National Insurance Fund - Long-term Financial Estimates

Report by the Government Actuary on the Financial Effects on the National Insurance Fund of the Child Support, Pensions and Social Security Bill 1999

January 2000

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the Secretary of State for Social Security
by Command of Her Majesty

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Government Actuary's Department

National Insurance Fund - Long-term Financial Estimates - January 2000

To: The Right Hon. Alistair Darling, MP Secretary of State for Social Security
Ms Dawn Primarolo, MP, Paymaster General

Sir and Madam,

I have reviewed the consequences of the proposed changes contained in the Child Support, Pensions and Social Security Bill 1999 on the National Insurance Fund financial estimates. My conclusions are given in the attached report.

I am, Sir and Madam,

Your obedient Servant,

Christopher Daykin, CB FIA

Government Actuary
January 2000

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Introduction

1.1 The Child Support, Pensions and Social Security Bill 1999 ("the Bill") gives effect to the proposals for a State Second Pension contained in the Green Paper "A new contract for welfare: Partnership in Pensions", Cm 4179, published in December 1998. This report provides estimates of the financial effects of the measures in the Bill on the income and expenditure of the National Insurance Fund for the purpose of the consideration by Parliament of these measures.

1.2 The National Insurance Scheme is financed on a pay-as-you-go basis with current rates of contribution set to produce the income needed to meet current expenditure on benefits and the costs of administration, as well as to maintain a reasonable working balance in the National Insurance Fund. Legislation provides for a limited Treasury Grant to be paid into the National Insurance Fund if the working balance is expected to fall below a certain level.

1.3. The legislation governing the National Insurance Scheme makes provision for 5 yearly reviews by the Government Actuary on the operation of the scheme, including long-term projections of the expenditure and of the corresponding rates of contribution likely to be required in future years. The last Quinquennial Review (QR), published as Cm 4406 in July 1999, contained financial projections to the year 2060.

1.4 That review was based on the legislation in force at March 1999. It included, in Section 10, estimates of the effects of the changes to the National Insurance contribution structure announced in the March 1999 budget, as far as they were known at that stage.

1.5 The QR did not include the effects of the Welfare Reform and Pensions Act 1999 or the Tax Credits Act 1999, but did include an allowance for home responsibilities protection to be extended to SERPS. However, the necessary secondary legislation to implement the latter has not been introduced. The Welfare Reform and Pensions Act 1999 increases expenditure in the short term in respect of benefits for widows and widowers but reduces it in the longer term. It also reduces expenditure on incapacity benefit. The Tax Credits Act 1999 increases expenditure on the State Earnings-related Pension Scheme (SERPS). The exclusion of the allowance for home responsibilities protection for SERPS reduces expenditure. Appendix 1 to this report sets out the effects of these changes on the figures in Section 10 of the QR to establish base-line financial estimates from which the changes resulting from the Bill can be measured.

1.6 The Welfare Reform and Pensions Act 1999 includes provision for 100% inheritance of SERPS to continue after April 2000 and for the Secretary of State to make regulations to amend this. Since it is not yet clear what regulations will be laid, it has been assumed for the purposes of these financial estimates that the 50% inheritance factor for SERPS and State Second Pension will apply from April 2000 as originally intended.

1.7 The financial effects of the provisions in the Bill on the base-line financial estimates are shown in section 2.

1.8 The Welfare Reform and Pensions Act 1999 also introduces the framework for stakeholder pension schemes. It has been assumed that these will first be available in the year 2001/02. The effects of the Bill should be assessed against the current SERPS regime incorporating the effect of stakeholder pension schemes. However, in isolation the only effect that stakeholder pension schemes might have on the National Insurance Fund is on the numbers contracting-out. It is not clear what effect stakeholder pension schemes would have on contracting-out if SERPS were retained. It is unnecessary to speculate on the level of additional contracting-out that might have arisen under SERPS when SERPS will be radically altered in the year after the introduction of stakeholder pension schemes. Additionally, stakeholder pension schemes and State Second Pension can be seen as a package of measures which should be considered together. Therefore, in this report, the possible effects of stakeholder pension schemes on the National Insurance Fund are calculated allowing for the effects of State Second Pension and are shown in section 3.

1.9 The estimates in this report are based on the same demographic, economic and other assumptions as those underlying the last QR and uses the same methodology. Estimates are shown assuming only price uprating of flat-rate benefit rates and earnings limits, with 1.5% a year real earnings growth. Estimates of future benefit expenditure are shown in 1999-00 price terms. Detailed discussion of the assumptions and methodology is not repeated in this report. Interested readers should refer to the QR. Section 3 of this report gives some indication of the sensitivity of the estimates to changes in the numbers contracted-out. For an indication of the sensitivity of the estimates to other assumptions, the reader is referred to the QR.

2
The Child Support, Pensions and Social Security Bill 1999

2.1 The Bill includes a number of changes to SERPS, which will subsequently be known as the State Second Pension. The main changes, which, for the purpose of this report, have been assumed to take effect from the year of accrual 2002/03, are:

- the introduction of 3 different accrual rates on different bands of earnings;
- treating earners at or above the annual lower earnings limit up to the low earnings threshold (£9,500 a year in 1999/00 terms) as though they earned the low earnings threshold;
- treating qualifying carers and the long-term disabled who have no earnings or earnings below the annual lower earnings limit, as if they had earnings at the level of the low earnings threshold in a qualifying year. Future expenditure that would have arisen if the anticipated home responsibilities protection had been introduced in respect of SERPS, for which allowance was made in the QR, will not now be incurred. It will be replaced by the expenditure in respect of carers and the long-term disabled who qualify for State Second Pension.

2.2 These changes will increase expenditure on earnings-related pensions. The changes will also increase the rebates payable for contracting-out of the State Second Pension.

2.3 On 29 November, the Government issued a consultation paper "The Structure of Rebates for the State Second Pension", seeking views on two approaches for the future contracting-out regime. This report provides the financial estimates for both approaches, referred to in this report as the "first approach" and the "second approach".

2.4 Under the first approach, rebates will reflect the State Second Pension accrual rate structure and COSRS (contracted-out salary related schemes) will be required to provide correspondingly higher benefits. Rebates will be based on actual earnings. People earning less than the low earnings threshold in a year will receive a State Second Pension top-up from the State based on the difference between their actual earnings in a year and the low earnings threshold.

