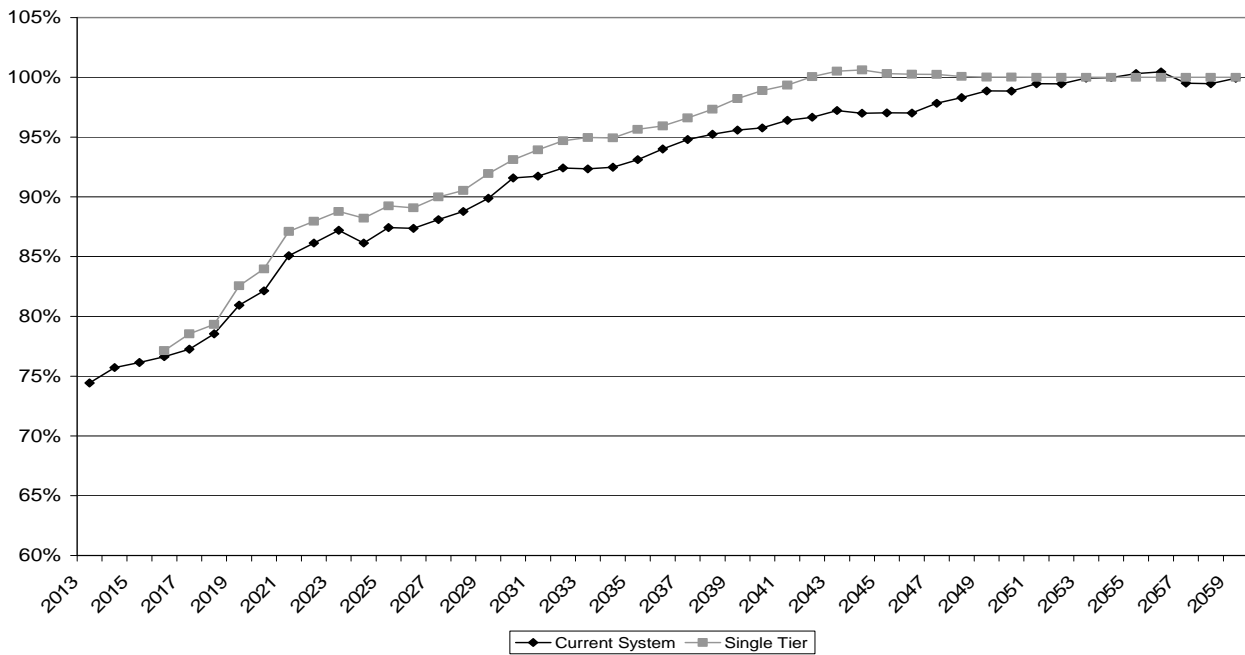
**Chart 3.5: Proportion of benefit units with changed notional outcomes over retirement, by year of SPa. Median change in net weekly income (2013/14 earnings terms)**



### 3.2 Impact of reform on outcomes for women

83. Historically, women have tended to get lower outcomes from the State Pension system. While the 2007 Pensions Act delivered improvements for women, the proportion of women in Great Britain qualifying for a full basic State Pension is not expected to equalise with men until around 2020, and it is expected to take more than a further 30 years for State Second Pension outcomes to equalise (according to DWP forecasts).
84. The main reason for this inequality is that women are more likely to take time out of the labour market or work part-time and, on average, tend to earn less than their male counterparts. Since 2002 those with caring responsibilities have been able to earn credits towards the State Second Pension, but it will be some time before their outcomes equalise with men.
85. The single-tier pension brings forward by a decade the point at which women get equivalent State Pension outcomes to men, as illustrated in Chart 3.6. As there is a period of transition from the old system, inequalities take time to be fully removed.

**Chart 3.6: Median female gross State Pension income (excluding MTBs) as a proportion of median male gross State Pension income, for those reaching State Pension age in each year, under the current system and the single-tier pension**



86. The gender gap closes due to the end of the earnings-related State Second Pension, and also because a new single-tier pension year is worth more than a current basic State Pension year. As a consequence, the median female State Pension is projected to align with the male median State Pension around a decade earlier under the single-tier pension, in the early 2040s rather than the early 2050s.
87. The main reason that notional outcomes for women improve more quickly in the early years is that the single-tier valuation benefits lower paid and part-time workers, who are predominantly women. In 2016 around 40% of women reaching State Pension age would get a notionally higher State Pension as a result of the single-tier valuation, with around 1 in 6 men also benefiting from this element of the reform. This mechanism results in the gap between average pension outcomes for men and women closing more quickly for early cohorts.
88. As a result of the single-tier valuation, around 650,000 women who reach State Pension age in the first ten years after the single-tier pension is implemented will receive an average of £8 per week more in State Pension (in 2013/14 earnings terms). As a consequence, reliance on means-tested benefits to provide a minimum level of income will fall.
89. Due to unequal State Pension ages, the first man to receive a single-tier pension was born on 6<sup>th</sup> April 1951 and the first woman on 6<sup>th</sup> April 1953. There is therefore a cohort of some 700,000 women (those born between 6<sup>th</sup> April 1951 and 5<sup>th</sup> April 1953) who will reach their State Pension age before the implementation of the single-tier pension, and will therefore receive a current system pension, when a man born the same day would be able to qualify for a single-tier pension. However, the women in this cohort will reach their SPa between 2 and 4 years before a man born the same day, and in this interval they could receive on average £19,000 in State Pension. This cohort will also retain access to features of the current system, such as an actuarially generous rate of deferral, Savings Credit, and derived entitlement to State Pension.<sup>22</sup>

<sup>22</sup> More details are available in a note at <https://www.gov.uk/government/publications/the-single-tier-pension-note-on-the-cohort-of-women-born-between-6-april-1951-and-5-april-1953>



### Case Study 5) Elizabeth – Low earner, broken work history, aged 59 in 2013

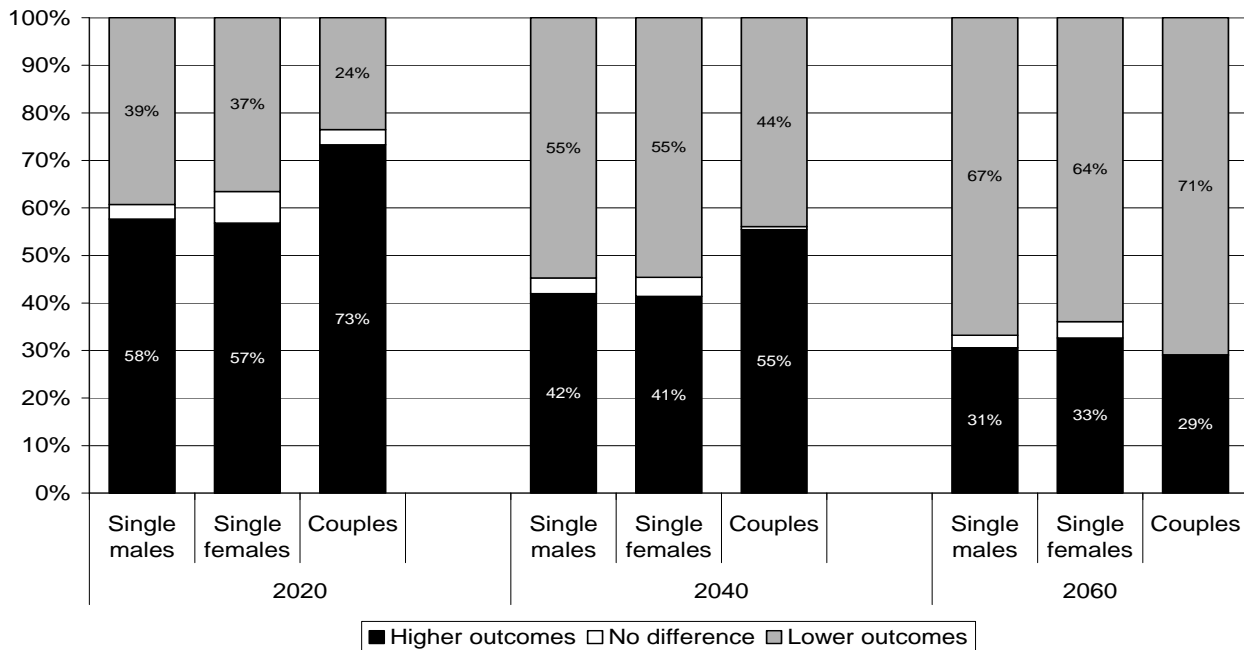
Elizabeth was born in 1954 and reaches State Pension age at 66 in 2020. She married and was a housewife until having her first child aged 25. She stayed at home looking after her children until the age of 43. She then went to work part-time until aged 59 in a job that pays her a salary equivalent to around £8,000 (2012/13 earnings terms). At the age of 60 she gave up paid employment to volunteer in a local charity. She achieves 35 qualifying years and has a life expectancy after State Pension age of 24 years.

While Elizabeth was looking after her children her State Pension entitlement for both the current and single-tier pension systems was protected by Home Responsibilities Protection. Elizabeth gets the full single-tier pension. She has a higher income under single-tier because each qualifying year is worth more, which helps to equalise State Pension outcomes for carers who would not have received much additional State Pension under the current system.

2012/13 earnings terms	Current State Pension	Single-tier Pension
Weekly pension in first year after reaching State Pension age	£132	£144
Average weekly pension over the rest of her life (for stated life expectancy)	£131	£149
Total pension over the rest of her life	£163,000	£184,000

90. To analyse the proportion of men and women who have notionally increased or lower outcomes from the reform overall, the rest of the analysis on gender outcomes looks at benefit units, as means-tested benefit entitlement is assessed for households rather than individuals. Furthermore, total household pension income is often a more relevant indicator of whether people benefit overall from the reform. Chart 3.7 below looks at the overall impact by benefit unit type, when all elements of the reform are included (changes to State Pensions and means-tested benefits).

**Chart 3.7: Notional impacts on the net household income of the cumulative stock of post 2016 pensioners, by type of benefit unit.**



91. In 2020 and 2040 couples are more likely to get a notionally increased income from the reform than single pensioners. This is partly due to the interaction with means-tested benefits. Couples are less likely to be entitled to means-tested benefits so are less likely to see gains from the single-tier pension being offset by reduced benefit entitlement, or to be affected by the removal of Savings Credit.

92. The ability to derive or inherit State Pension entitlement will end with the single-tier pension, although some transitional arrangements will be put in place. The Department has published a detailed note on this aspect of reform on the DWP website, including case studies.<sup>23</sup>
- We estimate that in 2020 fewer than 30,000 women (less than 5% of single-tier pension female pensioners, a proportion which then gradually falls until 2060) will be affected by the loss of derived entitlement to a basic State Pension, based upon the National Insurance record of their spouse or civil partner.<sup>24</sup>
  - While people may lose the ability to inherit additional pension from a spouse or civil partner, they may nevertheless suffer no overall notional loss due to gaining from another aspect of the reform package.

### 3.3 Impact of reform on outcomes for disabled people

93. Disabled people's chance of being eligible for means-tested benefits is less affected by the reforms, since those with a severe disability who are in receipt of a qualifying disability benefit may still be able to receive Guarantee Credit which will also passport them to full Housing Benefit and council tax support. This is because the minimum income guarantee is higher for those in receipt of a qualifying disability benefit<sup>25</sup>.

### 3.4 Individual outcomes not fully modelled in the Impact Assessment

94. Pensim2 is not able to fully model three aspects of the single-tier reform package: the introduction of a minimum qualifying period (MQP), changes to deferral policy and the impact of the reforms on overseas pensioners. In order that these aspects of policy are not left out of the assessment of the costs or impacts of the single-tier pension, the Department has estimated these impacts separately. This section outlines the main results from this analysis and information about the methodology is in Annex A.
95. The main impacts estimated outside of the main modelling are:
- a. **Deferrals:** the ability to take a lump sum will be ended, and the rate of increment for deferral will be set closer to implementation and so, for illustrative purposes, this paper assumes a rate of 1 per cent for every ten weeks' deferral. We expect that between 10,000 and 25,000 people will be affected each year by the end of the ability to take a lump sum and the change to the rate of return for deferrals. We estimate this component to save around £200m in 2020, rising to £300m by 2030 (in 2013/14 prices).
  - b. **Minimum Qualifying Period (MQP):** there will be a 10-year minimum qualifying period (MQP) for the single-tier pension. In Pensim2 we are unable to fully model the impact of this policy due to migration, so we have used a different approach to model these impacts.

In summary:

- The numbers affected and savings in the early years of the policy are expected to be relatively low (rising from zero to around 35,000 people in 2020).
- In 2040 we estimate that the MQP could affect around 400,000 people living overseas.
- The expected savings from the MQP in 2040 are around £650m (in 2013/14 prices).

The proportion of overseas residents, who reach State Pension age under the single-tier pension, which is affected by the MQP is much greater than the proportion of GB residents which is affected. This is expected to be approximately 2% of the GB cohort and around 20% of the overseas cohort.

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<sup>23</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/181235/derived-inherited-entitlement.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181235/derived-inherited-entitlement.pdf)

<sup>24</sup> This estimate is based on the number of women who receive a lower notional non-inherited State Pension outcome under the single-tier and who would have claimed Category B or Category BL under the current system.

<sup>25</sup> Means-tested support for pensioners changed in April 2013 with the localisation of council tax support. The implementation of the Welfare Reform Act 2012 will also bring changes to means-tested support for pensioners.

