Title: The single-tier pension: a simple foundation for saving **IA No:** DWP0028 **Lead department or agency:** DWP **Other departments or agencies:** HMRC, HMT	**Impact Assessment (IA)** **Date:** May 2013 **Stage:** Final Proposal **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries**: Joseph Clease, 020 7449 7362
Summary: Intervention and Options	**RPC Opinion**: 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 almost 11 million people are estimated to be 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 and their entitlement, 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)

The 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 Bill.

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.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** n/a	**Non-traded:** 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: Steve Webb   Date: 17/04/2013

Contact for enquiries: Joseph Clease, 020 7449 7362

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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 of 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. It is therefore time for the Government to refocus the state pension on providing a clearer and simpler foundation for saving.
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 on 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 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 40 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[1]. The single-tier pension will be set at a rate that is above the basic level of means-tested support and will therefore help to reduce the need for means-testing. By 2020, eligibility for Pension Credit for new pensioners is halved under single tier 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 2010 state pension reforms, the proportion of women in Great Britain qualifying for a full basic State Pension is not expected to catch up 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. A 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. A single-tier pension will retain the contributory principle while reducing the rate of increase of spending on state pensions, particularly after 2050.
5. On 4 April 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 under way to deliver a flat-rate, two-tier pension more quickly; and
   - The 'single-tier' option was a more radical reform to a single-tier pension set above the basic level of means-tested support.

[1] 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 a single tier. 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 be introduced 6 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 return 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 18th March 2013 the Government announced that the single-tier pension will be implemented in April 2016.

Single-tier reform

8. The key 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 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. Transitional protection 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 will be of most benefit to individuals who have not or would not have been able to build up as much entitlement to State Second Pension under the current system. The reforms benefit women and enable them to reach 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 fifteen years earlier under single tier, 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 single tier 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 single tier 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 single tier more quickly but also recognises contributions made prior to the implementation of single tier. Under this approach, for those not yet retired the amount of state pension an individual would be awarded under the current rules is valued as at the point single tier is implemented, based on their NI contribution record up to that point (we refer to this as their 'foundation amount'*)*. This increases the proportion of people qualifying for the full amount of single-tier pension in the early years of implementation.

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 uprating 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 uprate by at least earnings. Decisions on these variables will be made by the Government shortly before implementation, alongside a decision on the minimum qualifying period (the Pensions Bill provides for an upper limit of ten qualifying years).

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[2]), and this will be uprated by the triple lock (the highest of growth in average earnings, CPI price inflation or 2.5 per cent) until 2060, in line with assumptions used by the Office for Budget Responsibility to project forward costs of basic State Pension. We present the impact that different assumptions about the start level and uprating would make to the overall cost and impact of reform in Annex B.

Main impacts of single-tier reform

14. A single-tier pension will deliver greater certainty of income in retirement. The large majority of pensioners (over 80 per cent) will receive the full single-tier pension by the mid 2030s. 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 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 would improve significantly, particularly among the poorest fifth of pensioners, so that they can keep more of any additional saving 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 reliance on 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 400,000 pensioner benefit units by 2040, mainly as low income pensioners will get higher incomes.

17. A single-tier pension will be fairer by delivering parity for women's state pension outcomes fifteen years sooner than under the current system. Around 700,000 women who reach State Pension age in the first ten years after the single-tier pension is introduced will receive an average of £9 per week more in state pension due to the single-tier valuation (in 2013/14 earnings terms).

18. Furthermore, single tier 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 mid 2040s. From the late 2040s the rise in pensions expenditure as a proportion of GDP reduces compared to the current system (from 8.5% of GDP to 8.1% of GDP by 2060)[3].

20. In 2016, most people will receive the same level of state pension income as they would have had the current system continued, however around 25% of people will get a higher outcome. By 2020, around 75% of new pensioners have higher outcomes under single tier. This proportion gradually diminishes over time: by 2060 around 50% of pensioners have higher outcomes. People that would have built up large amounts of additional State Pension had the current system rolled forward without future reform are the main group who have notionally lower outcomes.

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 90 per cent of individuals who reach State Pension age in the first two decades of single tier will gain enough extra State Pension to offset the extra NICs and any adjustments to their workplace pension scheme.

The majority of the impacts presented in this impact assessment are estimates and are subject to a degree of uncertainty. In addition, many of the impacts are highly dependent upon the choice of start level for the single tier and uprating policy, particularly in later years.

[2] See Annex A for more details.

[3] These figures are based on DWP projections. These differ from projections in the OBR Fiscal Sustainability Report 2012. See Chapter 7 for further details.

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[4]:

- 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. The past year has seen 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[5].

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[6].

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 was agreed 5 years ago, according to the most recent forecasts, a man retiring in 2012 can expect to spend more than an extra year in retirement.

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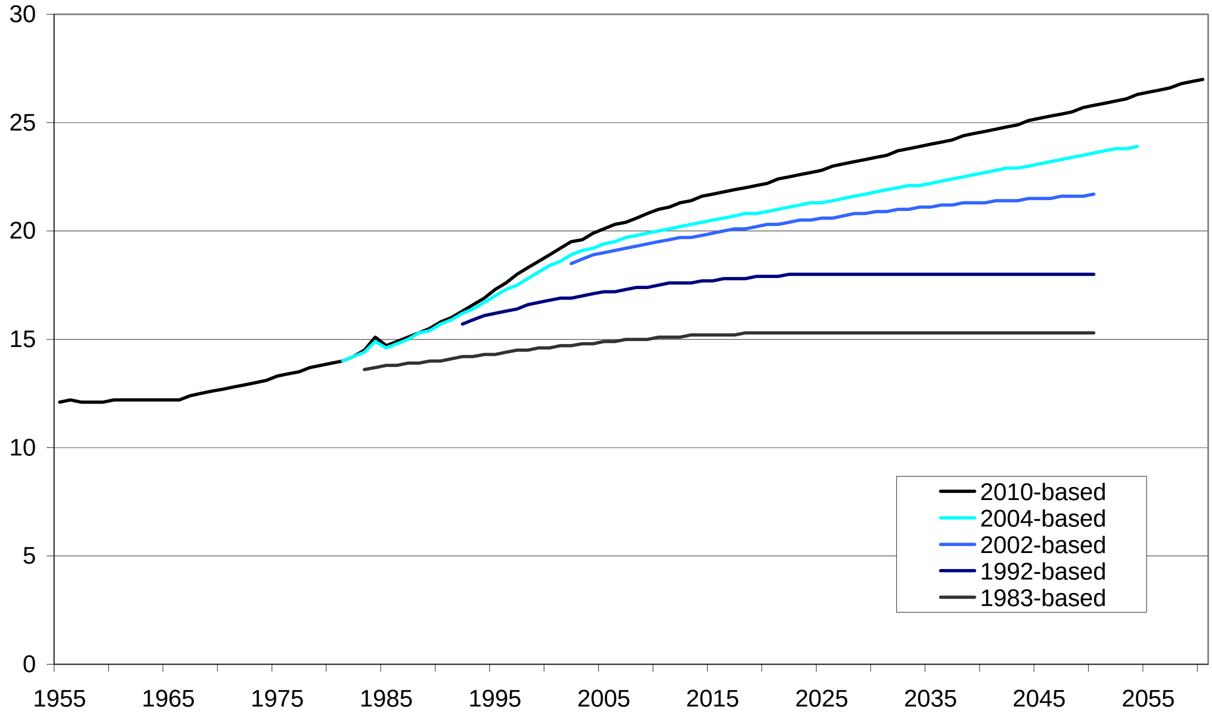
[4] The Pensions Commission, 2004, *Pensions: Challenges and Choices: The First Report of the Pensions Commission* and 2005*, A New Pension Settlement for the Twenty First Century: The Second report of the Pensions Commission.*

[5] Office for National Statistics, 2011, 2010 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.

[6] Office for National Statistics, 2009, *2008-based national population projections*.

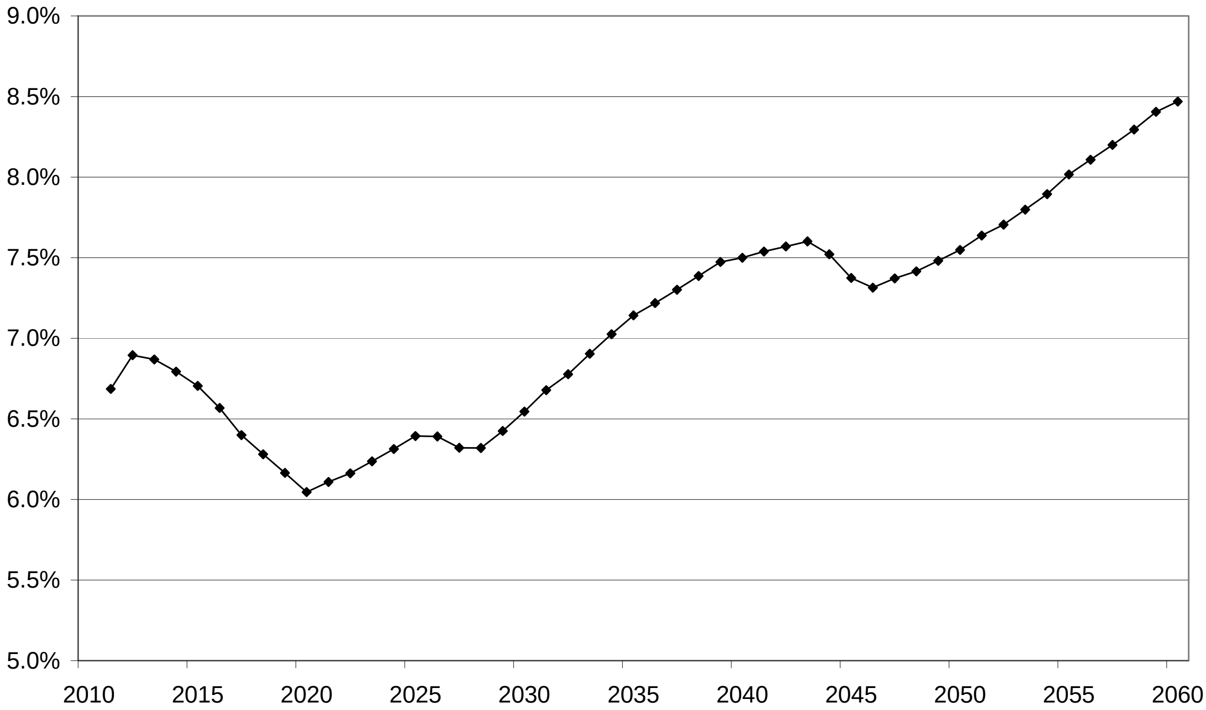
Chart 1.1: Cohort life expectancy for a 65 year old male, 1955-2060



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, without further reform state pension spending as a proportion of GDP is forecast to rise significantly (Chart 1.2).