2.5 Under the second approach, COSRS and COMPS (contracted-out money purchase schemes) rebates will reflect the current SERPS accrual rates. Rebates will be based on actual earnings. Members of COSRS and COMPS earning below £21,600 (in 1999/00 terms) will receive a State Second Pension top-up from the State. This will be based on the difference between what their State Second Pension (based on the low earnings threshold if they earn less than that) and what their SERPS entitlement would have been if they had not been contracted-out. APPs (appropriate personal pension schemes) rebates will reflect the State Second Pension accrual rates structure. Rebates will be based on actual earnings. Those with an APP who earn less than the low earnings threshold in a year will receive a Second State Pension top-up from the State based on the difference between the low earnings threshold and their actual earnings in a year.

2.6 Assuming the State Second Pension takes effect from April 2002, the last year of accrual of earnings to count for the calculation of SERPS benefit will be the year 2001/02. Accrual of earnings for SERPS purposes arising from years before 2002/03 is unaffected by the introduction of the State Second Pension. SERPS will still be calculated and paid in respect of those accruals under the current rules.

2.7 The State Second Pension will start to accrue on earnings (actual or treated as earned) between the lower earnings limit and the upper earnings limit in the years after 2001/02. Earnings between the lower earnings limit and the upper earnings limit will initially be divided into three bands. Band 1 will be from the annual lower earnings limit to the low earnings threshold. The low earnings threshold will be £9,500 a year in 1999/00 terms[1]. Band 2 will be from the low earnings threshold plus £1 to (3 x the low earnings threshold – 2 x the lower earnings limit). This will be £21,600 in 1999/00 terms. Band 3 will be from the top of the second band plus £1 to the upper earnings limit. The low earnings threshold will be increased each year in line with the annual increase in average earnings, including the period between 1999/00 and 2002/03. Rounding rules will apply to the calculation of the low earnings threshold and the calculation of the top of Band 2 as described in 5.2 below.

2.8 The top of the second band will increase faster than earnings. The upper earnings limit will be increased in line with prices, which are expected to increase at a slower rate than earnings. Thus, the top of the second band will exceed the upper earnings limit after a number of years. There will then only be two bands, as the upper earnings limit will continue to apply. On the assumption that earnings increase at 1.5% a year faster than prices, this will occur approximately in the year 2014 on the QR assumptions, allowing for the increases in the upper earnings limit in excess of price inflation announced in the March 1999 budget. If there are further increases in the upper earnings limit over and above price inflation, this will delay the time when the top of the second band will exceed the upper earnings limit.

2.9 In the longer term the low earnings threshold will also exceed the upper earnings limit. On the assumption that earnings increase at 1.5% a year faster than prices, this will occur in about the year 2074, again allowing for the increases in the upper earnings limit in excess of price inflation announced in the March 1999 budget. There would then again only be one band, the lower earnings limit to the upper earnings limit, but with an accrual rate double that of SERPS, as described below.

2.10 Later references to the low earnings threshold in this review, should, where appropriate, be taken to refer to the annual threshold appropriately increased for future years in line with earnings.

2.11 People earning between the lower earnings limit and low earnings threshold will be treated as though they had earnings at the level of the low earnings threshold. This will create a significant break point. Those earning below the lower earnings limit, even if only by a penny, will accrue no State Second Pension, whereas those earning at or over the lower earnings limit, will have their State Second Pension based on earnings equal to the low earnings threshold.

2.12 The QR assumed that, with price uprating of the lower earnings limit, many earners who currently earn below the lower earnings limit would earn above the lower earnings limit at some point in the future. Their earnings are assumed to increase at 1.5% a year faster than the increase to the lower earnings limit. Thus, they will then qualify for a significant State Second Pension based on the low earnings threshold. Additionally, those earning just above the lower earnings limit will not be liable for income tax or National Insurance contributions. There will be scope for low earners to arrange for their earnings to be just above the lower earnings limit rather than just below the lower earnings limit. It will be necessary, from an administrative point of view, to collect information on the earnings of those above the lower earnings limit but below the income tax/new primary threshold for National Insurance contributions.

2.13 It is impossible to predict with any certainty exactly what the shape of the earnings distribution will be around the lower earnings limit in the future and this could have a significant effect on the level of benefit expenditure. This uncertainty is compounded by the introduction of the national minimum wage. Thus, a further degree of uncertainty is introduced to the financial estimates as a result of these changes.

2.14 The State Second Pension accrual rates will be double, half and equal to the current SERPS accrual rates on bands 1, 2 and 3 of earnings respectively. Thus, for retirements in the year 2009-10 for example, the State Second Pension will be based on 40%, 10% and 20% of earnings in bands 1, 2 and 3 respectively. The accrual rates appropriate for different years of retirement in future are shown in appendix 2.

2.15 Certain categories of carers and the long-term disabled that satisfy the qualifying conditions for a full financial year will qualify for the State Second Pension if they have no earnings or if they earn below the lower earnings limit. The categories are:

- People receiving home responsibilities protection because they receive child benefit in respect of a child aged under six;
- People receiving long-term incapacity benefit, if by the end of their working life they meet a labour force attachment test of having worked and paid National Insurance contributions for approximately 10% of their working lives;
- People with underlying entitlement to long-term incapacity benefit but who fail the contribution conditions or receive another overlapping benefit, if by the end of their working life they meet a labour force

attachment test of having worked and paid National Insurance contributions for approximately 10% of their working lives;

- People receiving severe disablement allowance (which will be abolished for new awards from the year 2001/02), if by the end of their working life they meet a labour force attachment test of having worked and paid National Insurance contributions for approximately 10% of their working lives;
- People receiving Invalid Care Allowance, or with underlying entitlement to it;
- People who are awarded home responsibilities protection because they:
    1. are regularly engaged for at least 35 hours a week in caring for someone who receives Attendance Allowance, Constant Care Allowance or the care component of Disability Living Allowance at the middle or highest rate; or
    2. received Income Support without needing to be available for work because they were caring for a disabled person.

2.16 These groups will accrue entitlement to the State Second Pension from the date of implementation.

2.17 The amount of the State Second Pension earned for a year in which a person qualifies under the criteria listed above will be calculated as if they had annual earnings at the level of the low earnings threshold in that year. The provisions for carers and the long-term disabled within the State Second Pension will be based on the State Second Pension accrual rate for the band of earnings from the lower earnings limit to the low earnings threshold.