Our estimate of the number of Great Britain and overseas residents affected by the MQP over the first three years of the single-tier pension is shown in Table 3.1 below.

**Table 3.1: Estimate of number of people affected by the 10-year MQP, 2016-2020**

Year of SPa	Average for each year, 2016-2020	As a proportion of those reaching SPa
Great Britain residents	9,000-12,000 per year	2%-3%
Overseas residents	6,000-10,000 per year	18%-23%

Source: Based on NICs records from L2 data for 2010/11 financial year (1% sample of NIRS2). DWP modelling of qualifying years gained in the intervening years.

Note: Data are presented as ranges to indicate uncertainty around the final outcome. The analysis is static and assumes no within-cohort migration or mortality. The overseas estimate assumes that all people living in a European Economic Area (EEA) or bilateral country will overcome the MQP on account of gaining the required balance of qualifying years over the rest of their working lives abroad. However, it also assumes that none of those living in non-EEA or non-bilateral countries gain sufficient qualifying years to overcome the MQP.

96. A limitation in our methodology for estimating the impact of the MQP is uncertainty around the State Pension contributions made by these individuals in countries with which the UK has a bilateral social security agreement<sup>26</sup> and the EEA countries. Qualifying years gained by individuals in these EEA and bilateral countries will count towards satisfying the MQP. For example, an individual reaching State Pension age who had worked for 8 years in France and 2 years in the UK would satisfy a 10 year MQP, and therefore would be paid a single-tier pension of 2/35<sup>ths</sup> of the full rate.
97. It is important for the reader to note that, while both the deferrals and MQP policies are included in the Exchequer impact presented in Chapter 6, one should not combine the estimates above with the numbers set out elsewhere in the report. For example, someone notionally affected by changes to deferrals may get a higher outcome overall from the reform or might have a partner who has a higher outcome after reform.

### 3.5 Spouses and civil partners of Armed Forces personnel serving overseas

98. In 2010 the Government introduced a National Insurance credit for the wives, husbands and civil partners of members of Her Majesty's Forces who accompany their partners on assignment outside the UK. This credit was put in place in recognition of the Government's commitment to the Armed Forces, as set out in the Armed Forces Covenant. Eligible individuals could apply for this credit to cover periods spent on an accompanied assignment from the 2010/11 tax year onwards.
99. The Government has now committed to making regulations that allow service spouses and civil partners, due to reach State Pension age from 6<sup>th</sup> April 2016, to apply for National Insurance credits for periods spent accompanying their partners on a posting outside the UK between 1975/76 and 2009/10. This will ensure that time spent overseas will not adversely impact these individuals' National Insurance records.
100. The Government estimates that up to 20,000 individuals could have a higher single-tier pension as a result of these credits.

<sup>26</sup> For list of bilateral countries, see: <http://www.dwp.gov.uk/international/social-security-agreements/list-of-countries/>

# Chapter 4) Changes to means-tested benefits

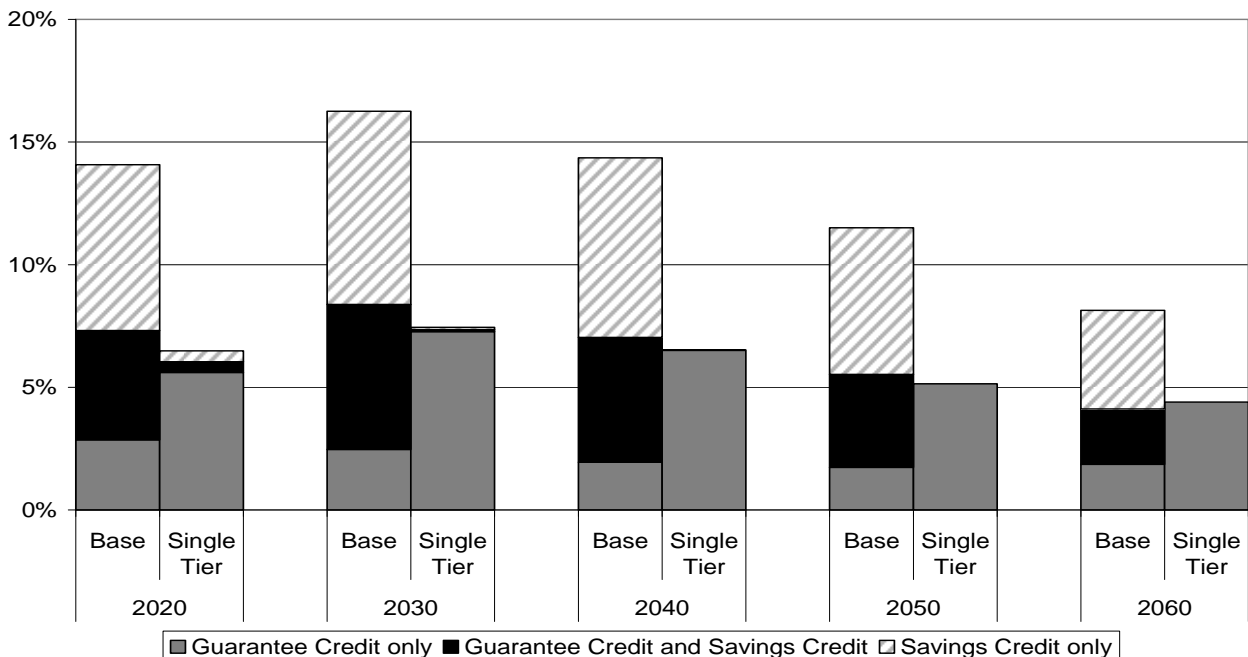
## 4.1 Eligibility for means-tested benefits

- 101. This chapter looks at the effect the single-tier reform has on means-tested benefits for pensioners. As with Chapter 3, most of the analysis in this chapter is focused on the population reaching State Pension age after the implementation of the single-tier pension (referred to as the single-tier population). Analysis of means-tested benefits is presented for benefit units (households) rather than individuals, as this is the basis on which eligibility is assessed.<sup>27</sup>
- 102. As part of the Universal Credit reforms, pensioners with a working-age partner will claim Universal Credit rather than Pension Credit or Housing Benefit. The baseline includes these reforms. For simplicity, the small numbers of Universal Credit claims are presented as being eligible to Guarantee Credit (and Housing Benefit where there is an element of support with rent).
- 103. As of April 2013 Council Tax Benefit has been replaced with localised support. The analysis assumes that localised council tax support for pensioners will be broadly similar in outcomes to the former Council Tax Benefit system.
- 104. This chapter shows that the proposed single-tier reforms lead to a reduction in the proportion of people eligible for Pension Credit, mainly due to the removal of the Savings Credit. The single-tier pension also reduces eligibility for Guarantee Credit and council tax support but has little effect on eligibility for Housing Benefit. By the 2040s, overall eligibility for means-tested benefits falls by around 3 percentage points, or around 350,000 households, as a result of the single-tier reforms.

### a) Eligibility for Pension Credit within the single-tier pension

- 105. The introduction of the single-tier pension leads to a reduction in the scope of Pension Credit for two reasons: a higher State Pension means that fewer pensioners require Guarantee Credit to top up their income under the single-tier pension and Savings Credit is no longer required to ensure that people benefit from additional saving. The scale of the expected reduction in eligibility is shown in Chart 4.1.

**Chart 4.1: Eligibility for Pension Credit from 2020 to 2060 amongst the population reaching State Pension age after implementation of the single-tier pension**



<sup>27</sup> A household can contain more than 1 benefit unit when, for example, there are non-dependant adults living in the same household.

“Base” represents the cumulative flow of single-tier pensioners under the current system rolled forward, so is not comparable to figures elsewhere for entitlement that include pensioners reaching State Pension age before 2016. Guarantee Credit figures include small numbers entitled to Universal Credit.

106. Under the current system, eligibility for Pension Credit (or Universal Credit where only one member of a couple is above the qualifying age for Pension Credit) amongst the single-tier population is expected to peak at around 15 percent in the mid 2020s and fall to around 10 per cent by 2060. Under the single-tier pension, eligibility for Pension Credit is halved compared to the current system in the first few years following implementation, and ultimately falls to around five per cent by 2060.
107. Ending Savings Credit for single-tier pensioners is the main driver of the reduction in the number of people qualifying for Pension Credit, although there is also a reduction in the proportion of pensioners eligible for Guarantee Credit. The reduction in the numbers within scope of the Guarantee Credit is the result of most single-tier pensioners under the single-tier pension having a State Pension above the level of the Standard Minimum Guarantee.
108. There are a number of reasons why a small number of pensioners remain eligible for Pension Credit, despite the full single-tier pension being above the Standard Minimum Guarantee. An individual may:
  - Have fewer than 35 qualifying years and so not have a full single-tier pension;
  - Receive an additional amount within Pension Credit, such as the Severe Disability Additional Amount<sup>28</sup>;
  - Be a member of a couple still receiving Savings Credit because one member reached the qualifying age before it was removed;
  - Be a member of a ‘mixed-age couple’, where one member is below State Pension age with little or no income, making them eligible for Guarantee Credit or Universal Credit based on their combined income.
109. By 2060 the most common reasons for entitlement to Pension Credit will be having less than 35 qualifying years or being entitled to an additional amount, for instance due to a disability. Entitlement to an additional amount becomes more important in explaining the continued scope of Pension Credit in later years. This change is partly due to the ageing of the single-tier population. As the single-tier population ages, there are greater numbers of older pensioners who are more likely to be entitled to the Severe Disability Additional Amount.

**b) Support with housing costs and council tax**

110. Housing Benefit (HB) provides means-tested support for households on a low income needing help with their rent and localised council tax support provides means-tested support for council tax bills. Entitlement amongst the single-tier population is shown in Table 4.1, with and without the single-tier pension. Entitlement to HB is not expected to change significantly.

**Table 4.1: Entitlement to housing and council tax support (amongst the population reaching State Pension age after implementation of the single-tier pension)**

		2020	2030	2040	2050	2060
<b>Housing Benefit</b>	Base	13%	17%	16%	13%	12%
	Single-tier	12%	16%	16%	13%	12%
<b>Council Tax Support</b>	Base	35%	37%	33%	28%	23%
	Single-tier	35%	35%	31%	27%	23%

Source: Pensim2; numbers rounded to the nearest 1 per cent.

111. Entitlement to support with rent and council tax bills is affected by the implementation of the single-tier pension because an increase in State Pension income means that individuals are less likely to need help with housing costs and also because the cut off point for support will be lower following the removal of Savings Credit.
112. Despite the average HB award falling, these changes have a limited effect on the overall number of people claiming HB. This is because it takes a lot of additional income to be taken out of HB

<sup>28</sup> Additional amounts are added to Guarantee Credit to help with the costs of caring, disability and some housing costs.

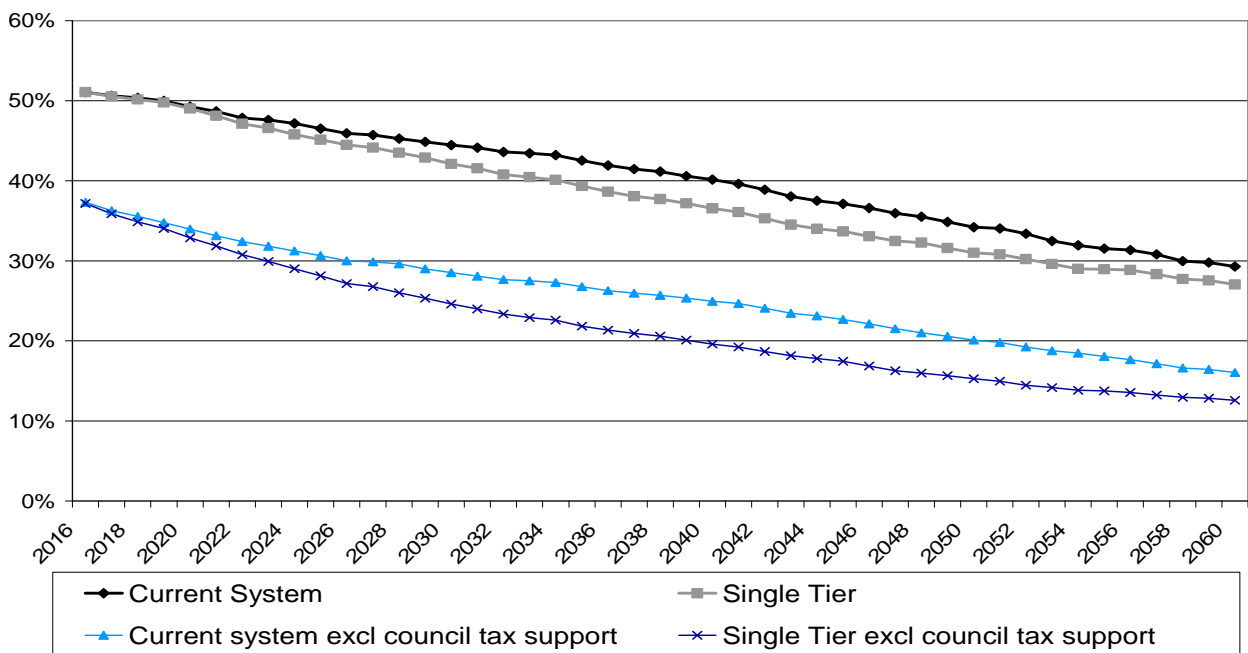
entitlement altogether, and the Government is proposing to protect the outcomes of those who could otherwise lose some rent support among people reaching State Pension age in the first five years after implementation. Therefore even where people are no longer entitled to Pension Credit (whether through removal of Savings Credit or higher State Pension income) some entitlement to housing or council tax support may remain.