Chart 1.2: Pensioner benefit expenditure as proportion of GDP



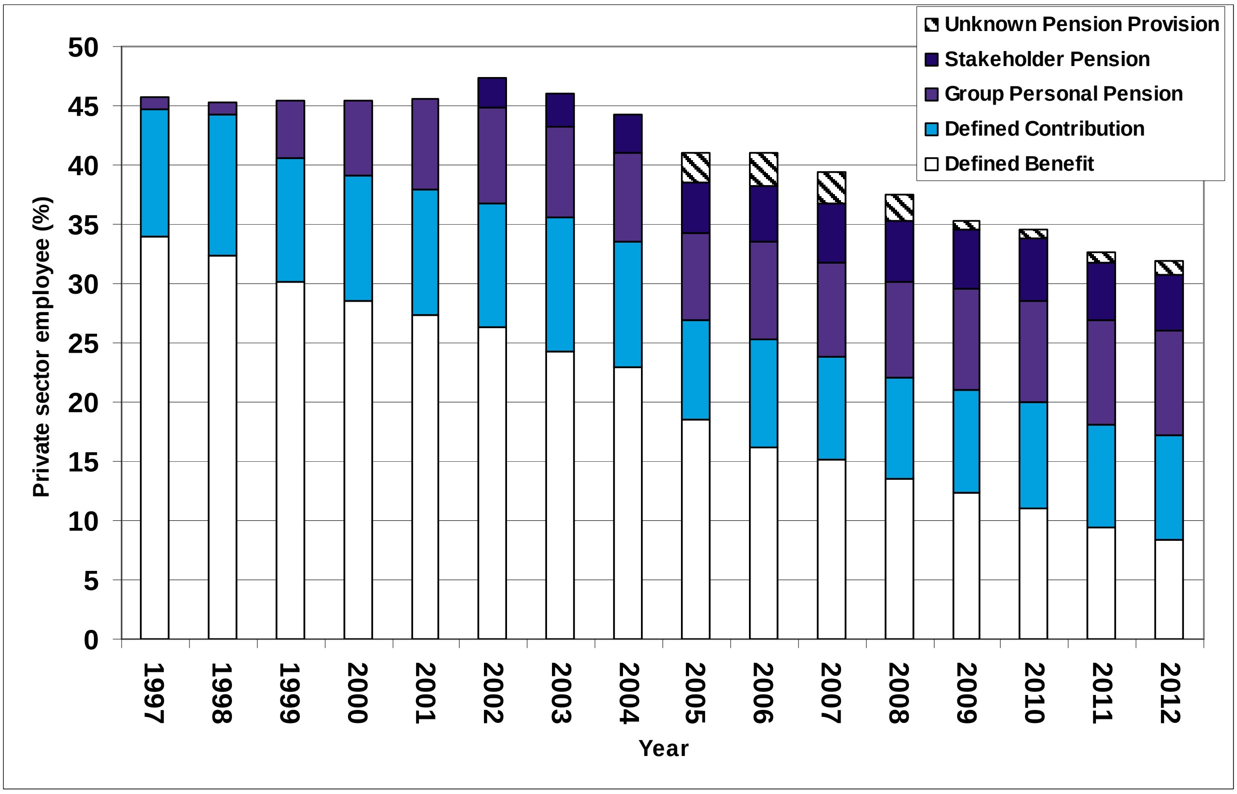
Source: DWP expenditure projections. Includes the announced increase to SPa 67 between 2026 and 2028, and the SPa equalisation to 65 (for women), and rises to 66 and 68 as set out in legislation. The dips in the series occur in periods when State Pension age is equalising or rising.

1.3 The challenge of the undersaving for retirement

29. Despite the fact we are living longer, fewer people are saving for their retirement. The numbers contributing or having contributions paid into a scheme (active members) continues to fall. In 2011 there were 8.2 million active (employee) members of occupational pension schemes compared with 12.2 million at the peak in 1967[7].

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 2011



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

31. As a consequence of undersaving for retirement, there are around 11 million people of working age in the UK who could have inadequate retirement incomes[8]. Just under a third of 45-64 year olds have no private pension wealth and this number rises to over a half of 25-34 year olds[9]. 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 15.4 million people saved into an Individual Savings Account (ISA) in 2010/11. But over half of ISA owners approaching State Pension age (aged 45-64) have less than £9,000 saved in their ISA, an amount which is unlikely to go far in covering retirement expenditure[10].

[7] Office for National Statistics, 2012, *Occupational Pension Schemes Survey 2011*. ONS

[8] *Estimates of the number of people facing inadequate retirement incomes,* DWP Ad-hoc, July 2012 (Figures predate implementation of Automatic Enrolment.)

[9] Office for National Statistics, *Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/08*.

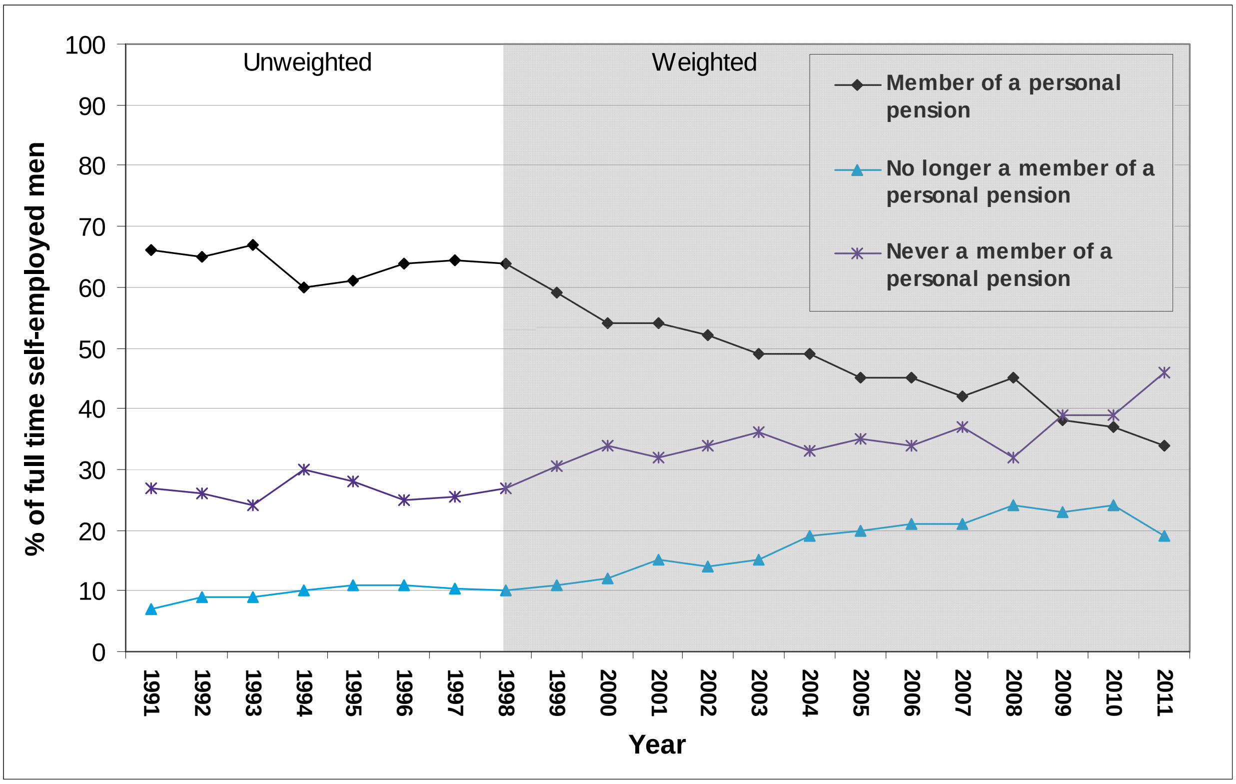
[10] HMRC ISA Statistics (2009-10), Tables 9.4 and 9.11

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 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[11].

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, and 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. People who have spent time self-employed are one of the key groups who benefit from these reforms. 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 4.2 million at the end of 2012, around 14 per cent of total employment[12]).

37. 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 GRB) 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.

[11] "Workplace pension reform: digest of key analysis", DWP 2012,

[12] *Labour Market Statistics* April 2013, ONS.

1.4 Complexity and uncertainty in the current state pension

38. Whilst the Pensions Act 2007 reforms provided improvements to the state pension system, the following problems remain:

Complexity and uncertainty

39. 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.[13] The current complex system means it is very difficult for 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

40. 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.

41. 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 Credit 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.

42. 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.[14]

1.5 Inequality in the current state pension system

43. As part of the Pensions Act 2007, reforms were taken forward 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[15].

44. In the current system, the self-employed pay National Insurance contributions on a different basis from employees, and some low earners that are self-employed can pay more in National Insurance than if they earned the equivalent sum as a wage. National Insurance contributions paid by the self-employed do not count towards the additional State Pension.

[13] *Attitudes to Pensions 2012,* DWP

[14] Department for Work and Pensions, 2012, *Income Related Benefits: Estimates of Take-up in 2009-10,* Department for Work and Pensions.

[15] DWP modelling.

Chapter 2) Policy objectives and options considered

2.1 Consultation and state pension reform objectives

45. In April 2011 the Government launched a consultation on state pension reform entitled "*A state pension for the 21st 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[16]; 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 of increasing longevity are shared fairly between generations. In addition, state pension reforms need to retain trust and confidence in a sustainable deal for the long term.

46. The consultation on state pension reform ran from 4 April 2011 to 24 June 2011. In total DWP received 101 responses from stakeholder organisations and approximately 1,600 from individuals. The Minister for Pensions hosted four roundtable discussions on specific aspects of the proposed reform and officials met thirty five stakeholder organisations during the consultation period.

47. 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

48. Three options were considered as follows:

Option 1: 'Do nothing' - the baseline

49. The Government's Green Paper set out the rationale for why doing nothing is not an option. Without reform to the current state pensions system:

- 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 by a state pension which provides a clear foundation for private saving.

[16] 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 2013-14 the thresholds have risen to £145.40 for singles and £222.05 for couples.

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

50. Single-tier reform aims 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.

51. The key features of the single-tier pension 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 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 single tier will need to have a minimum number of qualifying years to become eligible for state pension (assumed to be 10 years for the purpose of the analysis in this paper 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 single tier, 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 single tier, with 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 single tier, 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. This rate will be finalised closer to the planned implementation date, taking into account the value of the income foregone by the delay in drawing a single-tier pension and the Government's agenda for supporting people who wish to work for longer.

52. 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 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.

53. Ending contracting out from Defined Benefit occupational pension schemes is another aspect of moving to a 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).