2.18 For the purposes of estimating the financial effects of State Second Pension it has been assumed that the level of contracting-out will be the same as was assumed in the QR. The possible financial effects of further contracting-out via stakeholder pension schemes are dealt with in section 3.

2.19 Following the Welfare Reform and Pensions Act 1999, SERPS is only payable to those receiving Widowed Parents Allowance, not those receiving Bereavement Allowance. SERPS expenditure in respect of Widowed Parents Allowance is small in the longer term and the extra cost of replacing this by State Second Pension is not significant.

2.20 Table 2.1 sets out the financial effects of the proposals for State Second Pension in the Bill on expenditure in respect of SERPS for those over state pension age. Table 2.1 contains estimates for both the first and second approach to contracting-out described in paragraphs 2.3 to 2.5 above. The expenditure under the current regime is taken from Table 4.2 in Appendix 1.

Table 2.1 Estimated effect of the State Second Pension on the expenditure in respect of earnings-related pension over state pension age - flat-rate benefit rates and earnings limits increase in line with prices (£bn in 1999-00 price terms)

	Year							
Benefit structure	**1999-00**	**2000-01**	**2010-11**	**2020-21**	**2030-31**	**2040-41**	**2050-51**	**2060-61**
Current SERPS	4.5	4.9	8.9	10.9	12.4	12.3	13.3	15.5
State Second Pension – the first approach	4.5	4.9	9.4	12.6	17.1	21.0	27.5	36.9
Extra cost of State Second Pension - The first approach	0.0	0.0	0.5	1.7	4.7	8.6	14.2	21.4
State Second Pension the second approach	4.5	4.9	9.5	12.8	17.8	22.5	30.2	41.4
Extra cost of State Second Pension The second approach	0.0	0.0	0.6	2.0	5.4	10.2	16.9	25.9

2.21 Table 2.2 shows the estimated total National Insurance Fund expenditure for all benefits as a percentage of estimated gross domestic product in future years before and after the changes in expenditure arising from State

Second Pension, assuming price uprating of flat-rate benefit rates and contribution limits.

Table 2.2 Total National Insurance Fund expenditure for all benefits as a percentage of projected GDP before and after the effects of the State Second Pension.

	TOTAL EXPENDITURE AS A PERCENTAGE OF PROJECTED GDP(%)		
Year	Before the Bill	After the Bill: the first approach	After the Bill: the second approach
1999-00	5.5%	5.5%	5.5%
2000-01	5.4%	5.4%	5.4%
2010-11	5.4%	5.5%	5.5%
2020-21	5.3%	5.4%	5.4%
2030-31	5.2%	5.5%	5.6%
2040-41	4.7%	5.2%	5.3%
2050-51	4.0%	4.8%	4.9%
2060-61	3.6%	4.5%	4.7%

2.22 Table 2.2 shows that in the longer-term total National Insurance Fund expenditure will constitute a higher percentage of GDP as a result of the changes introduced by the Bill. However, the higher expenditure from the National Insurance Fund will be partially offset by lower expenditure on income-related social security benefits (e.g. income support).

2.23 Table 2.3 shows the effect on the amount of the contracted-out rebates payable from the National Insurance Fund following the changes introduced by the Bill. The increased rebates reflect the higher benefits under the State Second Pension, depending on the approach adopted for the contracting-out regime. Rebates are based on the current rebate basis and are applied to the relevant earnings in the band between the lower earnings limit and the upper earnings limit, taking account of their respective accrual rates. Rebates are based on actual earnings. Table 2.3 does not include the effect on rebates of any further contracting-out via stakeholder pension schemes.

Table 2.3 Estimated effect of the State Second Pension on the amount of the contracted-out rebate payable before allowing for stakeholder pension schemes - flat-rate benefit rates and earnings limits increase in line with prices (£bn in 1999-00 price terms)

	CONTRACTED-OUT REBATES £bn		
Year	Before the Bill	After the Bill: the first approach	After the Bill: the second approach
1999-00	8.4	8.4	8.4
2000-01	8.8	8.8	8.8
2010-11	8.8	10.3	9.5
2020-21	9.1	10.9	9.8
2030-31	8.5	11.0	9.3

2040-41	8.3	11.6	9.1
2050-51	8.5	13.1	9.5
2060-61	8.5	14.6	9.8

2.24 Table 2.4 shows the estimated Class 1 contribution rates required to balance income and expenditure following the Bill compared to the rates required prior to the Bill, assuming price uprating of flat-rate benefit rates and earnings limits. The figures for "Before the Bill" are taken from the final column of Table 4.3.

Table 2.4 Estimated Class 1 contribution rates to balance income and expenditure before and after the State Second Pension – price uprating of flat-rate benefits and earnings limits.

	Joint Employee And Employer Contribution Rate* %		
Year	Before the Bill	After the Bill: the first approach	After the Bill: the second approach
1999-00	20.0	20.0	20.0
2000-01	20.2	20.2	20.2
2010-11	18.6	19.2	19.0
2020-21	17.5	18.4	18.2
2030-31	17.8	19.4	19.2
2040-41	16.4	18.7	18.5
2050-51	14.6	17.8	17.7
2060-61	13.5	17.7	17.6

*These rates exclude that part of the rates allocated to the NHS. They are based on the revised Class 1 contribution regime announced in the March 1999 budget.

2.25 The effects of the State Second Pension on the pension entitlement of an individual will depend on their earnings. Figure 2.1 shows the total basic plus SERPS pension that a person would receive at award under the current scheme for various levels of earnings and years of retirement, as a percentage of those earnings. Figure 2.2 shows corresponding figures following the introduction of the State Second Pension for the first stage of the State Second Pension, assuming it continues indefinitely. In both cases it is assumed that the person works in every year of their working life.