113. By 2040 the average weekly entitlement to support with Housing Benefit is notionally around £6 lower than in the current system, and notionally around £2 lower for council tax support. However, many recipients will see an increase in their State Pension award and so may be better off overall.

**c) Overall scope of means-tested benefits**

114. Chart 4.2 below shows that eligibility for means-tested benefits is expected to fall over time. This reflects growth in pensioner incomes associated with the triple-lock, automatic enrolment, female labour market participation and previous State Pension reforms. It is also partly driven by the reduced scope of Savings Credit under current policy and the introduction of Universal Credit.
115. In the early years the impact of the reforms is small since changes only apply to new pensioners. In the long-term the impact of the reforms is to reduce eligibility for means-tested support by three percentage points, or around 350,000 pensioner benefit units by the 2040s. The bottom two series on Chart 4.2 show eligibility excluding council tax support, which is now locally administered.

**Chart 4.2: Eligibility for any means-tested benefit (all pensioners), with and without council tax support**



116. Pensioners from ethnic minority groups are more likely to draw part of their income from means-tested benefits compared to white pensioners. For example, the latest Pensioners’ Income Series shows that 53% per cent of black or black British pensioners drew part of their income from means-tested benefits compared with 29% per cent of white pensioners<sup>29</sup>.

117. Research undertaken to understand why DWP’s Pensions Service consistently receive poorer feedback from their ethnic minority customers shows that ethnic minority customers have additional difficulties in understanding the benefits system, and that they may be disproportionately impacted by complexity<sup>30</sup>. We may therefore expect some ethnic minority people to benefit from the increased simplicity and reduced means-testing that the single-tier system offers, either in terms of their take-up of benefits or satisfaction with the process.

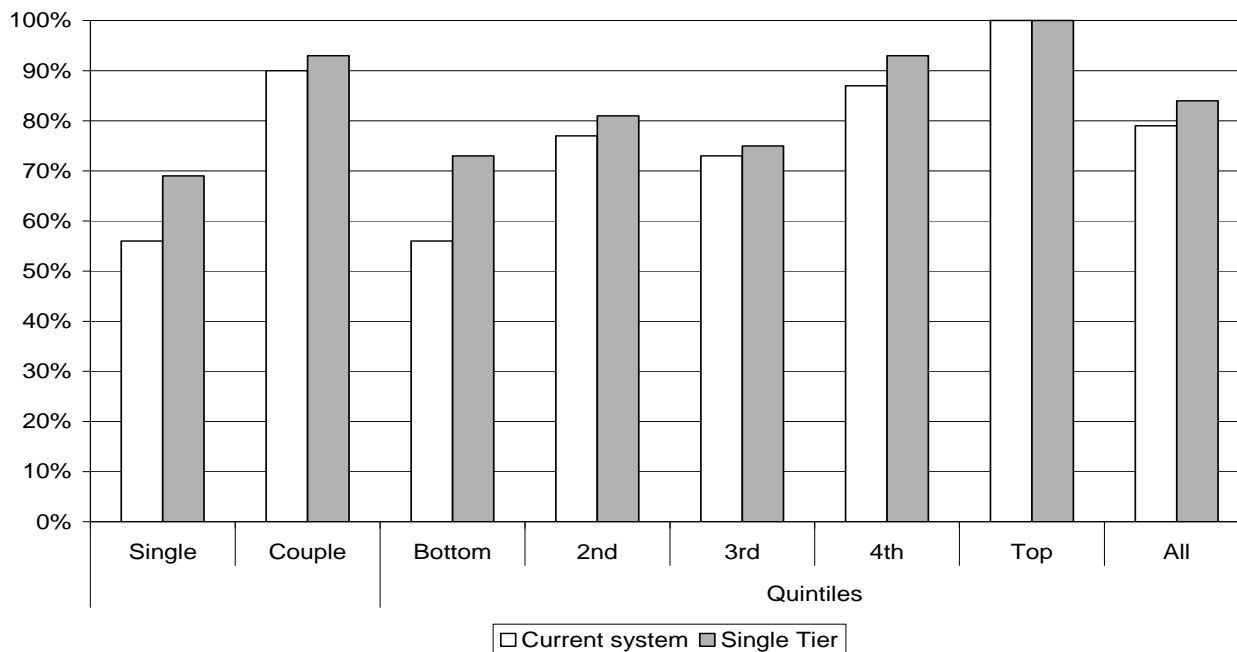
<sup>29</sup> The Pensioners’ Income Series 2011-12. Department for Work and Pensions.

<sup>30</sup> Ethnic minority customers of the Pensions, Disability and Carers Service: An evidence synthesis.’ DWP Research Report. 684. (2010)

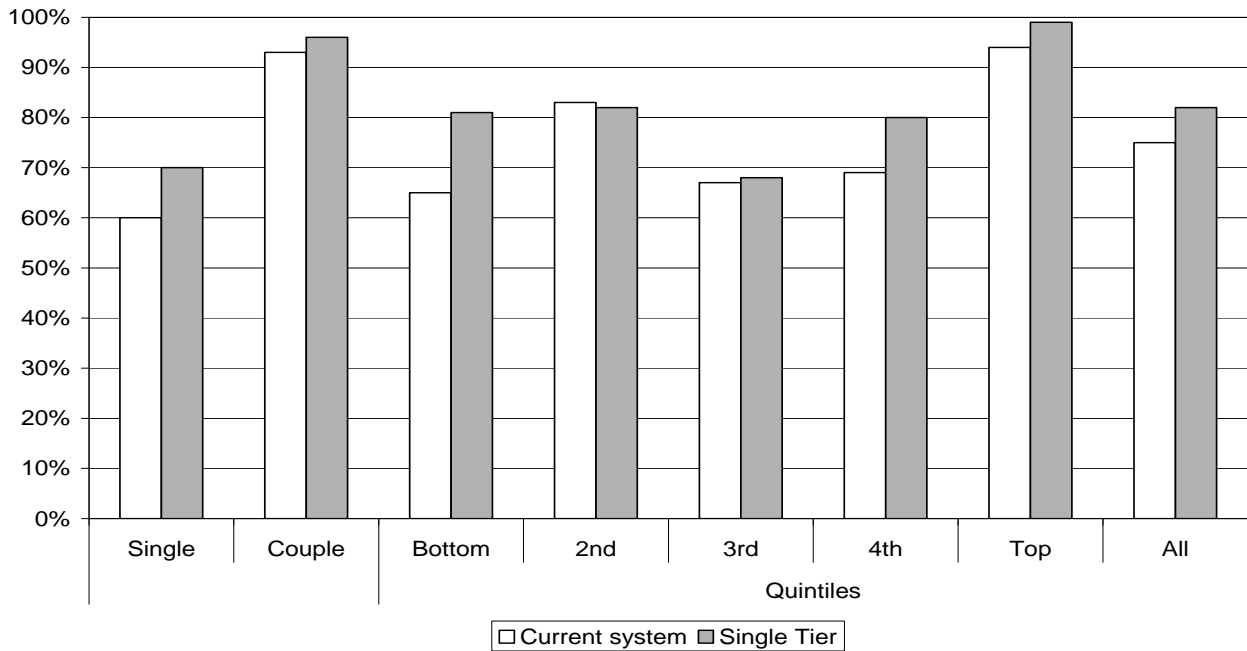
## 4.2 Means-tested benefits and rewards for saving

118. Means-tested benefits can reduce the reward from saving or working, since income from saving and working is taken into account when calculating entitlement. Marginal Deduction Rates (MDRs) give a measure of the effect that means-tested benefits have on the reward from saving or earning. The MDR is the proportion of an additional £1 of income (after tax) that a person would lose once their means-tested benefit award had been calculated. For example, if a person is on a 100 per cent MDR then every £1 of private income (including State Pension) reduces their benefit income by £1 and they see no additional reward for saving or working. The lower the MDR the higher the potential rewards from saving or working.
119. The removal of Savings Credit under the single-tier system will reduce the number of different marginal deduction rates that pensioners face at different income levels. This will simplify the pension system and reduce the interaction that any additional income may have with means-tested benefits for those with modest incomes, which will enable these pensioners to see greater benefits from saving or working past State Pension age. Despite this positive feature, it is possible that overall some households may not be notionally better overall (if their specific circumstances mean that the benefit from the reduced MDR is offset by a change from another aspect of the reform).
120. Charts 4.3 and 4.4 show how the single-tier reforms affect MDRs for the cumulative number of pensioners reaching State Pension age after 2016. The proportion facing a low marginal deduction rate of 20 per cent or less would rise significantly, particularly for the poorest pensioners and single pensioners, so that they can keep more of any additional saving or earnings.
121. The single -tier reforms have less impact on the MDRs of couples since they are less likely to interact with means-tested benefits and as a consequence are less likely to face high MDRs.

**Chart 4.3: Proportion of single-tier pensioners with a low Marginal Deduction Rate (at or below 20 per cent) in 2020, by income quintile**



**Chart 4.4: Proportion of single-tier pensioners with a low Marginal Deduction Rate (at or below 20 per cent) in 2040, by income quintile**



*Note: The proportion with a low Marginal Deduction rate is generally slightly higher in 2020 than 2040 under both the current system and single-tier pension. This simply reflects that in 2020 the single-tier population consists only of relatively young pensioners who are less likely to be entitled to means-tested benefits. As the single-tier cohort matures, this composition issue diminishes.*

**Case Study 6) John – Median earner, Automatically Enrolled from 2017, aged 31 in 2013**

John was born in 1982 and reaches State Pension age at 68 in 2050. He works from the age of 20 earning a salary equivalent to around £29,000 (2012/13 earnings terms) and gains 48 qualifying years of National Insurance contributions. He has a life expectancy after State Pension age of 23 years.

He is automatically enrolled from 2017 and pays the minimum contribution of 8% (4% employee +1% tax relief +3% employer contributions). However, before 2017 he had no private pension arrangements.

John chooses not to opt out of his Automatic Enrolment pension as he is now more certain about what his State Pension will be under the single-tier system and he wants to boost his state retirement income. Although his single-tier pension is notionally lower than under the current system, his combined income from single-tier and Automatic Enrolment is higher and, without the recent workplace pension reforms, he may only have had his State Pension income to rely on.

2012/13 earnings terms	Current State Pension	Single-tier Pension	Automatic Enrolment	Single-tier + Automatic Enrolment
Weekly pension in first year after reaching State Pension age	£215	£156	£90	£246
Average weekly pension over the rest of his life (for stated life expectancy)	£199	£162	£58	£220
Total pension over the rest of his life	£251,000	£193,000	£69,000	£262,000

**4.3 Impact on the take-up of means-tested benefits**

122. Until this point the analysis of the scope of means-tested benefits has focused on how the proposed reforms change entitlement. However, not all pensioners will take up benefits to which they are



entitled. Where pensioners are entitled to only the Savings Credit element of Pension Credit, take-up is low, estimated to be between 43 per cent and 48 per cent in 2009/10<sup>31</sup>. As the single-tier pension will result in many people receiving a pension above the level of the Guarantee Credit threshold, it may help to alleviate poverty for some pensioners who would otherwise not have claimed a means-tested top-up.

123. Take up of Guarantee Credit, Housing Benefit and council tax support is not expected to change significantly because these benefits are not changing with the single-tier pension. In the baseline it is assumed that the reforms included in the Welfare Reform Act 2012 will mean that anybody who would claim one of Pension Credit or Housing Benefit under today's system will claim both under the reformed system. Localised support for council tax is assumed to have the same level of take-up as Council Tax Benefit.

#### 4.4 Passported Benefits

124. Receipt of Pension Credit can 'passport' pensioners to automatic entitlement to a number of other benefits. If pensioners are no longer eligible for Pension Credit as a result of the single-tier reforms then they could lose eligibility to some of these 'passported benefits'.
125. Receipt of Guarantee Credit passports pensioners to the full amount of Housing Benefit and Council Tax Benefit, if the pensioner is eligible for these benefits. There is little reduction in Guarantee Credit eligibility resulting from the single-tier pension (around 1 percentage point in 2020), so this has a limited impact on the proportion of pensioners that is eligible to be 'passported' to the full amount of housing or council tax support. Those who have no income other than the single-tier pension will often still be entitled to an award. Again it should be remembered that responsibility for Council Tax Benefit has been localised from April 2013.
126. Receipt of Pension Credit can lead to qualification to certain other benefits. Most of these are linked to receipt of Guarantee Credit and so pensioners no longer entitled to Guarantee Credit as a result of the single-tier pension may also lose eligibility to these other benefits (however, as stated above, there is only a small impact of the single-tier pension on entitlement to Guarantee Credit). Some of these schemes are set out below, assuming that the criteria operated by the supplier organisation will not change:
- **Health benefits:** receipt of Guarantee Credit passports claimants to free dental treatment, and to vouchers for glasses, wigs and fabric support (however, free prescriptions and sight tests are available to all individuals over the age of 60).
  - **Free school meals:** recipients of Guarantee Credit with dependent children are eligible for free school meals. This is estimated to affect less than 1 per cent of single-tier pension recipients (before the removal of Savings Credit).
  - **Social Fund Payment:** Pension Credit acts as a passport to certain elements of the Social Fund. Guarantee Credit and Savings Credit both act as a passport to maternity grants, funeral expense payments, cold weather payments and budgeting loans.
  - **Local benefits:** further 'passports' may also be available from the local authority, such as grants to help with home insulation or from education institutions. However, rules governing eligibility for these schemes will vary across different local authorities and institutions.