54. It is intended that the single-tier pension will commence on 6 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 April 2016, all their National Insurance contributions or credits will be dealt with under the single-tier rules.
- People who reach State Pension age after 6 April 2016 may receive a single-tier pension upon reaching State Pension age, based on pre- and post implementation National Insurance contributions or credits.

55. A key challenge of reform is to do this in a way that is fair, while also delivering the simplicity and clarity of single tier 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 half of pensioners would still not receive the full single-tier amount even though the majority of these would have 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.

56. 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. A key challenge of the single-tier reform is to translate these records into a single-tier start valuation – or foundation amount – at the date of the introduction of the new scheme.

57. The Government will recognise contributions that have been made prior to implementation in managing the transition from the current system to single tier through the 'foundation amount'. Where on reaching State Pension age an individual's pre-implementation contribution record gives rise to an entitlement of more than the full amount of single tier, the additional amount would be recognised in their start valuation as a 'protected payment' (uprated annually by prices).

58. 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** weekly pension, the amount above the single-tier pension will be protected, and added to the full single-tier weekly payment;
- Where this foundation amount is **lower than the full level of the single-tier** weekly pension, individuals will be able to increase their single-tier pension up to their State Pension age to the full £144 per week 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.

59. 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 weekly amount.

60. 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.

61. 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). Chapter 4 of this impact assessment provides further analysis of the impact on means-tested benefits.

Option 3: Faster flat rating of additional State Pension

62. 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 was outlined within the Green Paper '*A state pension for the 21st 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.

63. 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 £1.70 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.

64. 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 single tier, 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.

65. 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

66. This chapter looks at the effect of the single-tier reform package on the various types of income 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. The baseline also includes the planned rise in State Pension age to 67 between 2026 and 2028.

67. We consider how outcomes change under the single tier, assuming a starting level of £144 per week 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 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 pension simulation model 'Pensim2', the details of which can be found in Annex A.

68. The analysis in this chapter only includes people who reach State Pension age after any reform has been implemented (unless stated) and only includes pensioners in Great Britain[17]. Those who reach State Pension age before implementation will continue to receive their state pension in line with existing rules.

69. As contributions under the current system will be recognised by applying similar rules to the current system, subject to the minimum qualifying period no person reaching State Pension age under the single tier will get a lower state pension than they could have become entitled to based on their own pre-implementation contributions under the current system's rules, so all impacts here are **notional**. This is as outcomes under the current system for individuals will remain uncertain until near the point they reach State Pension age (for example due to the impact of their unknown future earnings on additional State Pension - hence we have to model these outcomes), and also as future changes to outcomes are assessed on the assumption that we were to maintain a pension system that would remain unchanged over the coming decades.

70. Notional impacts also arise because **total net income** received from the state and National Insurance paid under the single tier 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 the impact on pensioner incomes. The effect of changes to National Insurance for individuals is discussed separately in chapter 5.

71. The transition from the old system 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 single tier 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 single tier, 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 in the next 40 years and after single tier is implemented will have a higher net income over the course of their retirement as a result of the reforms.

72. Pensioners living overseas may receive less state pension than they would have done under the current system because of the introduction of the minimum qualifying period of up to 10 years. They might also experience a notional change in outcomes as a result of other aspects of single-tier reform, in common with GB pensioners.

[17] Pensim2 only models Great Britain but under the 'parity principle' we have anticipated that Northern Ireland will introduce equivalent measures.

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

73. This section compares outcomes under single tier to the baseline of the current system rolled forward. As is the case throughout this impact assessment, the impacts presented are notional.

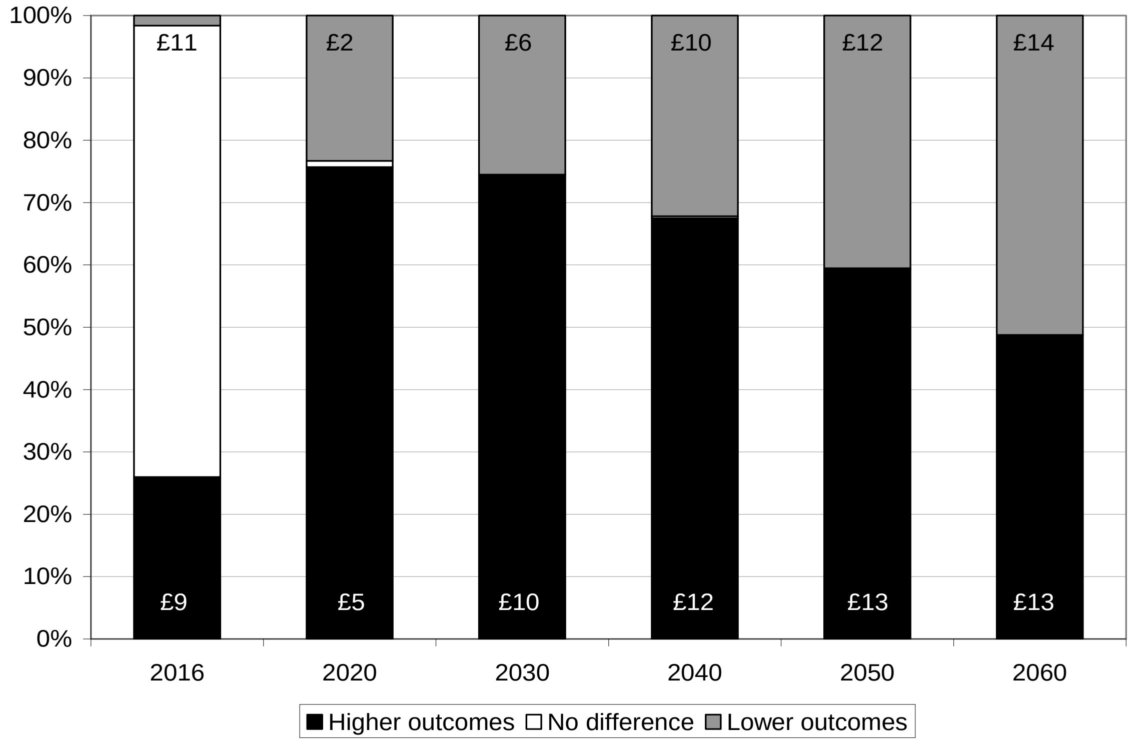
74. We first look at state pension outcomes for individuals, before considering overall state support including income-related benefits at benefit unit (household) level. This is as state pension is an individual award, whereas income related benefits are assessed and awarded at household level.

75. 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)

76. Chart 3.1 shows that within a few years of implementation, single-tier 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 pensioners who reach State Pension age after the implementation of the single-tier pension (i.e. the cumulative stock of single-tier pensioners versus the equivalent cohort of pensioners in the baseline of the current system).

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



77. In 2016, the first year of reform, most people receive the same level of state pension income as they would have had if 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 2060, approximately half of the single-tier pensioners will have an outcome that is higher than under the current system.

78. Three case studies on the following page illustrate how individuals in a range of different circumstances are affected by the introduction of the new single tier pension. These have been chosen to be broadly illustrative of what happens to individuals retiring both early and late into the single tier, and as such are highly stylised. Further case studies can be found in various places elsewhere in the Impact Assessment (see pages 23, 25, 30 and 34).[18]

[18] 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 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 today. 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 single tier 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	£124	£134
Average weekly pension over the rest of her life (for stated life expectancy)	£125	£137
Total pension over the rest of her life	£155,000	£171,000

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 today. 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 under single-tier in the first year of her retirement she does get a protected payment (uprated by prices). Due to the uprating of the single-tier pension she receives approximately the same income on average over retirement.

2012/13 earnings terms	Current State Pension	Single Tier Pension
Weekly pension in first year after reaching State Pension age	£194	£181
Average weekly pension over the rest of her life (for stated life expectancy)	£175	£175
Total pension over the rest of her life	£219,000	£219,000

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 a salary equivalent to around £40,000 today, 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 from single tier due to the end of the ability 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	£223	£154	£136
Average weekly pension over the rest of his life (for stated life expectancy)	£200	£159	£85
Total pension over the rest of his life	£239,000	£190,000	£102,000

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

79. 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 instead of individuals[19].

80. Chart 3.2 below shows that a majority of households reaching State Pension age under single tier (cumulative stock) have notionally higher outcomes than in the baseline of the current system rolled forwards, until the 2050s. The median changes to outcomes are relatively modest; for example a £13 per week higher outcome in 2040 represents a median four 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) due to single-tier reform, median weekly change for those with higher or lower notional outcomes (2013/14 earnings terms)

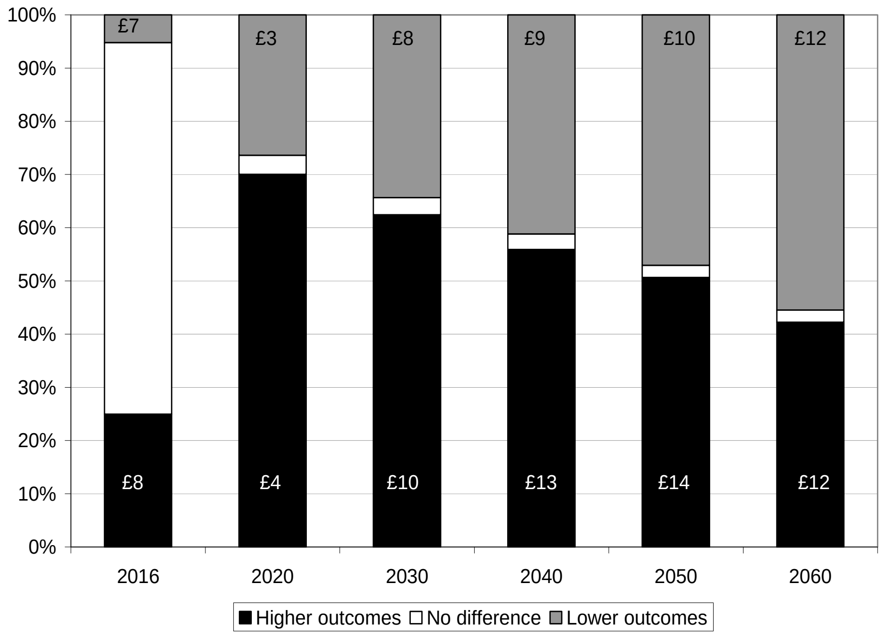
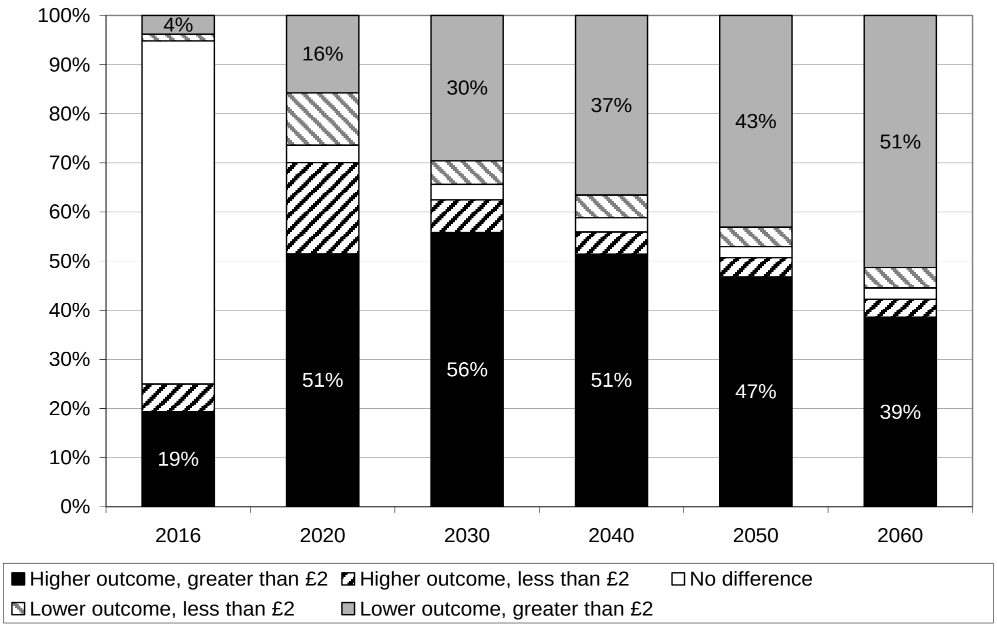