Figure 2.1 Estimated total basic plus SERPS pension at award before the effects of the State Second Pension, as a percentage of earnings for different earnings levels and different years of retirement

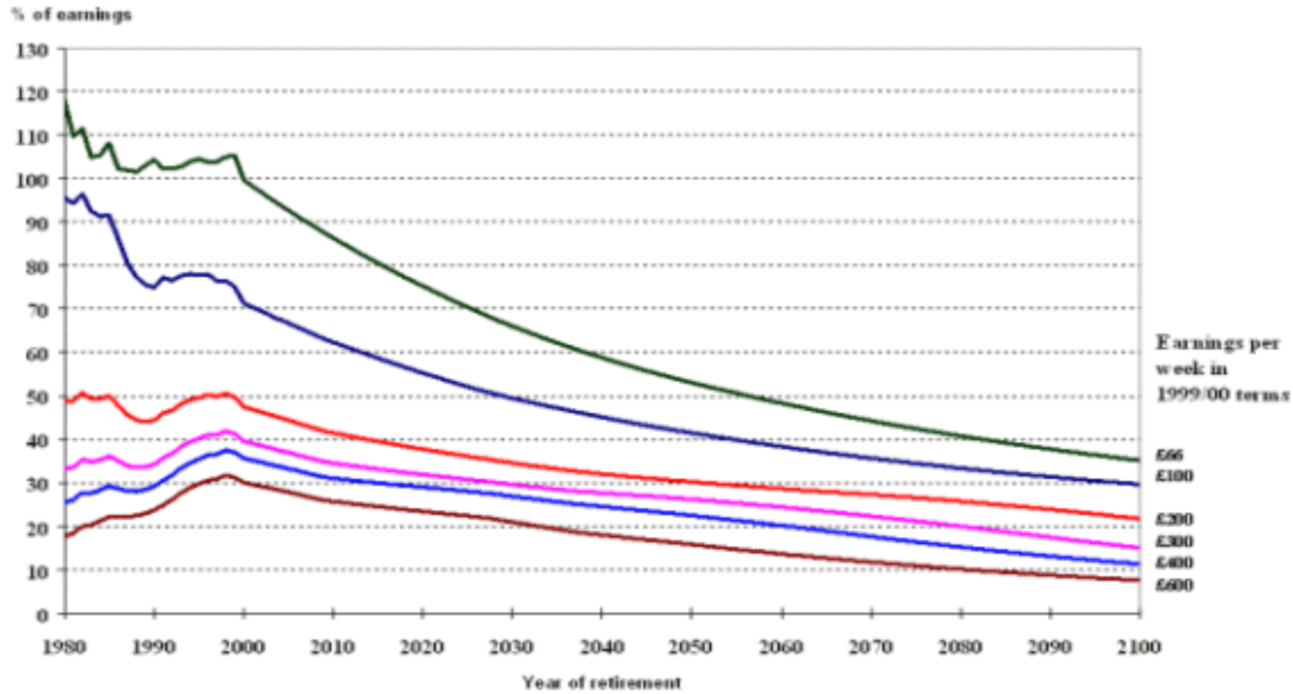
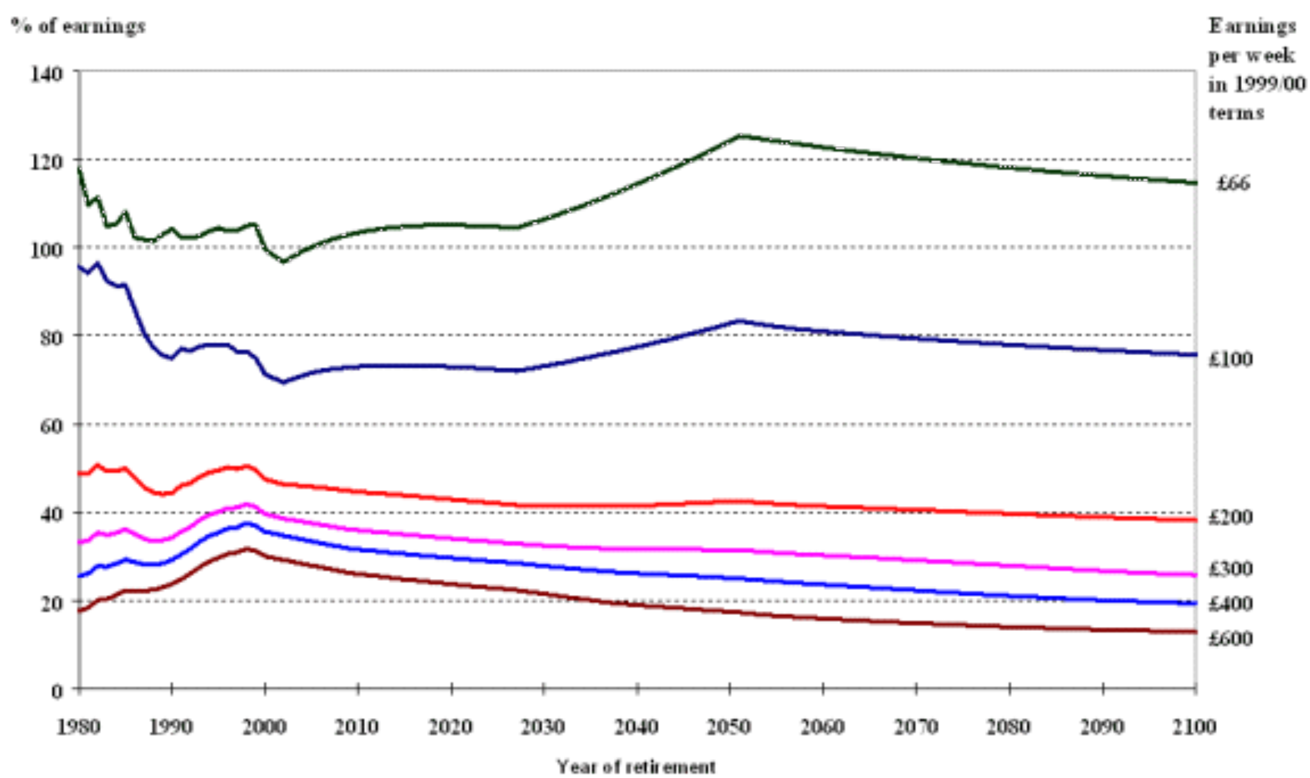
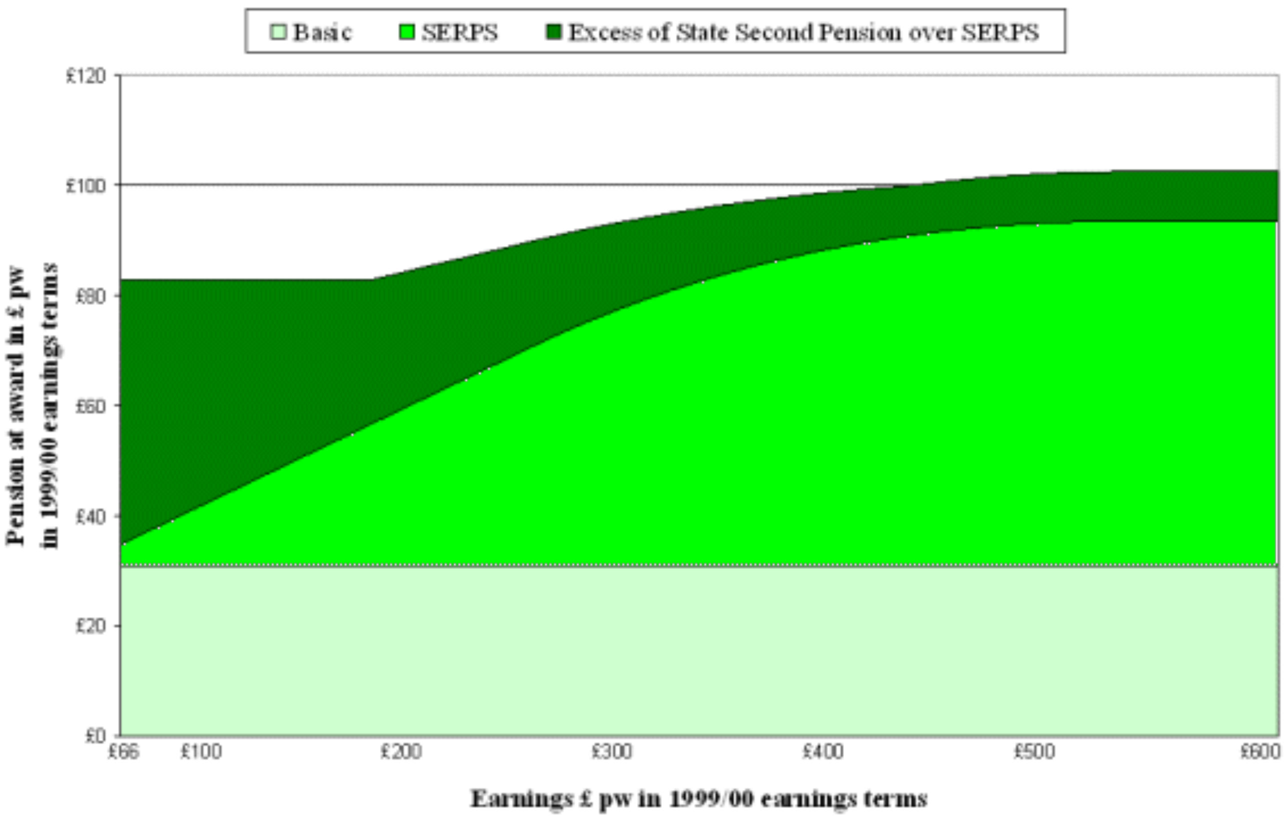