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<sup>31</sup> DWP, February 2012, *Income Related Benefits: Estimates of Take-up in 2009/10*.

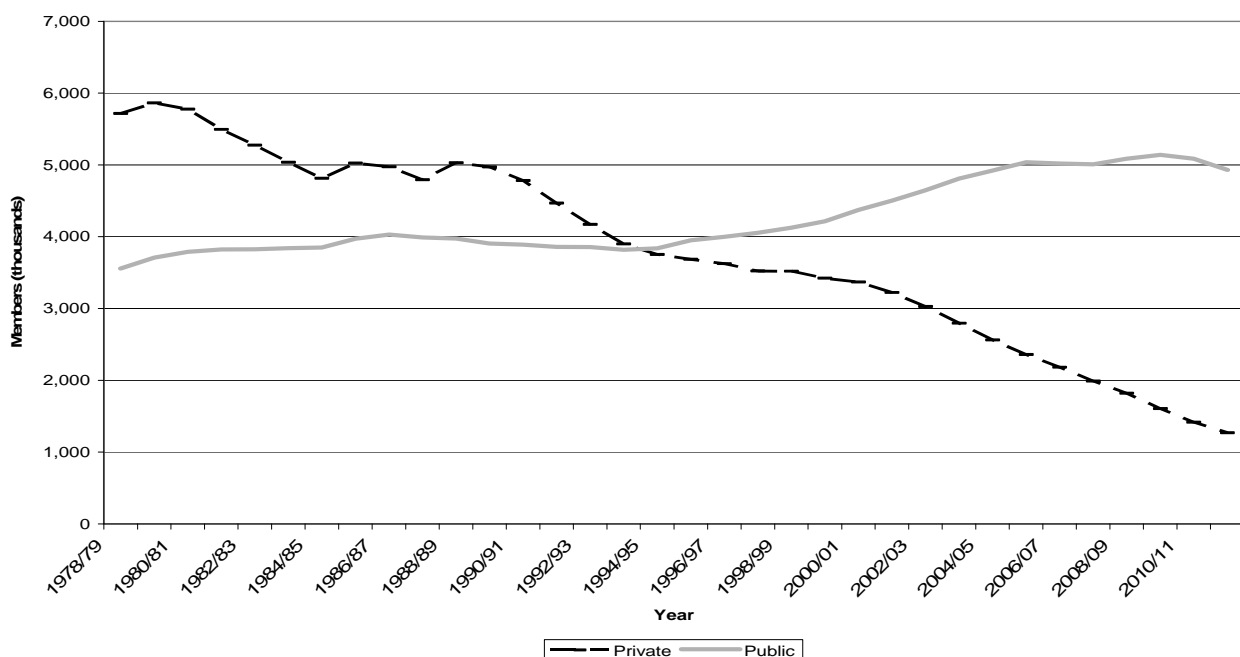
## Chapter 5) Ending Defined Benefit contracting-out: impact on individuals, scheme sponsors and pension industry

127. Under the single-tier reforms, the State Second Pension – the earnings-related element of state provision – will close. This means that the system whereby Defined Benefit (DB) pension schemes can contract-out of the State Second Pension will also come to an end.
128. Ending contracting-out is a key consequence of a single-tier pension system and will contribute to simplifying the State Pension system. It will remove the connection between state and private pension schemes that can cause misunderstanding and confusion for individuals, difficulty in providing accurate estimates of State Pension and that adds to the administrative burdens for both pension schemes and HMRC. It will harmonise National Insurance rates paid by both employers and employees and ensure people are able to claim the same amount of State Pension.

### 5.1 Contracting-out demographics

129. Chart 5.1 below shows the number of individuals in contracted-out Defined Benefit (DB) schemes since 1978, split by whether they are in the public or private sector.

**Chart 5.1: Contracted-out DB scheme membership by sector, 1978 – present**



Source: Second Tier Pension Provision 2011/12 – 2013 DWP statistics

130. The chart shows that membership of private sector DB contracted-out schemes has been in decline since 1978, reflecting the wider decline in DB schemes in the private sector<sup>32</sup>. Meanwhile, membership of contracted-out DB schemes in the public sector has grown steadily, in line with general employment growth in the public sector over this period.
131. According to the 2011 Occupational Pension Schemes Survey<sup>33</sup>, there are currently around 1.6 million active<sup>34</sup> members of contracted-out DB schemes in the private sector and 5.3 million active members of contracted-out DB schemes in the public sector. These are expected to reduce to 950,000 in the private sector and 4.5 million in the public sector by 2016.

<sup>32</sup> See for example 'Pensions: Challenges and Choices, -The First Report of the Pensions Commission', 2004.

<sup>33</sup> Occupational Pension Schemes Annual Report 2011, ONS. The information on contracted-out DB schemes or membership size (Table 5.1) is not published in the 2012 Report

<sup>34</sup> Active members are those that continue to accrue new pension rights in a scheme.

132. Table 5.1 below shows how active membership is distributed by scheme size.<sup>35</sup> It shows that most members are concentrated in the biggest schemes. It also shows the number of contracted-out DB schemes in the public and private sectors in 2010. Together with the active membership data, this shows that while the public sector will be more affected in terms of membership, the number of different schemes involved is much larger in the private sector.

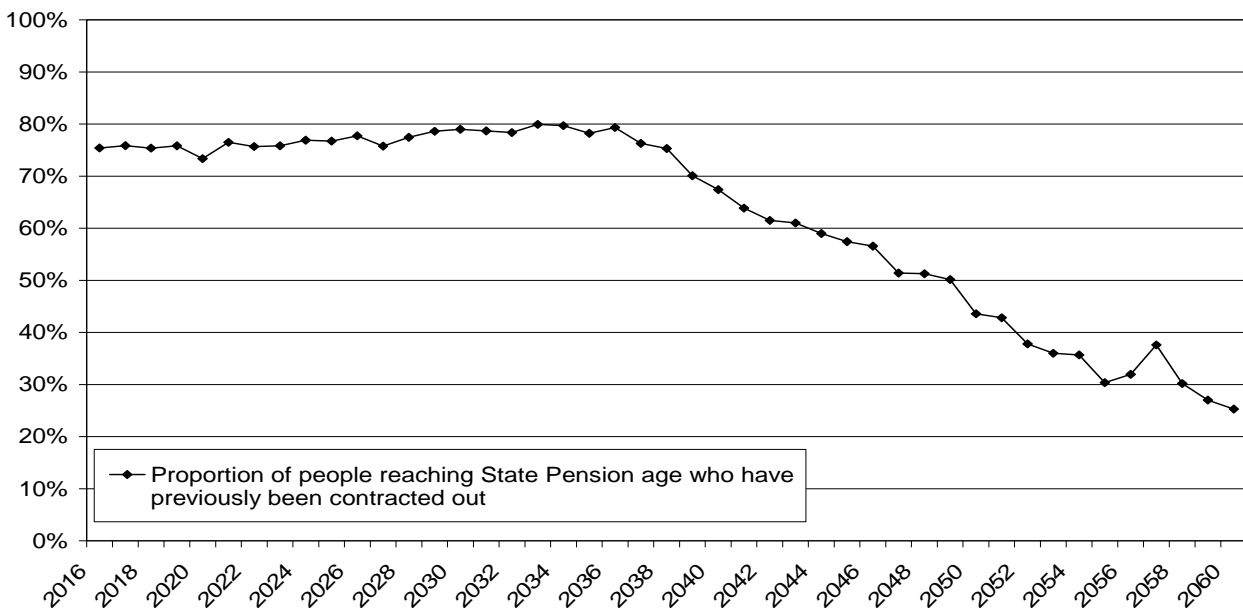
**Table 5.1: Number of active members of contracted-out DB schemes, and number of schemes, by size of membership and whether in public or private sector, 2011**

Membership size	Membership of DB schemes (millions)		Number of DB schemes	
	Private <sup>1</sup>	Public <sup>2</sup>	Private <sup>3</sup>	Public <sup>4</sup>
5,000+	1.2	5.3	140	132
1,000 to 4,999	0.2	0.1	450	69
100 to 999	0.1	0	1,600	63
12 to 99	0	0	..	37
2 to 11	0	0	..	30
<b>Total</b>	<b>1.6</b>	<b>5.3</b>	<b>3,290</b>	<b>331</b>

Source: OPSS data 2011

133. However, Chart 5.2 below shows that until the late 2030s over three quarters of people reaching State Pension age in any year will have been contracted-out at some point in their working lives. This will include people who were contracted-out when in a private sector DB or DC scheme (DC scheme members were able to contract-out until 2012).

**Chart 5.2: Proportion of people reaching SPA by year, that have been contracted-out at any point in their working lives**



Source: DWP (Pensim2)

## 5.2 Impact on individuals

134. When the single-tier pension is implemented and contracting-out ends, all employees who were members of a contracted-out scheme immediately before implementation will cease to receive the 'contracted-out rebate' and will start to pay full National Insurance contributions (NICs). This will mean an increase in the rate of NICs that they pay equivalent to the value of the rebate (calculated

<sup>35</sup> This information is not available in the 2012 report so 2011 table is provided

as 1.4 per cent of their earnings between the LEL and the UAP<sup>36</sup>), bringing them into line with the rate of National Insurance that is paid by other employees. The precise increase in National Insurance will vary across individuals and will depend on their level of earnings in each year. In return, contracted-out employees will be brought fully back into the State Pension.

135. Table 5.2 below shows that the impact of the loss of the rebate for contracted-out workers is £23 per month for an individual on approximately median earnings. Values in future years have been expressed in 2013/14 earnings terms.

**Table 5.2: Monthly increase in individual National Insurance contributions as a result of ending DB contracting-out in 2016, in 2013/14 earnings terms**

Annual earnings	2016	2017	2018	2019	2020	2030
£10,000	£5	£5	£5	£5	£6	£6
£15,000	£11	£11	£11	£11	£11	£12
£25,000	£23	£23	£23	£23	£23	£17
£40,000*	£36	£34	£33	£31	£30	£17

Source: DWP modelling rounded to nearest £1.

Note: In our modelling, the LEL has been uprated by CPI until 2022/23 and thereafter by average earnings. Costs fall over time for middle and higher earners due to the effects of flat-rating.

Earnings in constant 2013/14 earnings terms.

\*The figure used in the modelling is £40,040, the level of the Upper Accrual Point (UAP). For all DB contracted-out individuals earning at or above the UAP the increase in National Insurance following the end of contracting-out is the same.

**Case Study 7) Mark – Median earner, former DC scheme member, aged 59 in 2013**

Mark was born in 1954 and reaches State Pension age at 66 in 2020. He works from the age of 20, earning a salary equivalent to around £29,000 (2012/13 earnings terms). He gains 46 qualifying years of National Insurance contributions and has a life expectancy after State Pension age of 22 years. Furthermore, Mark made savings into a Defined Contribution private pension scheme over his whole working life and, as a consequence, he was contracted-out of the additional State Pension. Following the end of DC contracting-out, he was contracted back in after 2012 until he reached State Pension age.

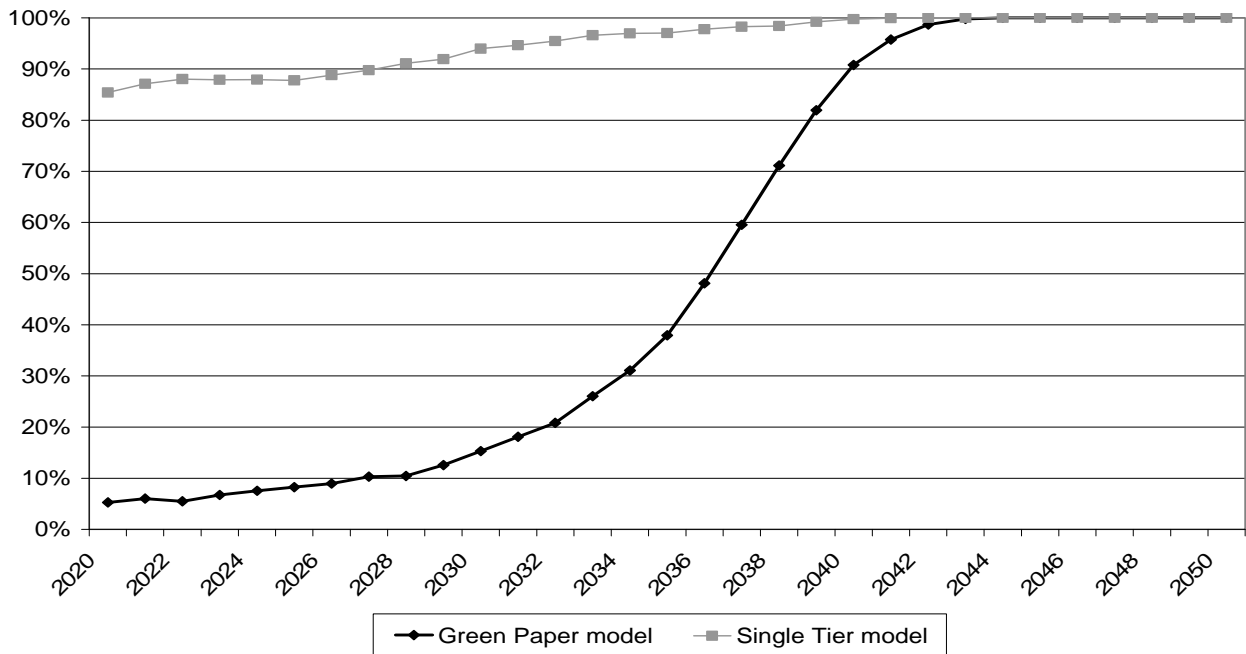
At the point of introduction, the valuation of Mark’s National Insurance record was assessed as being worth more under the current system rules therefore this is given as his ‘foundation amount’. He has the opportunity to build on his foundation amount if he gains extra qualifying years after the implementation of single-tier. This means that under the single-tier he gets a higher income than he would have done if the current system had rolled forward, as each qualifying year he gains after 2016 increases his State Pension by 1/35th of the full single-tier pension. By contrast, under the current system each qualifying year would only have given him a small amount of additional State Pension (as he already has enough qualifying years for the full basic State Pension).