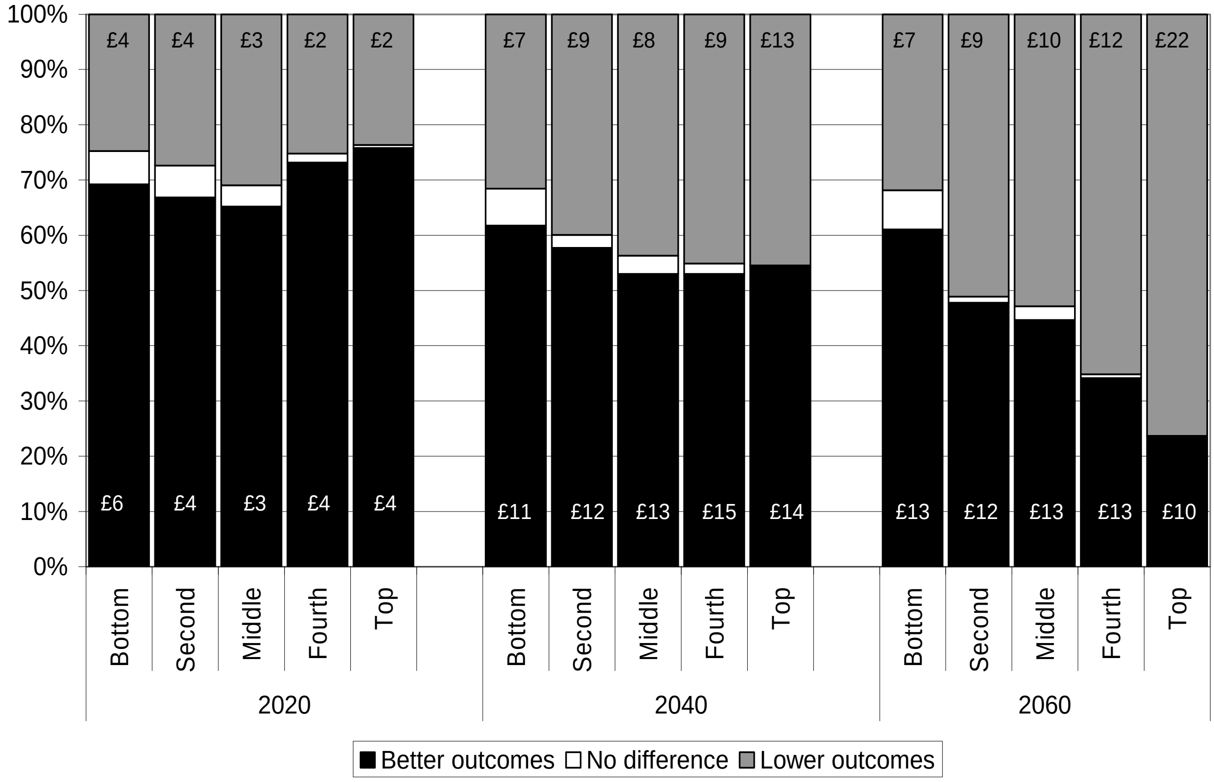
Chart 3.3: Proportion of benefit units with changed notional outcomes due to single-tier reform, broken down to show impacts of more than or less than £2 per week, (net incomes, 2013/14 earnings terms)



[19] '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 cohabitees)

81. 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 later in the impact assessment 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)

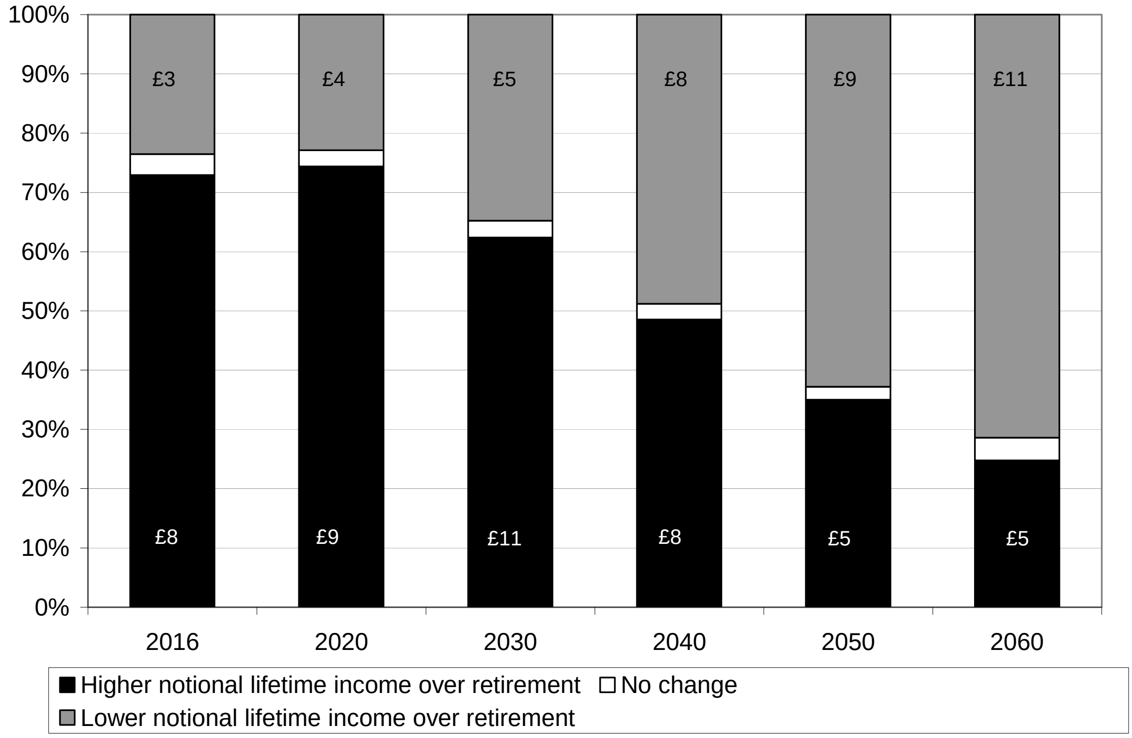


82. Chart 3.5 below shows the proportion of benefit units that receive higher notional incomes over the whole of their retirement under single-tier than they would have received under the current system.

83. The majority of households reaching State Pension age up to 2040 receive higher incomes over the whole of their retirement under single tier. Initially the majority of households gain over retirement because of the single-tier calculation and the triple lock, but households start to receive lower notional incomes over retirement after 2040. This is because people reaching SPA after 2040 are likely to accrue large amounts of State Second Pension under the current system,[20] which will not be possible under single tier. This increases the probability that they will have a notionally lower state pension after the reforms.

[20] For a cohort reaching State Pension age this year, the maximum amount payable by way of SERPS + S2P is around £150 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 due to single-tier reform, by year of SPA. Median change in net weekly income (2013/14 earnings terms).



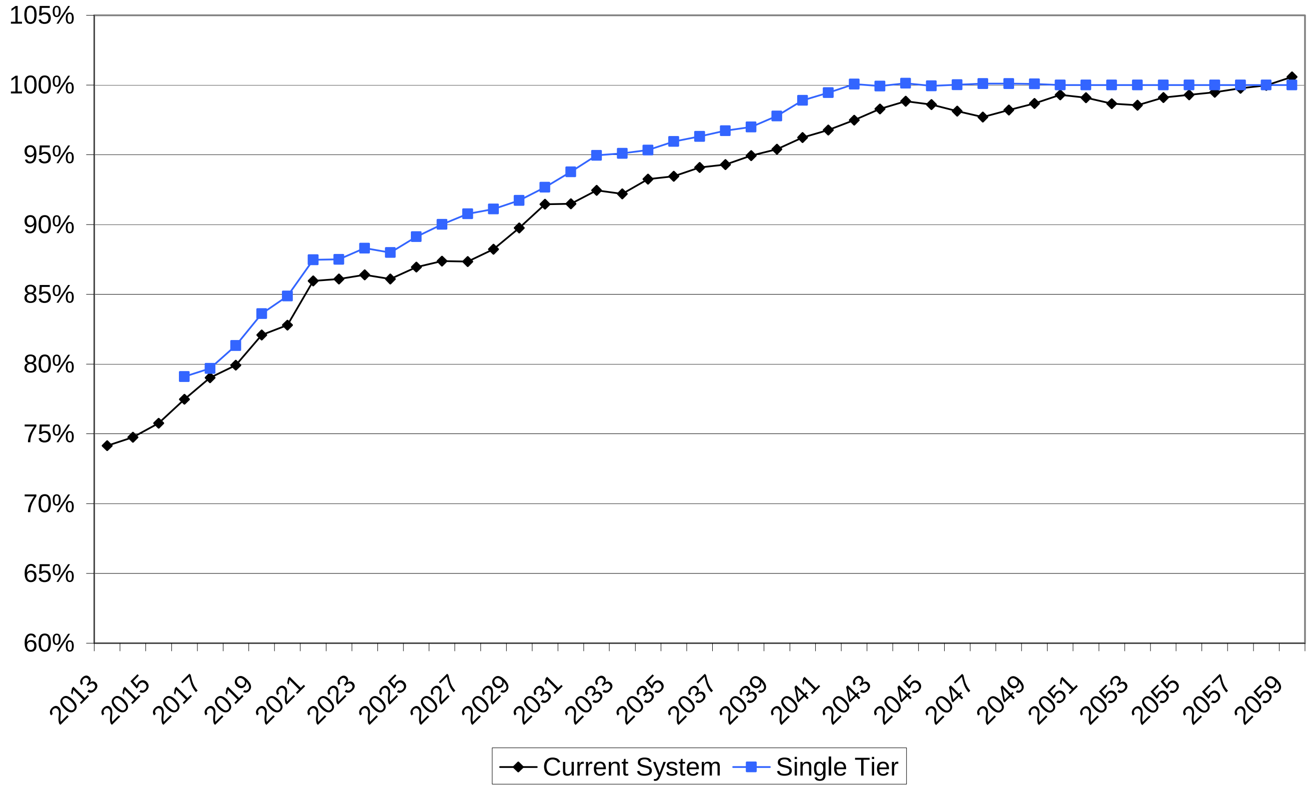
3.2 Impact of reform on outcomes for women

84. Historically, women have tended to get lower outcomes from the state pension system. While the 2007 Pensions Act delivered improvements for women, they still lag behind men in overall state pension outcomes. Despite reforms, the proportion of women in Great Britain qualifying for a full basic State Pension is not expected to catch up 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).