Figure 2.2 Estimated total basic plus SERPS/State Second Pension at award, as a percentage of earnings for different earnings levels and different years of retirement



2.26 Figure 2.3 shows the award of basic and earnings-related pension in the year 2051, the first year of retirement under which a person would have been in the State Second Pension for all their working life. It shows the award, for different levels of earnings, that a person would have had if SERPS were to continue and the award that they will have under the first stage of the State Second Pension, assuming it continues indefinitely. Figure 2.3 assumes that the person works for each year of their working life. The earnings and pension at award are shown in 1999/00 earnings terms. The pensions at award in 1999/00 price terms would be approximately double those shown in Figure 2.3. With higher living standards in the year 2051, the figures in earnings terms give a better feel of what it will be like to live on those pensions.

Figure 2.3 Estimated total basic and earnings-related pension at award in the year 2051 for different levels of earnings, before and after the introduction of the State Second Pension, in 1999/00 earnings terms.



2.27 Under stage 2 of the State Second Pension, the scheme will convert to a flat-rate basis. However, under either approach to contracting-out, rebates will continue to be earnings-related. If the private pension arising in respect of the rebate does reproduce in practice the pension that the rebate is based on, then for a person who is contracted-out the total award at pension age from the basic pension, State pension top-up (if applicable) and the private pension resulting from the contracted-out rebates will be as illustrated in Figures 2.1, 2.2 and 2.3 above.

2.28 The State Second Pension significantly affects the pension for lower earners. Those earning at the lower earnings limit in 1999 and whose earnings increase in line with the average increase in earnings will receive a State Second Pension based on the low earnings threshold. This, together with their basic pension entitlement, will give them a pension well in excess of 100% of their earnings at award. This will continue to be the case in the long-term even though the basic pension is increased in line with prices. This contrasts with their position if SERPS were to continue unaltered, where their total state pension would be approximately 50% of their earnings. Similarly other low earners will be much better off, although the higher their earnings the less the improvement is in percentage terms.

Note:

1. The original proposal in the Green Paper was £9000 in 1998/99 terms. Back

3
Stakeholder Pension Schemes

3.1 The Welfare Reform and Pensions Act 1999 contains the primary legislation for the introduction of stakeholder pension schemes. For the purpose of this report it is assumed that they will first be available in the year 2001/02. Stakeholder pension schemes are private pension arrangements that can be structured as occupational pension schemes or personal pension schemes. Stakeholder pension schemes can be used to contract out of SERPS/State Second Pension and will therefore have an effect on the rebates payable for contracting-out and the amount of SERPS/State Second Pension payable.

3.2 For the purposes of the estimates in this review, it has been assumed that people contracting-out via stakeholder pension schemes will do so using personal pension style stakeholder pension schemes and that they will receive the same rate of age-related rebates as apply in respect of appropriate personal pensions. If different rebate rates are adopted, then the contracted-out rebates payable will be correspondingly different.