2012/13 earnings terms	Current State Pension	Single-tier Pension	Private pension
Weekly pension in first year after reaching State Pension age	£129	£137	£178
Average weekly pension over the rest of his life (for stated life expectancy)	£132	£141	£117
Total pension over the rest of his life (for stated life expectancy)	£151,000	£161,000	£134,000

<sup>36</sup> Lower Earnings Limit and Upper Accrual Point. The LEL is £5,668 and the UAP is £40,040 in 2013/14.

136. As Chart 5.3 below shows, under the single-tier pension the vast majority of those who will pay a higher rate of National Insurance as a result of the ending of contracting-out will be able get extra State Pension for years worked or credited after 2016, up to the full amount of single-tier pension.

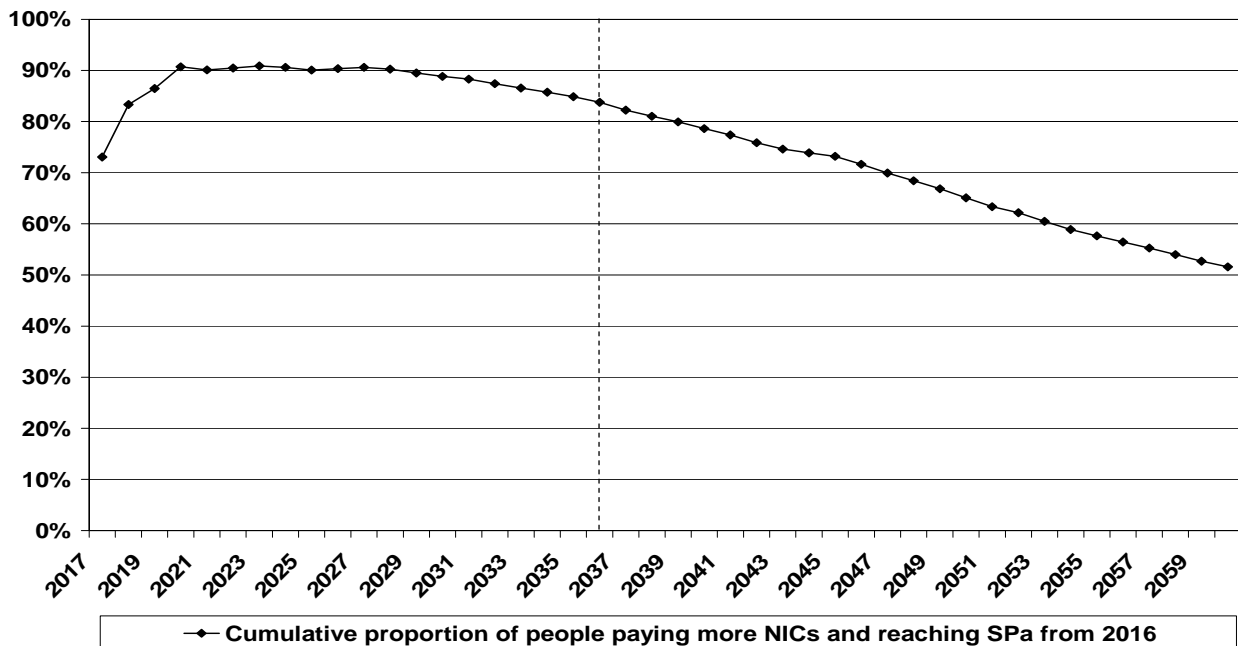
**Chart 5.3: Proportion of those who pay higher NI contributions who increase State Pension entitlement after 2016, by year they reach State Pension age**



Note: 5 year moving average

137. Chart 5.4 below shows that under the single-tier system around 85% of people who start to pay higher National Insurance contributions (NICs) and reach State Pension age over the first two decades after implementation will receive enough extra State Pension over their retirement to offset the increase in NICs, and any potential adjustments to their occupational pension schemes.

**Chart 5.4: Proportion of people paying extra NICs who gain enough in extra State Pension to compensate**



138. Chart 5.4 also shows that around 15% of people retiring in the first twenty years of the single-tier pension do not get enough extra State Pension to compensate for the extra NICs paid. There are several factors which would make someone less likely to recoup the additional contributions:

- Firstly, people who have previously been contracted in to SERPS or State Second Pension may gain less in exchange for their additional contributions, because their foundation amount may be closer to £144 than it would have been if they had been contracted-out for their entire working lives. In particular, where someone has previously been contracted-in for a prolonged period and has a foundation amount at or above the full value of the single-tier pension, they will not be in a position to gain through adding further qualifying years from 2016.
  - Secondly, people who change jobs or leave their Defined Benefit pension scheme after April 2016 would have been contracted back in under the current system, so may have notionally less State Pension under the single-tier pension. However, this depends on what happens to people after implementation of the single-tier pension and calculation of their 'foundation amount', so it is not possible to establish in advance who will find themselves in this situation.
  - Thirdly, people who die at a relatively young age are less likely to recoup the additional contributions, as they receive their State Pension for a shorter period and will not fully benefit from the compound effect of the more generous uprating under the single-tier pension. Note that people who die before reaching State Pension age are excluded from the analysis.
  - Fourthly, private sector workers may also face adjustments to their occupational pension. This is captured in the analysis by treating private sector workers as if they were paying both the employer and employee components of the rebate. If the analysis is limited to people who work wholly in the private sector from 2016, then the proportion who recoup the additional contributions is lower, but still high, at around 75%. Overall, around a quarter of those who do not recoup the additional contributions are private sector workers (however, this estimate is dependent on what changes employers actually make to the pension schemes they offer).
  - Fifthly, higher earners will have to pay more National Insurance, so are slightly less likely to recoup the additional NICs, all other things being equal. However, as the current system was already scheduled to move towards a flat-rated system in which the band of earnings to which the contracted-out rebate applied would become narrower over time, the amount of additional NICs paid will shrink over time, gradually reducing the number affected.
  - Sixthly, people reaching SPa within the first year of single-tier who will pay some extra NICs but will not have enough time to gain a qualifying year (as the applicable period for gaining qualifying years runs from April to April). However, they may still be able to gain over retirement due to having more of their pension uprated at least in line with earnings.
139. None of these factors in isolation will necessarily prevent someone from recouping all of the additional contributions, and almost everybody in the first twenty cohorts who remains in their Defined Benefit scheme for the rest of their career and who lives to their life expectancy will gain more in State Pension than they pay in extra National Insurance Contributions.

#### Public sector schemes

140. All public service DB schemes are contracted-out. With the decline in membership of Defined Benefit schemes in the private sector, by 2016 the vast majority of people who are contracted-out are likely to be in the public sector.
141. In 2010, the Government invited Lord Hutton to undertake a fundamental structural review of public service pension provision. His Independent Public Service Pensions Commission set out recommendations for reform in March 2011, which formed the basis of extensive consultation with trade unions and other representative bodies to develop new scheme designs. Final Proposed Schemes Designs were announced in 2012, and the Public Service Pensions Act which received Royal Assent in Spring 2013 sets out the framework for these new schemes. Implementation work is now underway to introduce the new schemes in April 2015 (or April 2014 for the Local Government Pension Scheme).
142. The Government has given a commitment to Parliament that the reforms to public service pensions should endure for twenty-five years, setting a high bar for future scheme changes to the Public Service Pensions Act. Public service employers, or employers who offer public service pensions, will therefore not be able to pass the cost of increased National Insurance contributions onto their employees by reducing the value of pension scheme benefits or by increasing employee contribution rates to their pension schemes.

### 5.3 Impact on DB scheme sponsors and the pension industry

143. DB scheme sponsors will cease to receive the 3.4 per cent National Insurance rebate. The abolition of DB contracting-out will affect any employer sponsoring a contracted-out DB scheme that still has active members. Schemes with no active members are not affected.
144. DB provision in the private sector has been in long-term decline, with many schemes being replaced by DC arrangements. This trend has been the result of significantly increased financial pressures on sponsoring employers. Unexpected increases in longevity, low investment returns and increased regulatory protection for members have increased the cost to sponsors of DB provision, while changes in pension accounting rules have made scheme funding positions more visible and volatile. The response of many private sector sponsors has been to close schemes.
145. In this context, the removal of the contracted-out rebate without any mitigating response may create the need for additional funding from DB sponsors. However, it is the Government's intention to provide employers with a limited override in order to allow them to fully recoup the cost of the lost rebate – so the overall impact of the lost rebate on DB sponsors should be small. The loss of the rebate on its own should not, in general, trigger scheme closures. However, it should be recognised that the loss of the rebate may be taken as a reason for some sponsors to close their DB scheme, particularly as sponsors will be reviewing their schemes in light of the end of contracting-out.
146. DWP sought the views of sponsoring employers in the private sector affected by the ending of DB contracting-out on how they would react. Many respondents to our consultation indicated that employers thought it unreasonable that they had to bear the cost of paying higher National Insurance contributions whilst maintaining the same scheme benefits. They therefore wished to reduce the level to which they must fund their scheme by the same amount as the increase in National Insurance contributions, reflecting the fact that employees would be brought back fully into the State Pension system when contracting-out ends. This could be done by reducing future pension benefits, increasing employee contribution rates to their pension schemes or a combination of both.
147. On the basis of the employer consultation, and as the Government therefore proposes to give employers limited powers to change scheme rules for this purpose without trustee consent, we have therefore assumed that the cost of the lost rebate is passed on to employees in the private sector immediately and in full by increasing employee contribution rates to their pension schemes, reducing future benefits or a combination of both. We are working closely with employers and employer organisations to ensure that the legislation enabling employers to make changes to their schemes to take account of the loss of the rebate fully meets the needs of those wishing to take advantage of those powers.
148. Following the announcement that the Government would be introducing the single-tier pension in 2016, one year ahead of the schedule laid out in the White Paper, DWP again sought the views of stakeholders to understand whether the new implementation date could reasonably be implemented by employers and schemes. Several stakeholders indicated that they did not have significant concerns regarding the new implementation date and delivering the end of contracting-out in a shortened timescale. However, some suggested that the reduced timescale would increase the number of scheme valuations needing to be performed outside of the normal valuation cycles, with a subsequent increase in demand for actuarial resource. Another issue raised was the importance of certainty around the implementation date, which we have now addressed by specifying this in the Bill.
149. It should be noted that any changes made to pension schemes under this option will most likely come with associated actuarial, legal and consultation costs. This has been considered in more detail in the Impact Assessment accompanying the draft secondary legislation on the end of contracting-out.<sup>37</sup> Re-designing the scheme is a voluntary endeavour and any costs incurred by the sponsor in doing so would be in the expectation that these would be outweighed by the benefits of making these changes.
150. As far as the single-tier pension is concerned, the options discussed above will ensure that the vast majority of private sector employers, of all sizes, will be able to mitigate the impact of the loss of the contracting-out rebate.

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<sup>37</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/308821/annex-c-impact-assessment.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/308821/annex-c-impact-assessment.pdf)

151. As National Insurance is classified as a tax by the Office for National Statistics, it is out of scope as a regulatory cost to business. The 'equivalent annual net cost to businesses of this policy is therefore zero, according to the rules set out in the relevant guidance for Government.

#### **5.4 Impact on protected persons**

152. There is a group of individuals (approximately 60,000) employed in some formerly nationalised industries (rail (including Transport for London), electricity, coal and nuclear waste and decommissioning) where the employers and trustees are limited in their ability to change scheme rules due to legislation made during privatisation. This relatively small group of workers represents less than 4% of the 1.6 million members of private-sector contracted-out pension schemes.

153. The Government has decided that employers of these individuals will not be allowed to use the statutory override to alter the pension schemes in relation to members with protected persons' status.