85. 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 catch up with men.

86. Single tier brings forward by over 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 current system and single tier



87. The gender gap closes due to the end of the earnings-related State Second Pension, and also because a new single-tier 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 fifteen years earlier under single tier, compared with the current system (in 2042 compared to 2057).

88. The main reason that notional outcomes for women improve more quickly in the early years is because the single-tier valuation most benefits lower paid and part time workers, who are predominantly women. In 2016, almost half 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.

89. As a result of the single-tier valuation, around 700,000 women who reach State Pension age in the first ten years after the single-tier pension is implemented will receive an average of £9 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.

90. Due to unequal State Pension ages, the first man to receive a single-tier pension was born on 6 April 1951, and the first woman on 6 April 1953. There is therefore a cohort of some 700,000 women (those born between 6 April 1951 and 5 April 1953) who will reach their State Pension age before the implementation of Single Tier, 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 approximately 2 and 4 years before a man born the same day, and in this interval they could receive up to £26,000 in state pension. This cohort will also retain access to legacy features of the current system, such as an actuarially generous rate of deferral, Savings Credit, and derived entitlement to state pension.[21]

[21] 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 4) Elizabeth – Low earner, broken work history, aged 59 in 2013

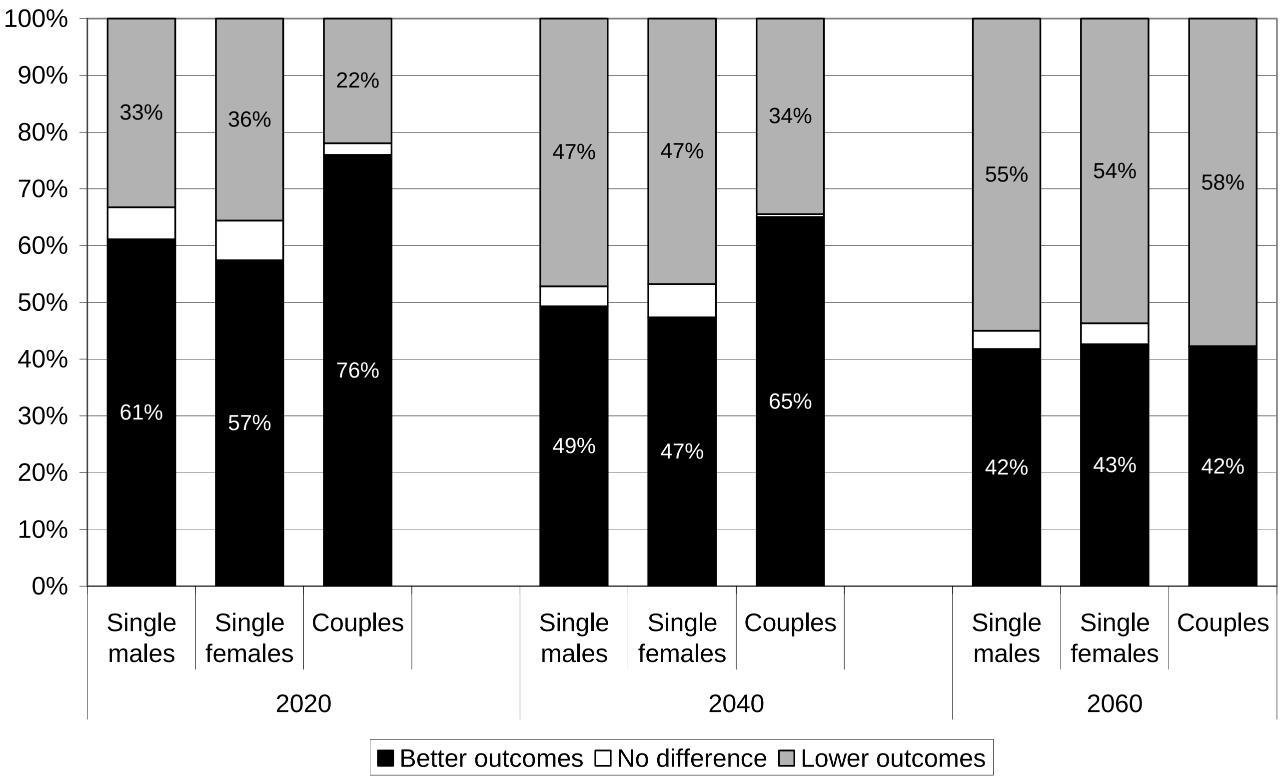
Elizabeth was born in 1954 and reaches State Pension age at 66 in 2020. She got married and was a housewife until having her first child aged 25. She stayed at home looking after her children until the age of 43. She then went to work part time until aged 59 in a job that pays her a salary equivalent to around £8,000 today. 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 Julie was looking after her children her state pension entitlement for both the current and single-tier pension systems was protected by Home Responsibilities Protection. However 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. Elizabeth gets the full single tier pension.

2012/13 earnings terms	Current State Pension	Single Tier Pension
Weekly pension in first year after reaching State Pension age	£131	£144
Average weekly pension over the rest of her life (for stated life expectancy)	£128	£148
Total pension over the rest of her life	£160,000	£184,000

91. 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 gender.



92. In 2020 and 2040 couples are more likely to get a notionally increased income from the reform than either single men or single women. 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 single-tier offset by reduced benefit entitlement, or to be affected by the removal of Savings Credit.

93. Disabled people's eligibility for means-tested benefits is less affected by changes, 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[22].

94. The ability to derive or inherit state pension entitlement will end with single tier, 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.[23]

- We estimate that in 2020 fewer than 30,000 women (less than 5% of single-tier 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.[24]
- 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 Individual outcomes not fully modelled in the impact assessment

95. 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 (it is still not possible to estimate the distributional impact on overseas pensioners). This section outlines the main results from this analysis and information about the methodology is in Annex A.

96. 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 2013/14prices).

b. Minimum Qualifying Period: there will be a minimum qualifying period (MQP) for the single-tier pension, which is modelled as ten years in this assessment with a final decision to be taken closer to implementation (although the Pensions Bill provides that the upper limit will be ten years). 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 380,000 people living overseas.
- The expected savings from the MQP in 2040 are around £650m (in 2013/14 prices).

The proportion of overseas residents that reach State Pension age under the single tier that are affected by the MQP is much greater than the proportion of GB residents that are affected. This is expected to be approximately 2% of the GB cohort and up to 40% of the overseas cohort.

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.

[22] The current system of means-tested support for pensioners is due to change 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 (from 2014 on latest planning assumptions).

[23] http://www.dwp.gov.uk/docs/derived-inherited-entitlement.pdf

[24] This estimate is based on the number of women who receive a lower notional non-inherited state pension outcome under the single tier who would have claimed Cat B or Cat BL under the current system.

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

Year of SPA	Average for each year, 2016-2020	As a proportion of those reaching SPA
Great Britain residents		
7 year condition	6,000-10,000 per year	1%-2%
10 year condition	9,000-12,000 per year	2%-3%
Overseas residents		
7 year condition	5,000-9,000 per year	22%-40%
10 year condition	6,000-10,000 per year	27%-44%

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 an 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.

97. A limitation in our methodology for estimating the impact of the MQP is uncertainty around the state pension accrued by these individuals in countries with which the UK has a bilateral social security agreement[25] 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 2/35ths of the full rate.

98. 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 as someone notionally affected by changes to deferrals or the MQP may get a higher outcome overall from the reform, or might have a partner who has a higher outcome after reform.

Case Study 5) 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 today. 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	£118	£144
Average weekly pension over the rest of his life (for stated life expectancy)	£118	£147
Total pension over the rest of his life	£135,000	£168,000

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.

[25] 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

99. This chapter looks at the effect the single-tier 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 (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.

100. From 2013, some pensioners with a working age partner will claim Universal Credit rather than Pension Credit or Housing Benefit. The baseline for this impact assessment includes these reforms. For simplicity, the small numbers of possible Universal Credit claims are treated as being eligible to Guarantee Credit (and Housing Benefit where there is an element of support with rent).