3.3 There is considerable uncertainty over the number, age, sex and earnings of those who will take up stakeholder pension schemes. Additionally, it is uncertain how many of those effecting stakeholder pension schemes will use them to contract out of the State Second Pension. Financial estimates have therefore been made on a number of assumptions about contracting-out via stakeholder pension schemes. People contracting-out in this way are assumed to be additional to those assumed to contract out in future years under the current arrangements.

3.4 If there is no additional contracting-out as a result of stakeholder pension schemes, the financial estimates in Section 2 will be unaffected by the introduction of stakeholder pension schemes.

3.5 The alternative assumptions made for the additional future level of contracting-out via stakeholder pension schemes under both the first and second approach are :

1. The additional number contracted-out is assumed to be 0.5 million in the year 2001/02 and thereafter. They are aged below 50 in 2001/02, 51 in 2002/03 etc.
2. The additional number contracted-out is assumed to be 0.5 million in the year 2001/02, increasing by 0.25 million each year until there are 2 million additional contracted-out. Thereafter the increase is 0.1 million a year until there are 3.0 million additional contracted-out. Numbers remain at this level thereafter. Everyone who is contracted-out is assumed to be under age 50 in the year 2001/02, 51 in the year 2002/03 etc.
3. The additional number contracted-out is assumed to be 0.5 million in the year 2001/02, increasing by 0.25 million each year until there are 1.5 million additional contracted-out in the year 2005/06. In the year 2006/07, everyone who is under age 40 in the year is assumed to be contracted-out, in the year 2007/08, everyone who is under age 41 in the year is assumed to be contracted-out etc. In the year 2030/31, everyone earning over the low earnings threshold in a year is assumed to be contracted-out.

3.6 The numbers contracted-out at each individual age are assumed to have earnings in excess of the low earnings threshold and the same age and earnings distribution as those who remain contracted in (if any).

3.7 Table 3.1 shows the effect on the contracted-out rebates payable and the reduction in State Second Pension expenditure due to higher contracted-out deductions that would apply for each of assumptions 1, 2 and 3 respectively. The contracted-out rebates are additional to those payable under the State Second Pension and represent an additional cost to the National Insurance Fund. The contracted-out deductions will also be additional to those applying under the State Second Pension and will represent a saving for the National Insurance Fund as the future amount of State Second Pension will be lower by the additional amounts of the contracted-out deductions.

Table 3.1 Estimated additional contracted-out rebates and contracted-out deductions in respect of stakeholder pension schemes - flat-rate benefit rates and earnings limits increase in line with prices (£bn in 1999-00 price terms)

Year	Assumption 1 Additional contracted-out rebates	Assumption 1 Reduction in State Second Pension Costs	Assumption 2 Additional contracted-out rebates	Assumption 2 Reduction in State Second Pension Costs	Assumption 3 Additional contracted-out rebates	Assumption 3 Reduction in State Second Pension Costs
1999-00	0.0	0.0	0.0	0.0	0.0	0.0
2000-01	0.0	0.0	0.0	0.0	0.0	0.0
2010-11	0.5	0.0	2.1	0.0	3.8	0.0
2020-21	0.6	0.0	3.4	0.1	5.9	0.1
2030-31	0.7	0.2	3.9	0.6	7.9	0.6
2040-41	0.8	0.4	4.6	1.7	9.7	2.7
2050-51	0.9	0.9	5.3	4.0	11.0	7.5
2060-61	1.0	1.3	6.1	6.8	12.2	13.5

3.7 The increase in the contracted-out rebates under each assumption exceeds the increase in the contracted-out deductions for each year shown except for 2060/61. This reflects the fact that extra contracting-out leads to an immediate increase in contracted-out rebates but the saving through higher contracted-out deductions does not occur until the person retires. Thus, before the year 2060/61 the net effect on the National Insurance Fund of the additional contracting-out via stakeholder pension schemes is a cost.

3.9 Tables 3.2 and 3.3 show the contribution rates required to balance income and expenditure for the first approach and the second approach respectively on each of the assumptions on the level of contracting-out via stakeholder pension schemes. For comparison, the first two columns of Tables 3.2 and 3.3 also show the contribution rate required before the State Second Pension is introduced, and the rate required for State Second Pension before the effects of stakeholder pension schemes. Those figures come from Table 2.4 above.

Table 3.2 Estimated Class 1 contribution rates to balance income and expenditure allowing for the effects of stakeholder pension schemes on the State Second Pension assuming the first approach to contracting-out – price uprating of flat-rate benefits and earnings limits.

	JOINT EMPLOYEE AND EMPLOYER CONTRIBUTION RATE*%				
	Before State Second Pension	After State Second Pension, before stakeholder pension schemes	After State Second Pension, after stakeholder pension schemes		
Year			Assumption 1	Assumption 2	Assumption 3
1999-00	20.0	20.0	20.0	20.0	20.0
2000-01	20.2	20.2	20.2	20.2	20.2
2010-11	18.6	19.2	19.3	19.8	20.3
2020-21	17.5	18.4	18.5	19.1	19.8
2030-31	17.8	19.4	19.5	20.1	21.0
2040-41	16.4	18.7	18.8	19.3	20.0
2050-51	14.6	17.8	17.8	18.0	18.4
2060-61	13.5	17.7	17.6	17.6	17.5

*These rates exclude that part of the rates allocated to the NHS.

Table 3.3 Estimated Class 1 contribution rates to balance income and expenditure allowing for the effects of stakeholder pension schemes on the State Second Pension assuming the second approach to contracting-out – price uprating of flat-rate benefits and earnings limits.

	JOINT EMPLOYEE AND EMPLOYER CONTRIBUTION RATE*%				
	Before State Second Pension	After State Second Pension, before stakeholder pension schemes	After State Second Pension, after stakeholder pension schemes		
Year			Assumption 1	Assumption 2	Assumption 3
1999-00	20.0	20.0	20.0	20.0	20.0
2000-01	20.2	20.2	20.2	20.2	20.2
2010-11	18.6	19.0	19.1	19.6	20.1
2020-21	17.5	18.2	18.3	18.9	19.5
2030-31	17.8	19.2	19.3	19.9	20.7
2040-41	16.4	18.5	18.6	19.1	19.8
2050-51	14.6	17.7	17.7	17.9	18.3
2060-61	13.5	17.6	17.6	17.5	17.4

*These rates exclude that part of the rates allocated to the NHS.