154. The impacts of this decision are set out in detail in the document "Government response to the consultation: Abolition of contracting out: statutory override for Protected Persons Regulations."<sup>38</sup>

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<[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/278982/impact-assessment-protected-persons.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/278982/impact-assessment-protected-persons.pdf)>



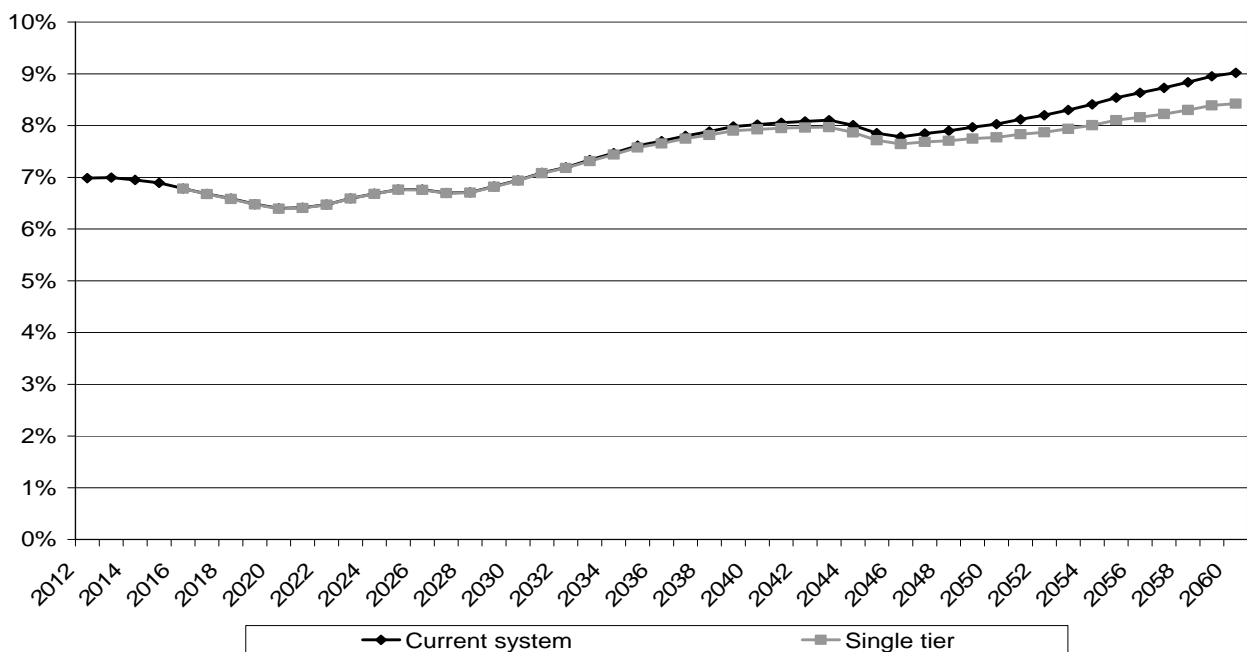
## Chapter 6) Impact on the Exchequer

155. The cost of the State Pension system is one of the main pressures driving up the costs of supporting an ageing society without reform. Expenditure on pensioner benefits is expected to rise from 7.0 per cent of GDP in 2012/13 to 9.0 per cent in 2060 according to DWP projections<sup>39</sup>, despite direct action to help keep the pension system sustainable through changes to the State Pension age.
156. For illustrative purposes, and in line with the White Paper, a start level of £144 (in 2012/13 earnings terms) and uprating by the triple-lock, for both the basic State Pension and the single-tier pension, is assumed in the analysis below, with final decisions to be taken before implementation. The Government has made it clear that any options for pension reform must cost no more than the current system overall, to avoid placing an unsustainable burden on future taxpayers. In order for the single-tier pension to remain affordable the Government of the day may need to adjust some of the parameters, such as the starting level and approach to uprating. The impact that changing these parameters makes to costs is shown in Annex B.

### 6.1 Overall impact of single-tier on pensioner benefit expenditure

157. The single-tier reform package has elements that increase costs to the Exchequer, such as the value of each qualifying year being worth more for the single-tier pension than for the basic State Pension, but also elements that decrease costs, for example the changes to inheritance rules.
158. This section presents the total impact on **overall expenditure** on pensioner benefits from the state. The results in this section cannot be derived by adding together analysis in subsequent parts of this report as there are a range of other aspects of the reform package that were not included in the earlier analysis that are included here (for example, the minimum qualifying period and changes to deferrals policy).
159. Chart 6.1 below shows the projected spending on pensions and pensioner benefits under the current system and the single-tier pension (using the assumed start level and uprating), as a proportion of GDP.

**Chart 6.1: Overall expenditure on pensions and pensioner benefits under current system and single-tier (£144 start level, triple-lock), as a proportion of GDP**



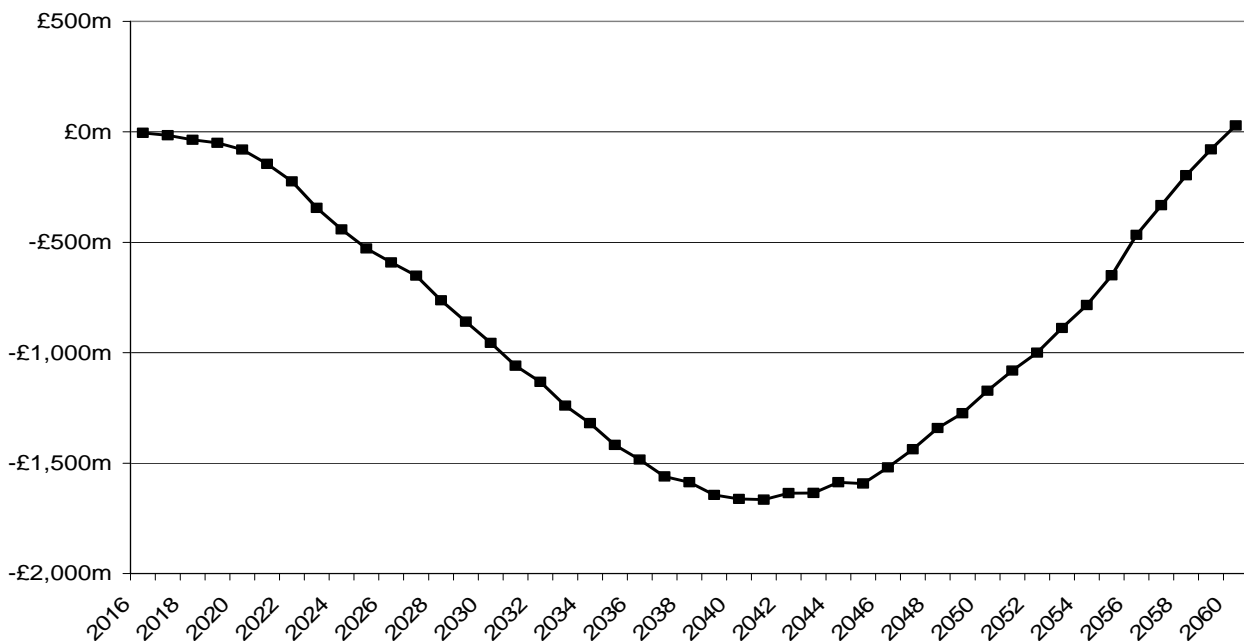
<sup>39</sup> Note that DWP projections differ slightly from those in the OBR's Fiscal Sustainability Report. See Chapter 7.

160. The chart shows that the overall costs for the single-tier pension are broadly in line with expenditure on the current system as a proportion of GDP until around 2040. From the 2040s onwards, the rise in pensions expenditure is smaller under the single-tier pension than under the current system (pensions expenditure is reduced from 9.0 per cent of GDP to 8.4 per cent of GDP by 2060), primarily because it will no longer be possible to become entitled to large amounts of State Second Pension..

## 6.2 The impact of the single-tier pension on means-tested benefits expenditure

161. The single-tier pension will reduce the need for means-tested benefits to provide a minimum level of income, leading to a reduction in expenditure on Pension Credit, Housing Benefit and council tax support. Chart 6.2 demonstrates the saving on means-tested benefits compared with the current system.

**Chart 6.2: Change in expenditure on means-tested benefits under the single-tier pension (£144 start level uprated by the triple-lock) compared with the current baseline, £millions, 2013/14 prices**



162. Expenditure on Pension Credit will fall in the medium-term because many single-tier recipients will no longer be eligible to receive Savings Credit and because fewer pensioners will be dependent on the Guarantee Credit to top up their income.
163. The single-tier system will also reduce expenditure on Housing Benefit and council tax support because the majority of pensioners eligible for these benefits will have a higher State Pension income and because the removal of the Savings Credit reduces the point at which income is tapered for these benefits. See Chapter 4 for more detail. In the long-term, the gap narrows, partly because only a small proportion of pensioners would have been in receipt of these benefits under the current system.

### 6.3 Reform implications for the National Insurance rebate

164. Chapter 5 described the impacts of ending contracting-out for Defined Benefit pensions, including the increase in National Insurance for employers and employees. This will result in additional National Insurance revenue for the Exchequer. The profile of the increase in National Insurance is shown for selected years in Table 6.1 below.
165. DWP does not forecast active membership of DB schemes in the public and private sectors. However, the National Insurance forecasts used to estimate costs and benefits of ending DB contracting-out do contain some implicit assumptions about future proportions of DB contracted-out membership in both sectors. These assumptions have been provided by the Government Actuary's Department and are explained in more detail in Annex A.

**Table 6.1: Increase in National Insurance revenues accruing to the Exchequer, selected years, GB, £ billion, 2013/14 prices**

	2016	2020	2030	2040	2050	2060
<b>Public sector employers</b>	3.0	3.0	2.6	2.2	2.7	3.4
<b>Public sector employees</b>	1.2	1.2	1.1	0.9	1.1	1.4
<b>Private sector employers</b>	-	-	-	-	-	-
<b>Private sector employees</b> (includes private sector employers passing on costs) <sup>40</sup>	0.7	0.4	0.1	0	0	0
<b>Total</b>	<b>5.0</b>	<b>4.6</b>	<b>3.7</b>	<b>3.1</b>	<b>3.8</b>	<b>4.8</b>

Source: DWP analysis

Note: Real terms additional revenues fall to begin with as the Upper Accrual Point is fixed in cash terms until the late 2030s as part of the gradual move to flat rating of the current system. From 2040 the extra revenue rises, as the flat-rated amount increases in line with earnings.

### 6.4 The single-tier pension administrative cost

166. The estimated costs of implementing the single-tier pension are around £380m in 2013/14 prices<sup>41</sup>. These are early estimates (including IT expenditure and all running costs) for both the Department for Work and Pensions (DWP) and HM Revenue and Customs (HMRC) until 2022/23. These estimates are being reviewed as detailed design and planning work continues and we expect them to be revised in due course.
167. Estimates of ongoing administrative costs or savings are not available at this stage. It is possible that in the longer-term administration costs may reduce as the running costs for the new IT platform become clearer. Detailed design and planning work is required before the impact on ongoing administrative costs can be established. However, the reduction in the number of customers claiming means-tested benefits, the abolition of contracting-out for Defined Benefit schemes and the overall simplification of the State Pension is expected to deliver administrative savings in the longer-term. In the short-term, some additional administrative costs may result from operating transitional arrangements.

<sup>40</sup> See section 5.4 above on protected persons. The figures here do not have any reduction in respect of employers who administer pension schemes which have some or all members who have protected persons' status.

<sup>41</sup> Implementation costs do not include the increased payroll costs for Government Departments as a result of ending the National Insurance rebate.

# Chapter 7) Risks and assumptions in the Impact Assessment

## 7.1 Assumptions

168. The main assumptions used in the modelling are detailed below.

### Differences from OBR Fiscal Sustainability Report

169. The GDP ratios in this paper are based on DWP projections. These have been updated to reflect the OBR's 2013 Fiscal Sustainability Report. However, DWP projections of pensioner benefit expenditure in 2060 are around one per cent of GDP lower than OBR estimates because of:
- a) **Different uprating of some benefits:** Winter Fuel Payments are a fixed cash amount, and DWP policy is to uprate Attendance Allowance and Disability Allowance by CPI. The OBR assume earnings uprating of these benefits in the longer-term. This has the effect of reducing DWP estimates of pensioner benefit expenditure by around 0.7 per cent of GDP by 2060 compared to the OBR approach.
  - b) **GB instead of UK:** The Pensions Bill refers to Great Britain rather than the United Kingdom. This reduces the DWP projections by around a further 0.2 per cent of GDP compared to the OBR's projections which include Northern Ireland. Note that both projections include spending on pensioners living overseas.
170. Expenditure on council tax support beyond 2013 is no longer included in DWP benefit expenditure publications, as it is now locally administered, but it is still included in the analysis in this Impact Assessment and in the White Paper.

### Economic assumptions

171. The medium and long-term economic assumptions used in the modelling are consistent with those forecast by the Office of Budget Responsibility (OBR). The long-term economic assumptions used in the modelling are as follows:
- CPI inflation is 2.0 per cent in the long-term
  - RPI inflation is 3.3 per cent in the long-term
  - Annual earnings growth is 4.45 per cent in the long-term
172. Over the long-term, the triple-lock is assumed to lead to growth of 0.3 percentage points above earnings. This is based on analysis of the behaviour of prices and earnings over the last twenty-five years.
173. All values that are shown in 2013/14 prices have been deflated using the GDP deflator.

### Demographic assumptions

174. The demographic assumptions for fertility, life expectancy and migration are consistent with the 2010-based ONS population projections. For fertility and life expectancy the central projection is used but for migration the lower estimated is used, consistent with the approach taken by the OBR in the Fiscal Sustainability Report.