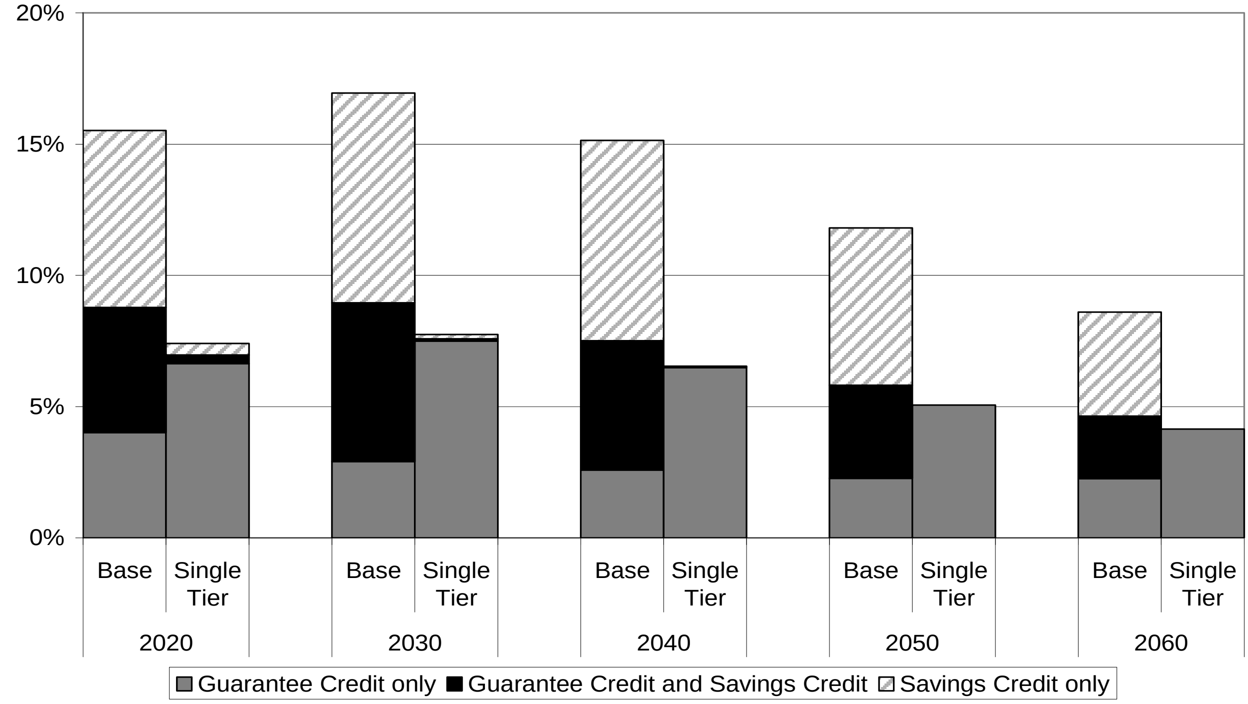
101. As of April 2013 Council Tax Benefit has been replaced with localised support. The analysis assumes that localised council tax support for pensioners will be broadly similar in outcomes to the former Council Tax Benefit system.

102. 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, in the context of an increased state pension for most people. The single tier also reduces eligibility for Guarantee Credit and council tax support but has little effect on Housing Benefit. By 2040, overall eligibility for means-tested benefits falls by around 4 percentage points, or over 400,000 benefit units, as a result of the single-tier reforms.

a) Eligibility for Pension Credit within single tier

103. Single tier 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, 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 single tier



"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.

104. 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 between 15 and 20 per cent in the mid 2020s and fall to around 10 per cent by 2060. Under the single tier, eligibility for Pension Credit is halved compared to the current system in the first few years of reform, and ultimately falls to around five per cent by 2060.

105. 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 pensioners under the single tier having a state pension above the level of the Standard Minimum Guarantee.

106. There are a number of reasons why a small number of pensioners remain eligible for Pension Credit under single tier, despite the single-tier pension being above the Standard Minimum Guarantee. An individual may:

- Have fewer have less 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[26];
- Be a member of a couple still receiving Savings Credit because one member retired 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.

107. 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. 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

108. 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. 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 single tier)

		2020	2030	2040	2050	2060
Housing Benefit	Base	12%	16%	15%	12%	10%
	Single tier	12%	15%	14%	12%	10%
Council Tax Support	Base	35%	37%	32%	28%	23%
	Single tier	34%	34%	30%	26%	23%

Source: Pensim2; numbers rounded to the nearest 1 per cent. Figures shown are based upon entitlement.

109. Entitlement to support with rent and council tax bills is affected by the implementation of the single tier 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 help may be lower with the removal of Savings Credit.

110. 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 entitlement altogether, and we are proposing to protect the outcomes of those who would otherwise lose rent support for people reaching State Pension age up in the first five years of Single Tier. Therefore even where people are no longer entitled to Pension Credit (whether through removal of

[26] Additional amounts are added to Guarantee Credit to help with the costs of caring, disability and some housing costs.

Savings Credit or higher state pension income) some entitlement to housing or council tax support may remain.

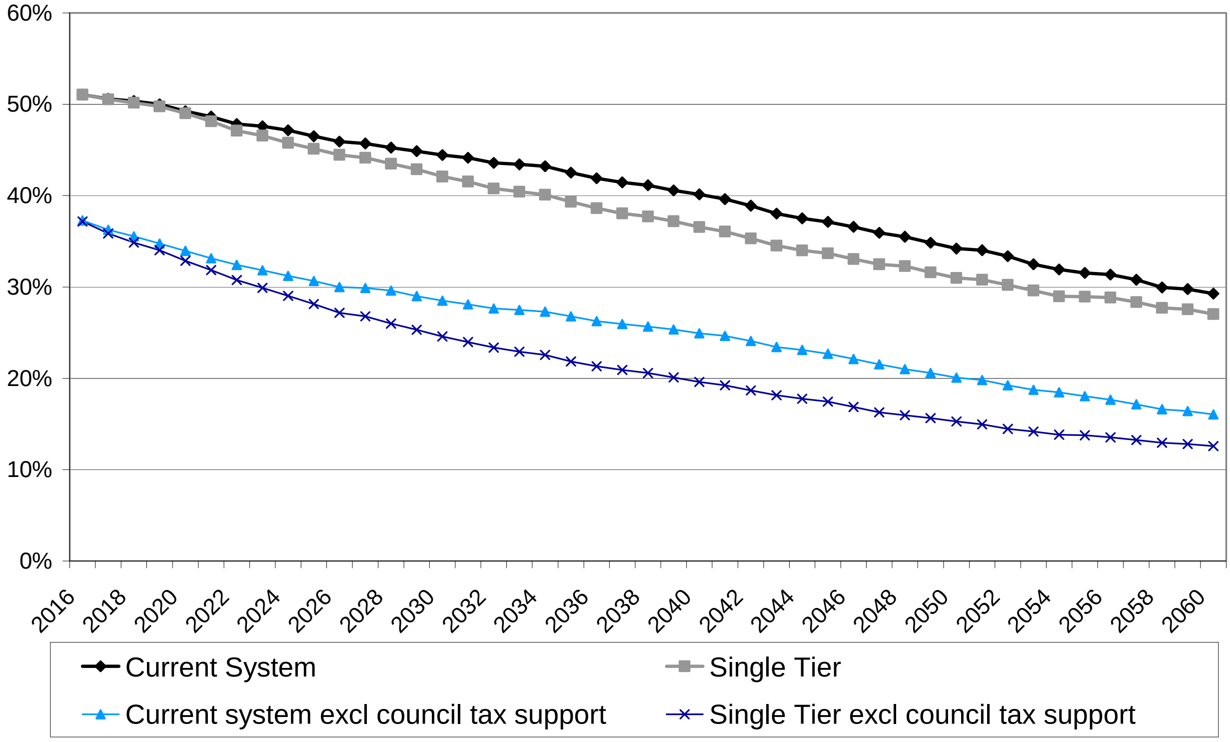
111. By 2040 the average weekly entitlement to support with Housing Benefit is notionally around £7 lower than in the current system, and notionally around £2 lower for council tax support. However, many recipients will see an increase in their state pension award and so may be better off overall.

c) Overall scope of means-tested benefits

112. Chart 4.2 below shows that overall eligibility for means-tested benefits is expected to fall over time for pensioners. 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 uprating policy and by the introduction of Universal Credit.

113. In the early years the impact of single tier 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 four percentage points, or over 400,000 pensioner benefit units, by 2040. 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



114. 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 30 per cent per cent of white pensioners[27].

115. Research undertaken to understand why DWP's Pensions Service consistently get 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[28]. 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.

[27] The Pensioners' Income Series 2010-11. Department for Work and Pensions.
[28] 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

116. 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 each additional £1 of income (after tax) that a person loses once their means-tested benefit award has 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.

117. The removal of Savings Credit under single tier will reduce the number of different deduction rates that pensioners face at different income levels and so reduces complexity. 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 incomes for some benefit units 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).

118. Charts 4.3 and 4.4 show how the single-tier reforms affect MDRs for pensioners reaching State Pension age after 2016 (the cumulative stock). The proportion facing a low marginal deduction rate of 20 per cent or less would rise significantly, particularly for the poorest single pensioners, so that they can keep more of any additional saving or earnings.

119. The single tier has less impact on the MDRs of couples since they are less likely to interact with means-tested benefits and as a consequence are not as affected by 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