3.10 The Bill provides for an order to be made at a future date to move the State Second Pension to a second stage flat-rate structure. This will only apply to those reaching state pension age after a date to be prescribed (so that the stage one earnings-related scheme will continue for those approaching state pension age). When the State Second Pension becomes a flat-rate scheme everyone will be treated as if they had earnings of the low earnings threshold for the purpose of calculating their State Second Pension entitlement, regardless of the actual level of their earnings. Qualifying carers and the long-term disabled will continue to be treated as if they had earnings at that level. However, contracted-out rebates will still be earnings-related. Thus, the rebates will not reflect the value of the State Second Pension forgone in stage 2, but the value forgone as though stage 1 still applied.

3.11 In these circumstances it is likely that most, if not all, of those earnings over the low earnings threshold in a year will contract out. The green paper "A new contract for welfare: Partnership in Pensions" suggested that this might occur around the year 2006/07 but be restricted to those under a certain age. If this is done in the year 2006/07 and restricted to those aged 40 and under in that year then the scenario is that shown under assumption 3 in Table 3.2 above and the financial effects are those illustrated for that assumption. Thus this can be taken as the effect of moving to the flat-rate stage 2 of the State Second Pension under the first approach to contracting-out, assuming that rebates are as in paragraph 3.10.

3.12 Assumption 3 under the second approach to contracting-out will only reflect stage 2 of the State Second Pension if, under stage 2 for this approach, people contracted-out via COSRS and COMPS continue to get a State benefit equal to the difference between a State Second Pension entitlement and a SERPS entitlement, both based on their actual earnings. However, this arrangement would not be flat-rate. Rebates will still be earnings-related, reflecting the value of SERPS as in stage 1, not a flat-rate State Second Pension benefit.

3.13 People contracted-out via APPs or stakeholder pension schemes that are structured as personal pensions are treated identically in the two approaches to contracting-out.

4
Appendix 1: The Welfare Reform and Pensions Act 1999, The Tax Credits Act 1999 and Home Responsibilities Protection

4.1 This appendix updates the estimates in the QR to take account of the financial effects of the changes to incapacity benefit and widow's benefit included in the Welfare Reform and Pensions Act 1999, the effect on SERPS of the Tax Credits Act 1999 and the exclusion of home responsibilities protection for SERPS.

4.2 The Welfare Reform and Pensions Act 1999 also introduced some of the changes to the National Insurance contribution regime announced in the March 1999 budget. Other changes are being introduced by regulations early in the year 2000. One measure announced in the March 1999 budget, extending Class 1A liability to other benefits in kind, is included in the Bill. It is estimated that this measure will increase contribution income by approximately £200m in 2001/02 and nearly £500m in the longer term. The effect of all the March 1999 budget changes on the National Insurance contribution regime was given in section 10 of the QR and the effect of those changes are not dealt with further in this report. The effects of the changes to incapacity benefit and widow's benefit included in the Welfare Reform and Pensions Act 1999, the effect on SERPS of the Tax Credits Act 1999 and the exclusion of home responsibilities protection for SERPS are shown on the post March 1999 National Insurance contribution regime using figures from section 10 of the QR as the baseline.

4.3 Legislation prior to the Welfare Reform and Pensions Act 1999 provides for the reduction to 50% inheritance of SERPS pensions derived from the contributions of a deceased spouse in respect of deaths from April 2000. The Welfare Reform and Pensions Act 1999 includes provision for 100% inheritance to continue after April 2000 and for the Secretary of State to make regulations to change this. Since it is not yet clear what regulations will be laid, it has been assumed for the purposes of these financial estimates that the 50% inheritance factor will apply from April 2000 as originally intended.

4.4 The changes to incapacity benefit under the Welfare Reform and Pensions Act 1999, which will affect new awards from April 2001, are:

- The contribution conditions will be tightened so that contributions will have to have been paid in one of the last three tax years before the claim, rather than in any year;
- The amount of benefit paid will be reduced in respect of a private pension being received or which could be received. The first £85 per week of pension will be disregarded but, for each additional £1 per week of pension over £85, the incapacity benefit will be reduced by £0.50 per week;
- People disabled at an early age who meet certain conditions will be entitled to incapacity benefit without having to satisfy the contribution conditions, as long as they claim benefit before age 20 (25 in certain circumstances). Severe Disablement Allowance recipients under age 20 at April 2001 will be transferred onto long-term incapacity benefit from April 2002.

These changes will lead to a reduction in incapacity benefit expenditure in the long-term.

4.5 The changes to widow's benefit under the Welfare Reform and Pensions Act 1999, which will affect new awards from April 2001 are:

- The lump sum payment of £1,000 will be doubled to £2,000 and extended to widowers;

- Widowed mother's allowance, including SERPS, will become a widowed parent's allowance, thus extending the benefit to widowers;
- Widows and widowers aged over 45 and with no dependent children will receive an age-related benefit called Bereavement Allowance, payable for twelve months only and without any SERPS.

These changes will lead to an increase in widow's benefit expenditure in the short term and a reduction in expenditure in the long-term.

4.6 The Tax Credits Act 1999 replaces family credit with working families tax credit. Like family credit, working families tax credit will qualify as earnings for the purposes of calculating SERPS entitlement. Since expenditure on working families tax credit is expected to be significantly higher than on family credit, SERPS expenditure will be correspondingly higher. Insufficient detailed data on the age, sex and earnings of those who will receive working families tax credit means that the extra SERPS expenditure has been estimated by approximate methods. Working families tax credit will not count as earnings for the State Second Pension.

4.7 The QR included an allowance in the SERPS expenditure estimates for home responsibilities protection to be extended to SERPS. This was included even though the nominal date of April 1999 for the introduction had passed without the necessary secondary legislation being brought into force. The allowance was included since it was clearly a government intention to make some provision for carers, the long-term sick and other categories. However for the purposes of this report it is inappropriate to compare the expenditure after the Bill is passed with expenditure based on legislation that was not in force before the Bill. Thus the allowance for home responsibilities protection included in the QR has been excluded in estimating the expenditure and contribution rates on legislation in force or enacted before the Bill.

4.8 Table 4.1 below shows the projected expenditure for the National Insurance Fund after taking account of the changes to the contribution structure proposed in the March 1999 budget. It is taken from Table 10.2 of the last QR.