### Policy assumptions

175. The proposed increases in State Pension age are included in the modelling. This includes the announcement that the rise to 67 will be phased in between 2026 and 2028. See the SPa Impact Assessment, published alongside this one, for more details of the proposed changes to SPa.
176. The introduction of automatic enrolment to workplace pension saving is included in the baseline, as are the reforms legislated for in the 2007 Pensions Act.
177. The Government is replacing a number of working-age benefits with Universal Credit, and will be reforming Pension Credit and Housing Benefit for pensioners, as legislated for in the 2012 Welfare Reform Act. These changes are included in the baseline for the impact analysis.

## **Behavioural assumptions**

178. In Pensim2 it is not possible to model whether State Pension reform will lead to an increase in saving as it does not account for behavioural change in response to a change in policy. However, we would expect that a simpler State Pension system, along with the reduction in marginal deduction rates shown in Chapter 4, will send out a message that it is worth saving for retirement, which could lead to a behavioural response.
179. The proportion of pensioners who take up means-tested benefits to which they are entitled is not assumed to change as a result of the single-tier reforms. The baseline already includes an assumed increase in take-up of Housing Benefit and Pension Credit as a result of the changes in the Welfare Reform Act 2012, under which the two benefits will be assessed jointly. The level of fraud and error as a proportion of the total expenditure on Pension Credit is also assumed to remain constant.
180. For the single-tier pension, the cost to business is based on the assumption that additional costs accruing to private sector employers are passed on to employees in full immediately (see chapter 5).

## **7.2 Risks**

181. The costs presented in this Impact Assessment are sensitive to the above assumptions and will vary as these assumptions change. Annex B presents analysis which looks at how changing the main policy assumptions would alter the costs of the preferred option.
182. The expenditure estimates in this Impact Assessment are based on current policies and proposals remaining unchanged. However, in the long-term, there may be changes to policies that alter these costs.
183. Demographic change different to that modelled is another variable that could affect projected costs.

## **7.3 Monitoring and Evaluation**

184. Any State Pension reform undertaken by the Government will be subject to thorough evaluation. Through analysis of administrative data, surveys and other sources, DWP will continue to monitor:
  - benefit and pensions caseload and take-up;
  - the level and distribution of pensioners' total incomes; and
  - the level of understanding of the benefit and pensions system.
185. DWP will also continue to report on progress against its performance in its annual and Departmental reports.

# ANNEX A: METHODOLOGY

## A1. Modelling capabilities

### Pensim2

1. Pensim2 is a dynamic micro-simulation model that has been developed by DWP to inform analysis of likely future trends in pensioner incomes. Pensim2 builds up a picture of the future pensioner population by modelling future life events and work histories for a representative sample of individuals.
2. The model starts from a set of base data representative of the household population of Great Britain in 2006. This base data includes detailed information on the characteristics of individuals and their employment and pension histories to date. For each subsequent year, sets of equations are used to model, for each individual, the probability of certain events occurring, based on estimates from historical data. The calculated probabilities are then used within the model to determine what happens to each individual in a given year.
3. The key elements that are simulated include:
  - partnership formation and dissolution;
  - mortality;
  - fertility;
  - education;
  - labour market status and earnings;
  - accrual and receipt of occupational and personal pensions;
  - accrual and receipt of State Pensions; and,
  - receipt of pensioner benefits.
4. The individual labour market and pension histories generated by the model are used to calculate estimates of pensioner incomes in each year of the simulation. For contributory State Pensions, the rules of the State Pension are used to calculate someone's entitlement given the extent to which they work or participate in activities that are credited. Entitlement to Pension Credit is then calculated based on all relevant income sources. Pensim2 is used to simulate up to 2100.

### How Pensim2 works

- In each year from 2007 to 2100 the model simulates the individual incomes for a representative sample (1 in 1,000) of the whole GB population.
- The model starts with a sample of 60,000 individuals across all ages in 2006.
- Each individual is dynamically given a life and labour market history, which is simulated using a large set of input assumptions.
- Important life events and processes are modelled, including birth, marriage, pension contributions and income, work patterns, changes of partners and death.
- The model uses probability-based processes with random number generation to create a life history for each member of the dataset, for each year to 2100. However, estimates after 2060 should be treated with caution and so are not used in this Impact Assessment.
- Based on this simulated life history, each individual accrues state and private pensions according to the rules set out in the model.
- Children born in the model become new working-age people who are also modelled forward.
- The size of the population is only changed via births and deaths from the base population, using the ONS population projections. Immigration and emigration are not simulated in the version of the model used for this Impact Assessment.

- Because Pensim2 models how people build up state and private pension rights over their working lives it is possible to explicitly model the impact of pension reforms on individuals over time and therefore on the future income distribution for pensioners.

### **Limitations of Pensim2**

- The key limitation of Pensim2 is the same as for all long-term models – the model estimates future outcomes under a set of assumptions including mortality, fertility, partnership rates, etc, which may be hugely uncertain.
- Detailed analysis is limited by sample size. The model is based on 60,000 synthetic individuals. Splitting this population into specific groups will soon lead to sample size issues; the smaller the sample size the larger the margin of error or uncertainty attached to the estimate.
- Other issues include limited treatment of non-pension savings information (Pensim2 does not model housing wealth, investments, assets, etc), and unsophisticated disability modelling.
- Pensim2 does not currently model deferral policy and the version used in this assessment does not model migration. To account for these limitations, outputs from Pensim2 are calibrated to DWP long-term projections of pensions expenditure and off-model adjustments are made to adjust for changes in deferrals policy and overseas expenditure.
- Pensim2 is not designed to model the potential behavioural changes in response to changes in pension policy so individuals' decisions do not respond to changes in policy, unless the user explicitly changes the input assumptions.

### **National Insurance contributions (NIC) Model**

- The National Insurance contributions (NIC) model produces a forecast of National Insurance contribution accruals and receipts. Owned and developed by the Government Actuary's Department (GAD) and HMRC, it is an aggregate collection of input spreadsheets which can be changed to model different policy scenarios. DWP has used this model to produce estimates of the additional National Insurance revenues resulting from the ending of contracting-out.
- Built into the model are projections of employment produced by HMT's long-term employment model, earnings distributions derived by GAD from Annual Survey of Hours and Earnings data, mortality and marital status assumptions derived from ONS projections, contracting-out assumptions derived from GAD projections and economic assumptions in line with those published by the Office for Budget Responsibility.

## **A2. Methodology**

### **Calibration**

5. The single-tier reforms have been modelled in Pensim2 to analyse how these policies change the State Pension and means-tested benefits received by pensioners. Calibration is then used to produce accurate projections of the additional costs of the reforms.
6. Expenditure estimates are calibrated to the Department's medium and long-term forecasts for expenditure on pensioner benefits in order to ensure consistency between the two estimates.
7. Calibration is done by taking the ratio of the baseline and single-tier pension expenditure figures estimated in Pensim2 and applying this ratio to the baseline forecasts. Calibration is done separately for basic State Pension, Additional Pension and the different means-tested benefits. As well as ensuring consistency between the Pensim2 model and the Department's forecasting models, calibration also accounts for migration and take-up of income-related benefits.
8. It is not possible to calibrate the distributional analysis in the same way and retain the ability to make worthwhile comparisons of who might experience changed outcomes from the reform. The calibration of costs reduces the cost of the single-tier package compared to the raw Pensim2 estimates. This implies that a lower proportion of people may get higher outcomes from the reforms, or the average size of the change might be lower or higher than implied by the distributional analysis.

9. The impact of calibration on estimates of expenditure increases over time. Calibration reduces estimates of the expenditure impact of the single-tier pension by around 1 percent of baseline pensioner expenditure by around 2040 and by around 2 per cent by 2060.
10. The analysis in Annex B also looks at how changes in economic assumptions change the cost of the single-tier reforms. The change, for example to the uprating assumptions, is first modelled in Pensim2. The new Pensim2 outputs for the baseline and the single-tier pension are then measured against the Pensim2 outputs for the base and the policy option with the standard assumptions. The ratio between the different baselines and the different single-tier pension expenditure figures is then applied to the baseline forecasts to analyse how the change in the assumptions changes both the baseline and the single-tier pension costings.

### **Overseas expenditure and the minimum qualifying period**

11. Pensim2 does not model overseas pensioners, so a different approach is used to estimate the impact of the single-tier pension on expenditure on pensioners with a GB pension living overseas. As the information on overseas pensioners is limited, the modelling is less detailed compared to the Pensim2 based analysis, for example it does not allow distributional analysis. So the distributional analysis in this Impact Assessment excludes the impact on pensioners living overseas.
12. DWP's Forecasting Division provide estimates of overseas expenditure on basic State Pension and additional State Pension under the current system. Overseas expenditure on basic State Pension and additional State Pension is then scaled up using the ratio between current system expenditure and single-tier pension expenditure derived from Pensim2, consistent with the calibration methodology described above.
13. Overseas expenditure is also affected by the minimum qualifying period. To adjust the overseas estimates to account for the Minimum Qualifying Period the Work and Pensions Longitudinal Survey (L2) is used to get historical data on the proportion of people who have less than 10 qualifying years. This proportion is applied to single-tier pension expenditure, assuming that changes to inflows broadly mirror changes to expenditure.
14. Using this method it is estimated that approximately 10 per cent of expenditure on individuals living overseas reaching State Pension age in 2040 would be saved under the single-tier scheme as a result of the 10-year Minimum Qualifying Period.
15. A Minimum Qualifying Period would also apply to GB residents. However, it is assumed that most residents who do not qualify for a single-tier pension would instead receive Guarantee Credit. Therefore most savings that would accrue from a Minimum Qualifying Period would be offset by an increase in income-related benefit expenditure and the net impact on expenditure would be small.

### **Uprating of basic State Pension and the single-tier pension – safeguard in the triple-lock**

16. To estimate the future expenditure on the basic State Pension and the single-tier pension, the triple-lock is applied using the Office for Budget Responsibility's (OBR) published medium-term Economic Assumptions. In the long run the central assumption is that the triple-lock average out to the equivalent of earnings growth plus 0.3 per cent.
17. There have been periods of volatility when earnings growth has been lower than price growth or 2.5 per cent. Therefore, simply uprating the basic State Pension or the single-tier pension by earnings growth for the long-term would underestimate the future level of the State Pension relative to prices and earnings.
18. The additional 0.3 per cent growth is derived from applying the triple-lock and earnings growth to the value of the basic State Pension and the single-tier pension over the last twenty-five years and then calculating the average difference at the end of the period.

### **Assumed start value for the single-tier pension**

19. For consistency with the White Paper, we still refer to "£144 in 2012/13 earnings terms" for the assumed start level of the full single-tier pension. Uprating this in line with earnings growth would give a value of £146.30 in 2013/14, which is above the 2013/14 level of the Standard Minimum Guarantee (£145.40 for a single person). The illustrative start rate used in Budget 2014 was increased to ensure it remained above the Standard Minimum Guarantee, which was uprated by



more than earnings in the most recent uprating round. The start level of the full single-tier pension will be decided by the Government nearer to implementation.

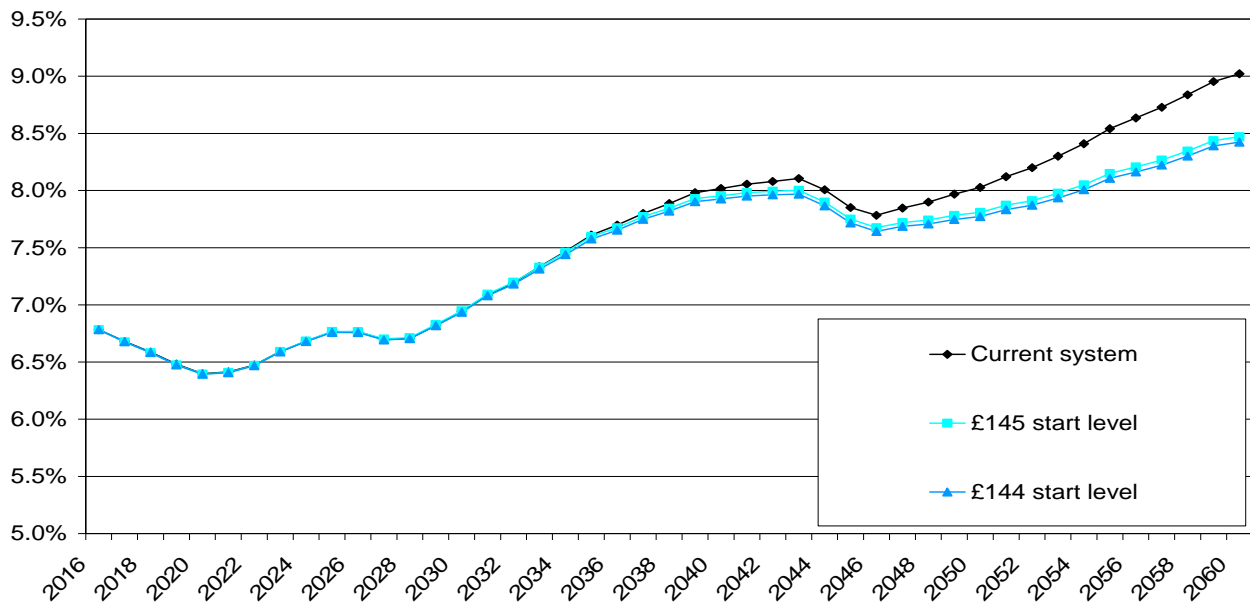
## ANNEX B: SENSITIVITY ANALYSIS

In the report published at the end of the Work and Pensions Select Committee’s pre-legislative scrutiny of the draft Pensions Bill, the Committee recommended that the DWP published further information about the expenditure implications of changing the single-tier pension start rate from the illustrative £144 per week used in the White Paper and accompanying Impact Assessment. This analysis is included in the section below, which also looks at how the assumptions around the uprating of the single-tier pension affect overall costs and the value of the single-tier pension.