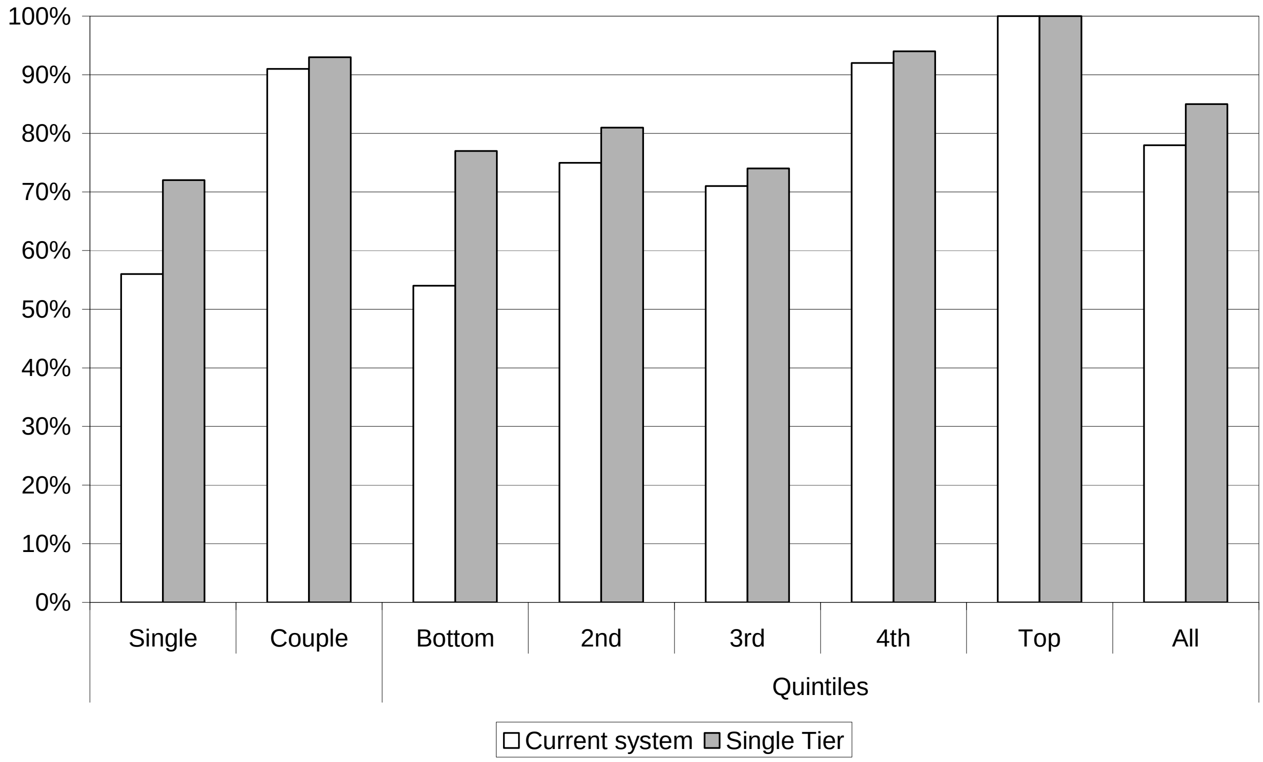
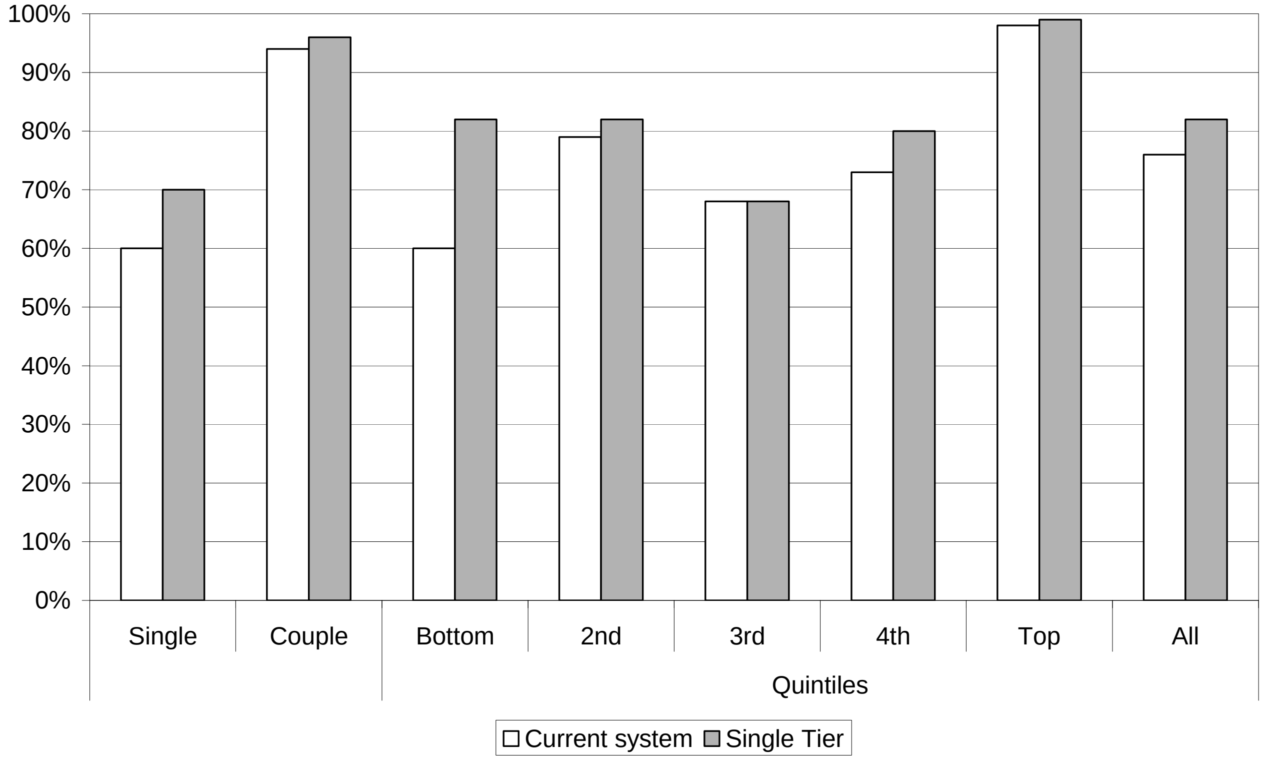


Chart 4.4: Proportion of single-tier pensioners with a low Marginal Deduction Rate (at or below 20 per cent) in 2040, by income quintile



Note: The proportion with a low Marginal Deduction rate is generally slightly lower in 2020 than 2040 under both the current system and single tier. 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 today money 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 single tier 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	£214	£154	£86	£240
Average weekly pension over the rest of his life (for stated life expectancy)	£193	£159	£54	£213
Total pension over the rest of his life	£231,000	£190,000	£64,000	£254,219

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

120. 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[29]. 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 poor pensioners who would otherwise not have claimed a means-tested top-up.

121. 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. In the baseline it is assumed that the reforms introduced 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

122. 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 then they could lose eligibility to some of these 'passported benefits'.

123. 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 (around 2 percentage points in 2020), so this has a limited impact on the proportion of pensioners that are 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.

124. 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 may also lose eligibility to these other benefits (however, as stated above there is only a small impact of single tier 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. However, this is estimated to affect less than 1 per cent of single-tier 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 for different local authorities/education institutions.

[29] 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

125. Under the single-tier pension, 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.

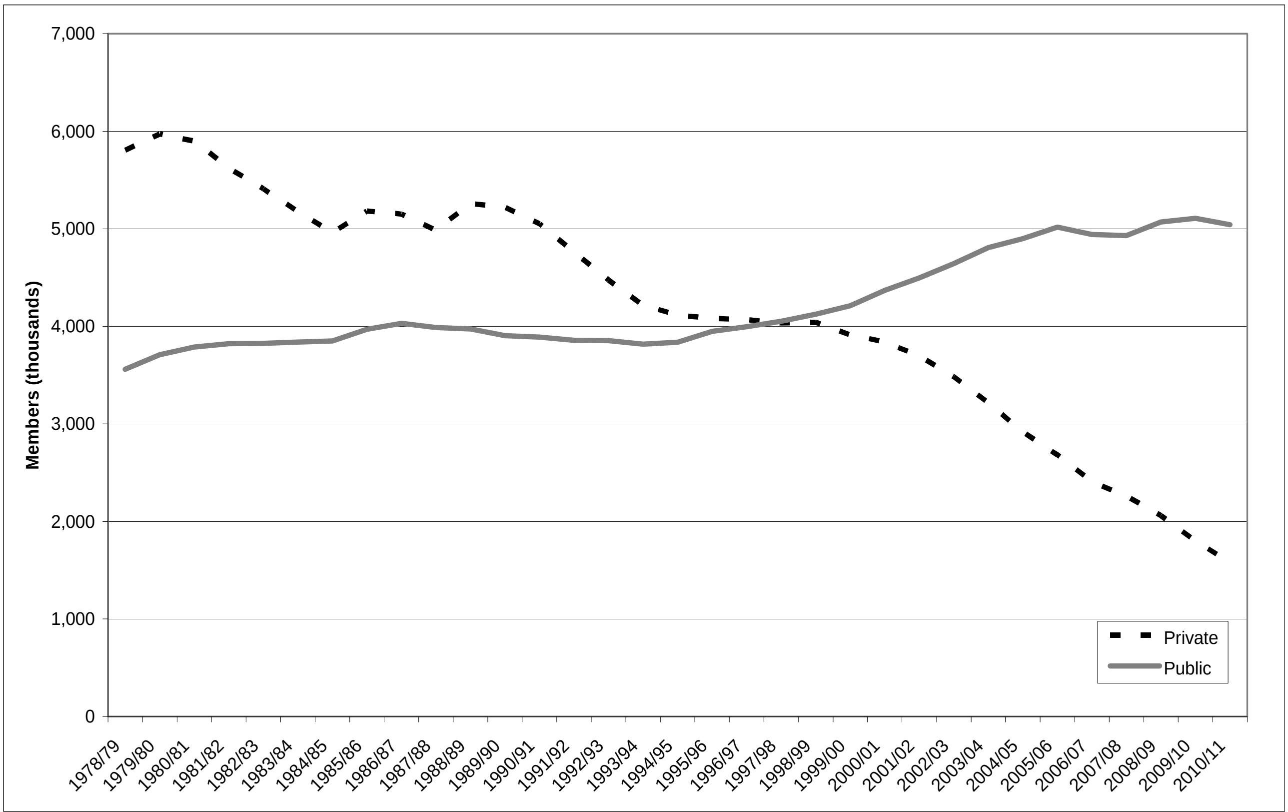
126. Ending contracting out is a key consequence of a single-tier pension system and will contribute to simplifying the state pension system. It will remove the connection between state and private pension schemes that can cause misunderstanding and confusion for individuals, difficulty in providing 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.

127. Note that the costs and benefits in this chapter relate only to the ending of DB contracting out. No interactions with the rest of the state pension reform are taken account of. However, this does not matter when considering the impacts on sponsoring employers of DB schemes, as the only impact of the reform on them comes through the ending of contracting out.

5.1 Contracting-out demographics

128. 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 2010/11 – DWP statistics

129. 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[30]. 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.

[30] See for example '*Pensions: Challenges and Choices, -The First Report of the Pensions Commission*', 2004.

130. According to the 2011 Occupational Pension Schemes Survey[31], there are currently 1.6 million active[32] 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.

131. Table 5.1 below shows how active membership is distributed by scheme size. 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.

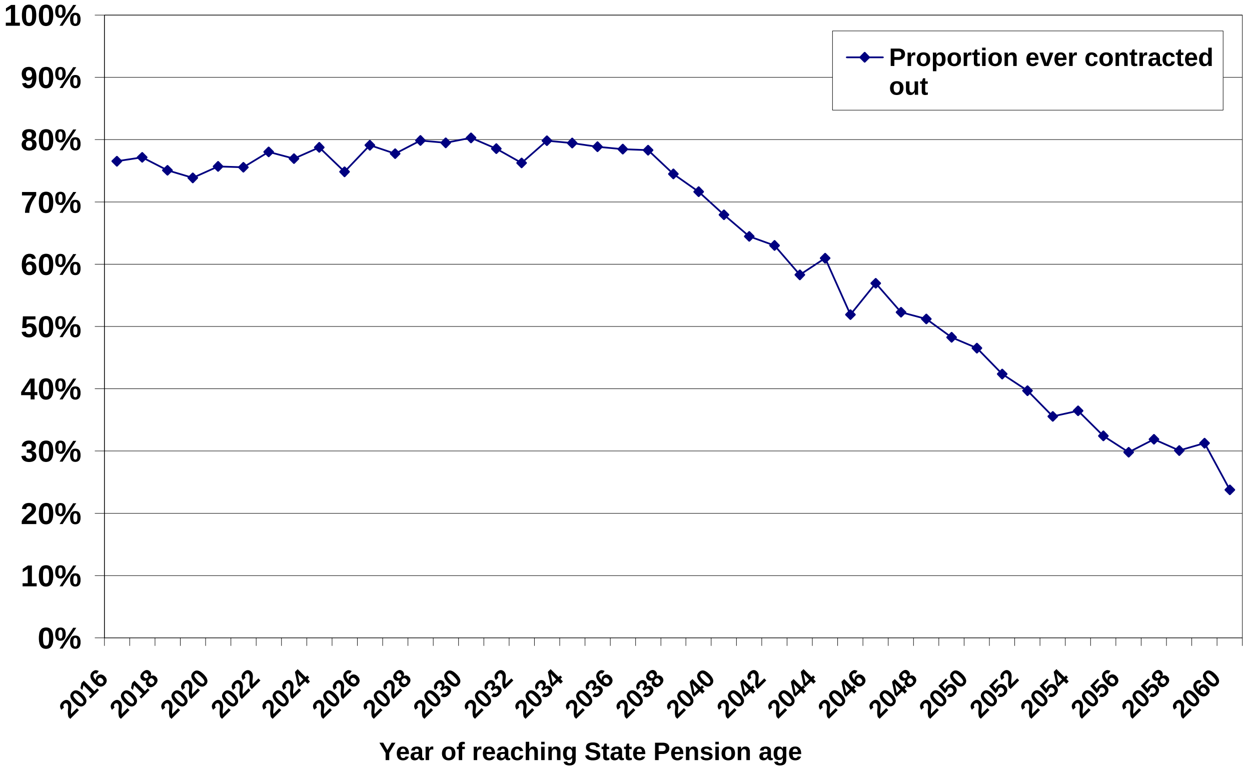
Table 5.1: Number of active members of contracted-out DB schemes, and number of schemes, by size of membership and whether in public or private sector, 2011

Membership size	Membership of DB schemes (millions)		Number of DB schemes	
	Private[1]	Public[2]	Private[3]	Public[4]
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
Total	**1.6**	**5.3**	**3,290**	**331**

Source: OPSS data 2011

132. However, Chart 5.2 below shows that until the late 2030s around 80% 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 that 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)

[31] Occupational Pension Schemes Annual Report 2011, ONS.