4.9 Table 4.2 below shows the projected expenditure for the National Insurance Fund after taking account of the changes in the Welfare Reform and Pensions Act 1999, the Tax Credits Act 1999 and the exclusion of home responsibilities protection from SERPS. Overall expenditure is estimated to be 4.8% lower in the year 2060.

Table 4.1 Estimated benefit expenditure from the previous QR - flat-rate benefit rates and earnings limits increase in line with prices (£bn in 1999-00 price terms)

Year	1999-00	2000-01	2010-11	2020-21	2030-31	2040-41	2050-51	2060-61
Retirement pension Basic	33.6	33.7	37.5	40.4	48.7	52.2	50.5	50.0
Earnings-related	4.5	5.0	9.8	12.5	14.9	15.2	16.2	18.7
Widow's pension Basic	0.7	0.7	0.5	0.9	0.7	0.6	0.7	0.7
Earnings-related	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Incapacity benefit Basic	6.3	6.4	7.6	9.6	9.3	8.7	8.9	8.5
Earnings-related	0.8	0.6	0.1	0.0	0.0	0.0	0.0	0.0
Jobseekers Allowance	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Other benefits	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Expenses	1.0	1.1	1.2	1.4	1.7	1.9	2.2	2.6

Total Expenditure	48.0	48.6	57.7	65.9	76.3	79.7	79.5	81.5

Table 4.2 Estimated benefit expenditure allowing for the effects of the Welfare Reform and Pensions Act 1999, the Tax Credits Act 1999 and the exclusion of home responsibilities protection for SERPS - flat-rate benefit rates and earnings limits increase in line with prices (£bn in 1999-00 price terms)

Year	1999-00	2000-01	2010-11	2020-21	2030-31	2040-41	2050-51	2060-61
Retirement pension Basic	33.6	33.7	37.5	40.4	48.7	52.2	50.5	50.0
Earnings-related	4.5	4.9	8.9	10.9	12.4	12.3	13.3	15.5
Widow's pension Basic	0.7	0.7	0.4	0.4	0.4	0.3	0.3	0.3
Earnings-related	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Incapacity benefit Basic	6.3	6.4	7.2	9.0	8.7	8.3	8.5	8.1
Earnings-related	0.8	0.6	0.1	0.0	0.0	0.0	0.0	0.0
Jobseekers Allowance	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Other benefits	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Expenses	1.0	1.1	1.2	1.4	1.7	1.9	2.2	2.6
Total Expenditure	48.0	48.6	56.3	63.2	72.8	76.0	75.8	77.5

4.10 Table 4.3 below shows the projected Class 1 contribution rate required for the National Insurance Fund to balance income and expenditure before and after the effects of the Welfare Reform and Pensions Act 1999, the Tax Credits Act 1999 and the exclusion of home responsibilities protection for SERPS. The figures before the changes described above are taken from the final column of Table 10.4 of the last QR. The contribution rates exclude that portion paid to the NHS.

Table 4.3 Estimated Class 1 contribution rates to balance income and expenditure before and after the effects of the Welfare Reform and Pensions Act 1999, the Tax Credits Act 1999 and the exclusion of home responsibilities protection for SERPS – price uprating of flat-rate benefits and earnings limits.

	JOINT EMPLOYEE AND EMPLOYER CONTRIBUTION RATE* %	
Year	Before changes	After changes
1999-00	20.0	20.0
2000-01	20.2	20.2
2010-11	19.0	18.6
2020-21	18.1	17.5
2030-31	18.5	17.8
2040-41	17.0	16.4

2050-51	15.2	14.6
2060-61	14.0	13.5

* These rates exclude that part of the rates allocated to the NHS. They are based on the revised Class 1 contribution regime introduced by the March 1999 budget. The rate actually payable in 1999/00 is 20.25% and is the sum of the employee and employer main rates of 10% and 12.2% respectively, less the corresponding National Health Service allocations of 1.05% and 0.9% respectively.

4.11 The projected contribution rates after the changes are lower after the year 2000, reflecting the lower expenditure.

5
Appendix 2: Accrual Rates for State Second Pension

5.1 Table 5.1 sets out the accrual rates that will apply in respect of years of accrual from 2002/03, on the different bands of earnings. The accrual rates will depend on the year of retirement until retirements in the year 2027/28. For years of retirement before 2003/04, those retiring will have their earnings-related pension based entirely on SERPS.

5.2 Band 1 will be from the annual lower earnings limit to the low earnings threshold, which will be £9,500 a year in 1999/00 terms. Band 2 will be from £9,501 to (3 x the low earnings threshold – 2 x the lower earnings limit). For the purpose of this calculation the figure of 2 x lower earnings limit will be rounded to the nearest £100 (£50 down). Band 3 will be from the top of the second band plus £1 to the upper earnings limit. The low earnings threshold will be increased each year in line with the annual increase in average earnings, including the period between 1999/00 and 2002/03 and rounded to the nearest £100 (£50 up).

Table 5.1 State Second Pension accrual rates (%)

Year of retirement	Band 1	Band 2	Band 3
2003-04	46/25	11.50/25	23.0/25
2004-05	45/26	11.25/26	22.5/26
2005-06	44/27	11.00/27	22.0/27
2006-07	43/28	10.75/28	21.5/28
2007-08	42/29	10.50/29	21.0/29
2008-09	41/30	10.25/30	20.5/30
2009-10	40/31	10/31	20/31
2010-11	40/32	10/32	20/32
2011-12	40/33	10/33	20/33
2012-13	40/34	10/34	20/34
2013-14	40/35	10/35	20/35
2014-15	40/36	10/36	N/A
	:		

:	40/42	:	:
2020-21	40/43	10/42	N/A
2021-22	40/44	10/43	N/A
2022-23	:	10/44	N/A
:	40/49	:	:
2027-28 and later*		10/49	N/A

* The year when the third band will disappear will depend on the rate of real earnings growth in future years and the rate at which the earnings limits are increased. On current assumptions, the band will disappear in 2014/15. On current assumptions the second band will also disappear in about the year 2074 leaving only band 1 with an accrual rate of 40%, double what it would have been under SERPS.

5.3 Accrual rates for SERPS for all years of retirement in respect of years of accrual up to and including 2001/02 are unchanged and are given in Table 14.9 of the last QR.