A £1 rise to the illustrative starting value of the single-tier pension has a modest effect on the proportion of GDP that would be spent on pensioner benefits; by 2060 pensioner benefit expenditure would be higher by around 0.05% of GDP. However, this still represents an increase of £2.3bn in 2013/14 prices (using the GDP deflator).

The aim that the single-tier pension should cost no more than the current system could also be compromised in the medium-term by a rise in the starting value, as there would be a longer period through the 2020s and 2030s during which there would be a risk of the single-tier system costing more than the current system. In the early 2030s the cost of single-tier pension relative to the current system would be around £350m higher (in 2013/14 prices) with a £145 start level than with a £144 start level.

**Chart B1: Pensioner benefit expenditure as proportion of GDP under different start levels for the single-tier pension (£144, £145 per week in 2012/13 earnings terms)**

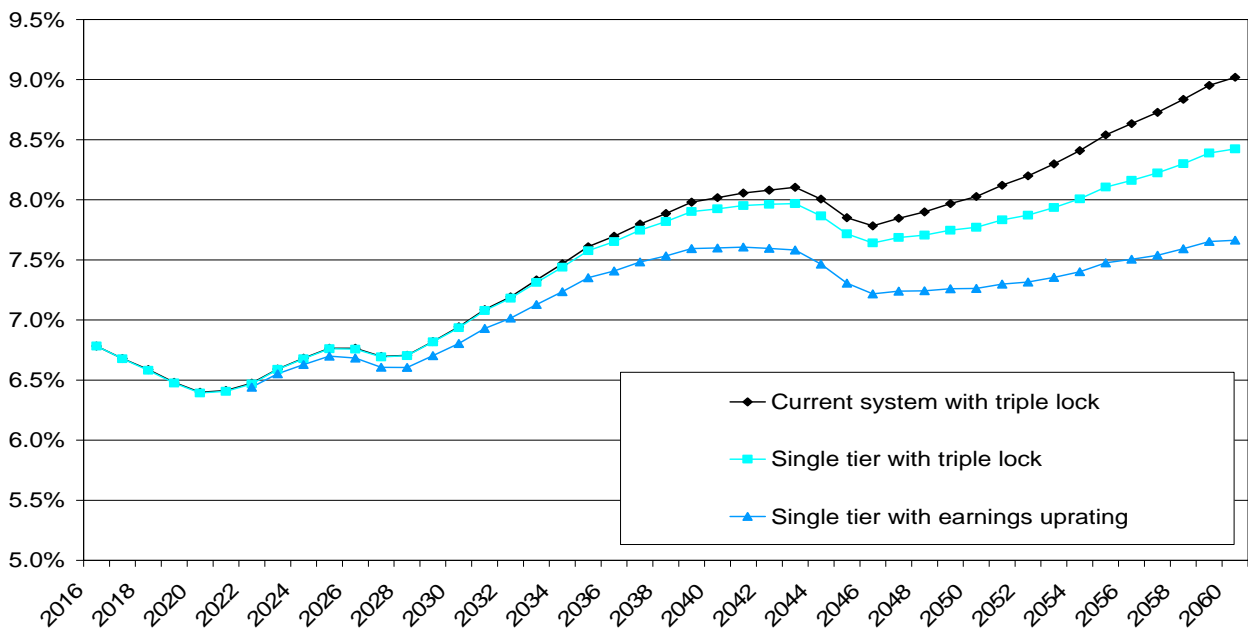


Charts B2 to B4 below compare the central scenario in which triple-lock uprating applies over the long-term against a version in which the single-tier pension is uprated in line with earnings. Over the long-term the triple-lock is assumed to add 0.3 percentage points to the annual uprating of basic State Pension and single-tier pension, over and above growth in average earnings.

Chart B3 shows that the cumulative effect is that by 2060 the value of the single-tier pension is estimated to be around **10%** lower if earnings uprating is used without the triple-lock. This would lead to lower pensions spending over the long-term, shown in chart B2, with 7.7% of GDP being spent on pensioner benefits by 2060, compared to 8.4% under the triple-locked scenario<sup>42</sup>.

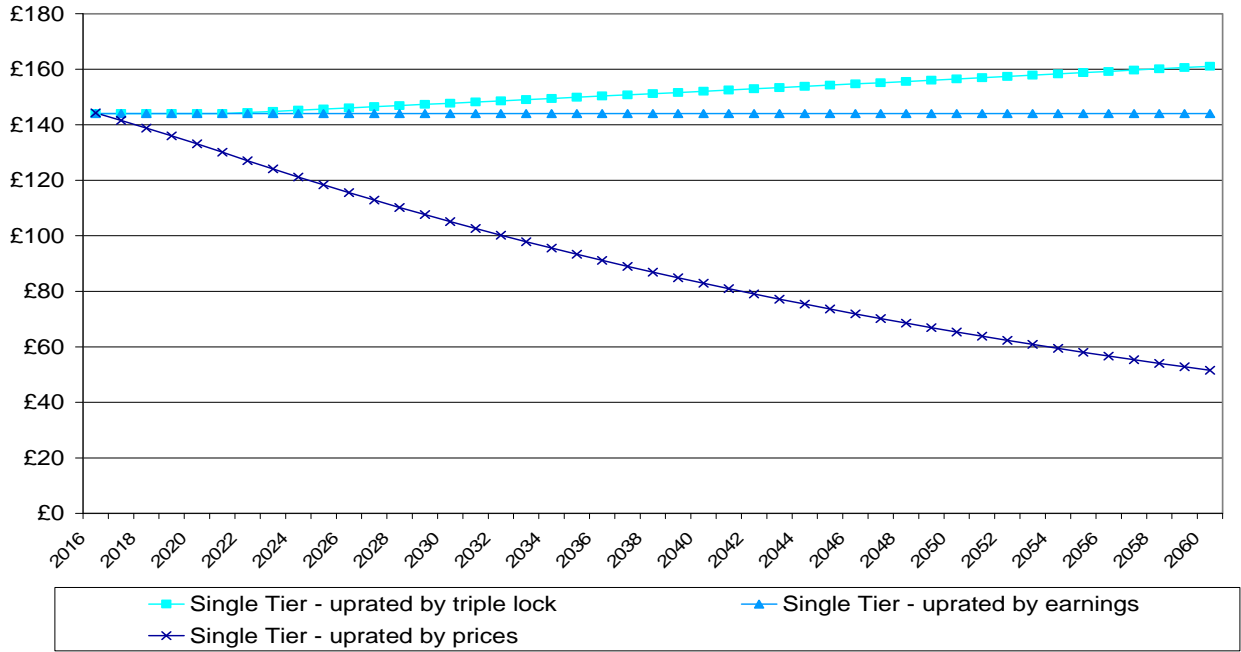
Note that in the earnings uprating scenarios below, basic State Pension for people who reached State Pension age before April 2016 is also assumed to be uprated in line with earnings.

**Chart B2: Pensioner benefit expenditure as proportion of GDP under different uprating assumptions**



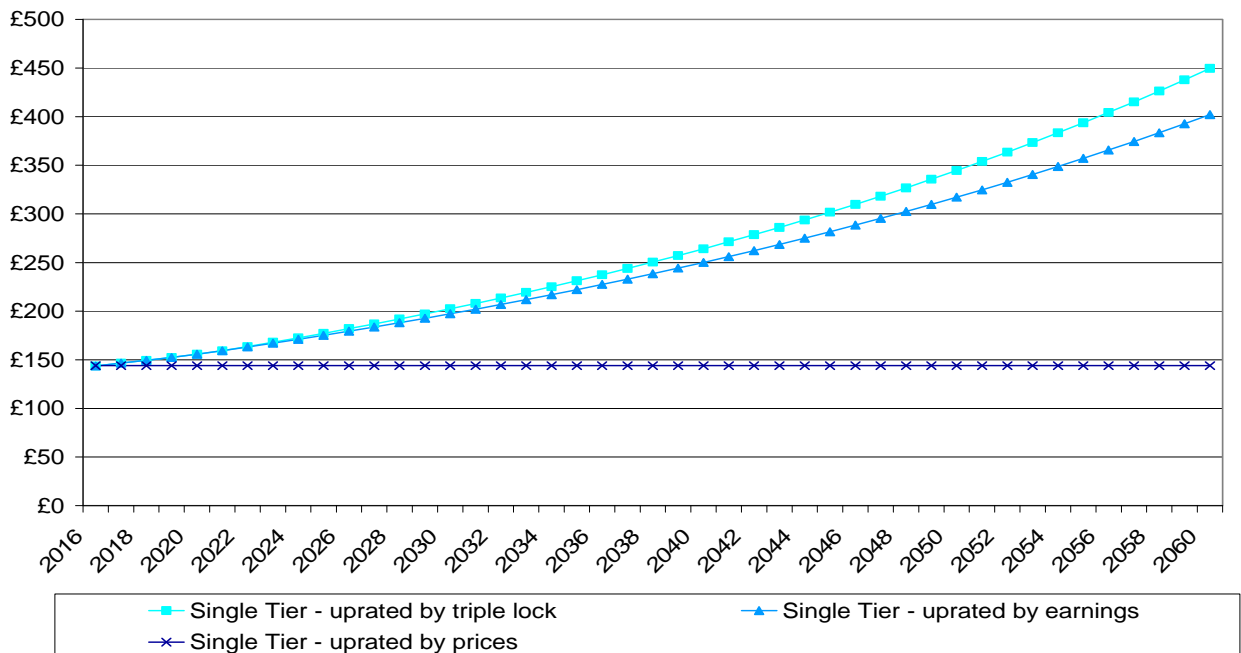
<sup>42</sup> Note that this is lower than the figure of 7.9% presented in the White Paper and the January 2013 edition of the Impact Assessment. The earlier figure was based on a model in which the single-tier pension was uprated in line with earnings while in payment, but with the triple-lock still applying to the underlying value of a full single-tier award used to model the award at State Pension age.

**Chart B3: Weekly value of the single-tier pension under different uprating assumptions (2012/13 earnings terms)**



Note: price uprating line is shown here for completeness and comparison purposes.

**Chart B4: Weekly value of the single-tier pension under different uprating assumptions (2012/13 CPI prices terms)**



Note: price uprating line is shown here for completeness and comparison purposes.

## ANNEX C: EXPENDITURE IMPACTS OF THE SINGLE-TIER PENSION

Table C1 below provides a breakdown of the main differences in costs between the current system and the single-tier pension for selected years.

It is important to note that the amounts shown can often represent very small percentage changes owing to the size of annual pensions expenditure.

**Table C1: Projected expenditure by component of total state support for pensioners in 2013/14 prices, £m, GB & overseas, under baseline and the single-tier pension**

<b>Current system</b>	<b>2016</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>	<b>2060</b>
State Pension (bSP+AP)	88,900	97,600	141,800	216,400	285,400	415,500
Pension Credit (GC+SC)	6,100	5,300	4,200	3,700	2,700	2,700
Housing Benefit and council tax support	7,500	7,200	9,600	12,700	13,000	14,100
Other pensioner benefits*	13,000	12,100	13,400	15,000	15,300	15,400
<b>Total</b>	<b>115,500</b>	<b>122,200</b>	<b>169,000</b>	<b>247,900</b>	<b>316,300</b>	<b>447,700</b>
<b>Single-tier pension</b>	<b>2016</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>	<b>2060</b>
<b>State Pension, of which:</b>	<b>88,900</b>	<b>97,600</b>	<b>142,600</b>	<b>215,200</b>	<b>276,500</b>	<b>385,800</b>
Current system State Pension	87,500	84,000	61,100	31,700	8,000	1,200
Single-tier State Pension	1,400	13,600	81,500	183,500	268,500	384,700
Pension Credit (GC+SC)	6,100	5,200	3,800	3,000	2,200	2,800
Housing Benefit and council tax support	7,500	7,200	9,100	11,800	12,200	14,000
Other pensioner benefits*	13,000	12,100	13,400	15,000	15,300	15,400
<b>Total</b>	<b>115,500</b>	<b>122,100</b>	<b>168,800</b>	<b>245,000</b>	<b>306,300</b>	<b>418,200</b>
<b>Change in expenditure</b>	<b>2016</b>	<b>2020</b>	<b>2030</b>	<b>2040</b>	<b>2050</b>	<b>2060</b>
State Pension	0%	0%	1%	-1%	-3%	-7%
Spend on all means-tested pensioner benefits	0%	-1%	-7%	-10%	-7%	0%
Spend on all pensioner benefits	0%	0%	0%	-1%	-3%	-7%

Source: Pensim 2, numbers rounded

\* 'Other pensioner benefits' includes Disability Living Allowance, Attendance Allowance, Personal Independence Payments, Christmas Bonus, Winter Fuel Payments and free TV Licences for people aged over 75.