[32] Active members are those that continue to accrue new pension rights in a scheme.

5.2 Impact on individuals

133. 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 as 1.4 per cent of their earnings between the LEL and the UAP[33]), 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.

134. Table 5.2 below shows that the impact of the loss of the rebate for contracted-out workers is about £20 per month for an individual on approximately median earnings. (Values in future years have been expressed in current 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	£4	£4	£4	£3	£3	£0
£15,000	£10	£9	£9	£8	£8	£3
£25,000	£20	£19	£19	£18	£17	£9
£40,000*	£37	£35	£34	£32	£31	£18

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.

* 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 today. 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.

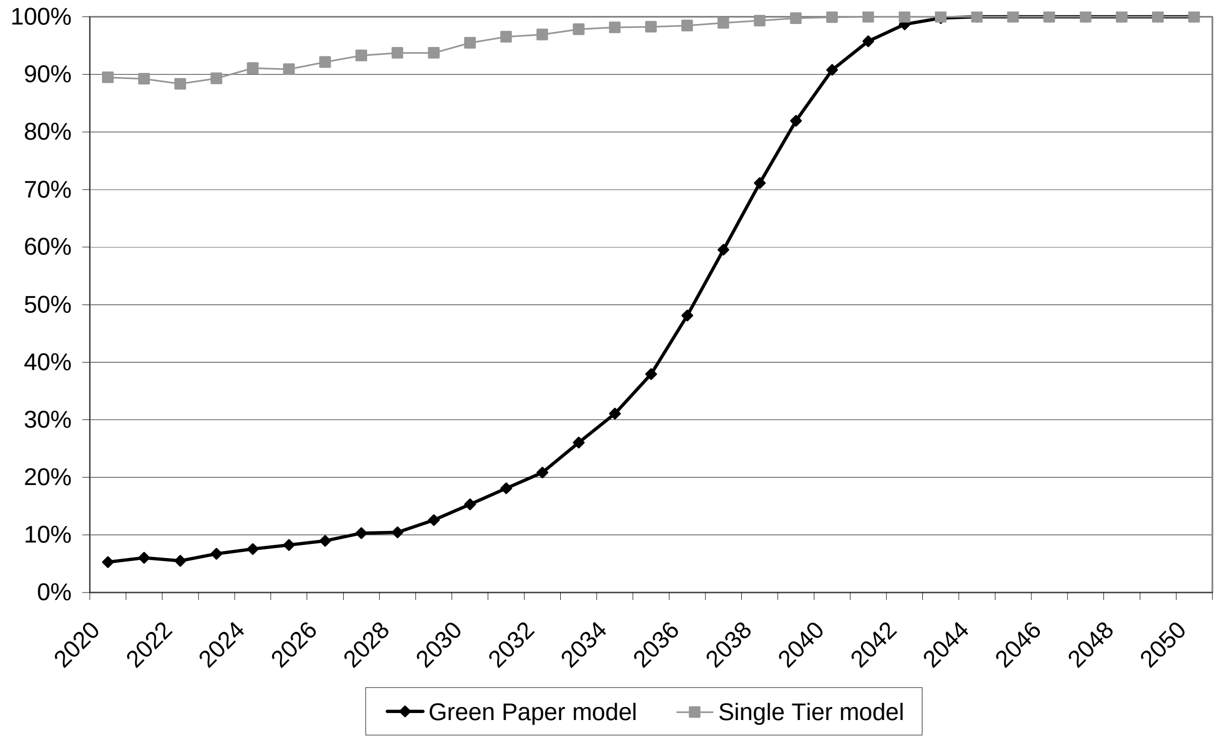
At the point of introduction, the valuation of Mark's National Insurance record was assessed as being worth more under the current system rules therefore this is given as his 'foundation amount'. He has the opportunity to build on his foundation amount if he gains extra qualifying years after the implementation 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 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	£136	£124
Average weekly pension over the rest of his life (for stated life expectancy)	£130	£139	£79
Total pension over the rest of his life (for stated life expectancy)	£149,000	£159,000	£91,000

[33] Lower Earnings Limit and Upper Accrual Point. The LEL is £5,668 and the UAP is £40,040 in 2013/14.

135. 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.

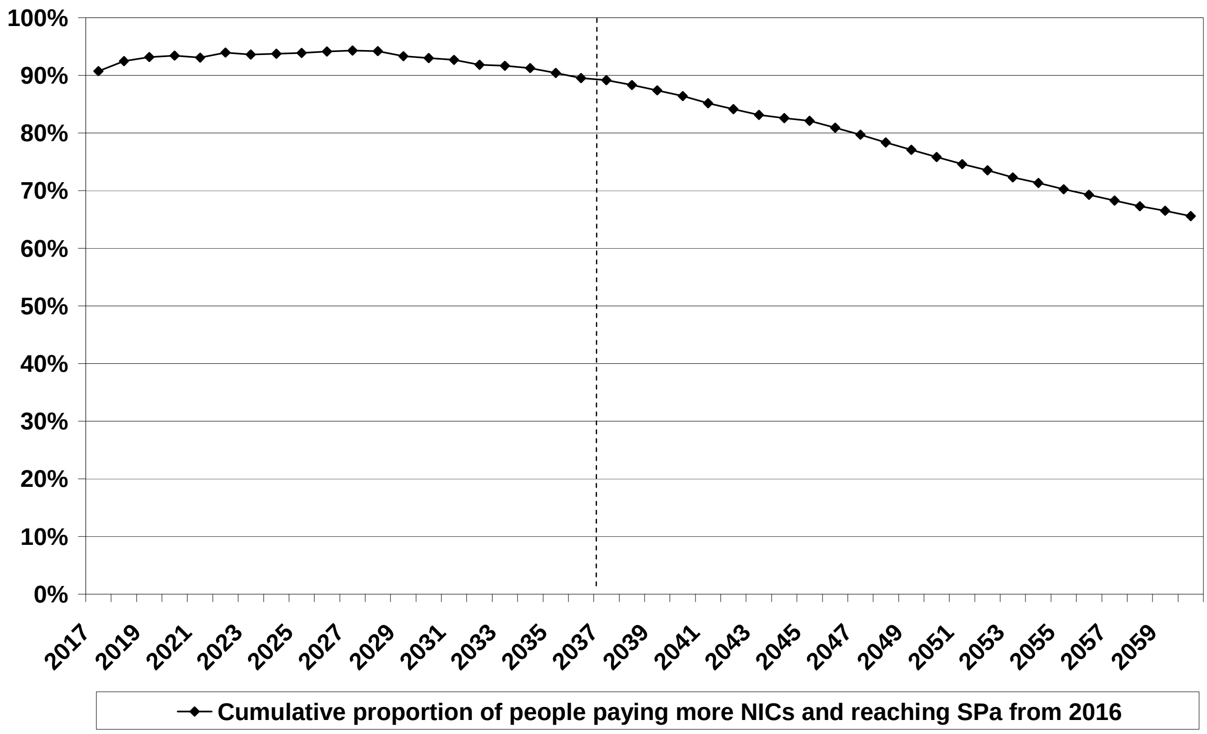
Chart 5.3: Proportion of those who pay higher NI contributions who increase state pension entitlement after 2016, by year they reach State Pension age



Note: 5 year moving average

136. Chart 5.4 below shows that under single tier around ninety per cent 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



137. Chart 5.3 also shows that around 10% of people retiring in the first twenty years of single tier 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, they will not be in a position to gain from 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 single tier. However, this depends on what happens to people after implementation of single tier and calculation of their 'foundation amounts', 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 single tier. 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 slightly lower, though still at over 80%. 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).
- Fifthly, higher earners will have to pay more National Insurance in cash terms, 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 gain from the triple lock uprating, just not enough to fully offset the additional NICs.

138. None of these factors in isolation will necessarily prevent someone from recouping all of the additional contributions, and almost everybody 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.

<u>Public sector schemes</u>

139. 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.

140. 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 have been announced, and the Public Service Pensions Bill which was introduced to Parliament on 13 September 2012 sets out the framework for these new schemes.

141. 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 in the Public Service Pensions Bill. Public service employers 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

142. Apart from the impact on employees, DB scheme sponsors will cease to receive their 3.4 per cent 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.

143. 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 as a result of running these schemes. 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.

144. 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 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.

145. 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.

146. 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 is passed on to employees in the private sector immediately and in full by increasing employee contribution rates to their pension schemes. We will work 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.

147. Following the announcement that the Government would be introducing the single tier pension in 2016, one year ahead of the original schedule, 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.

148. It should be noted that any changes made to pension schemes under this option will most likely come with associated actuarial and legal costs. The value of such costs is unknown, but will be small. Furthermore, 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.

149. As far as single tier is concerned, the options for mitigating the impact on employers discussed will ensure that no private sector employer, of any size, is left without options to mitigate the impact of the loss of the contracting-out rebate.

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

Chapter 6) Impact on the Exchequer

151. The cost of the state pension system is one of the main pressures driving up the costs of supporting an ageing society. Expenditure on pensioner benefits is expected to rise from 6.9 per cent of GDP in 2012/13 to 8.5 per cent in 2060 according to DWP forecasts[34], despite direct action to help keep the pension system sustainable through changes to the State Pension age.

152. 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 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 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.

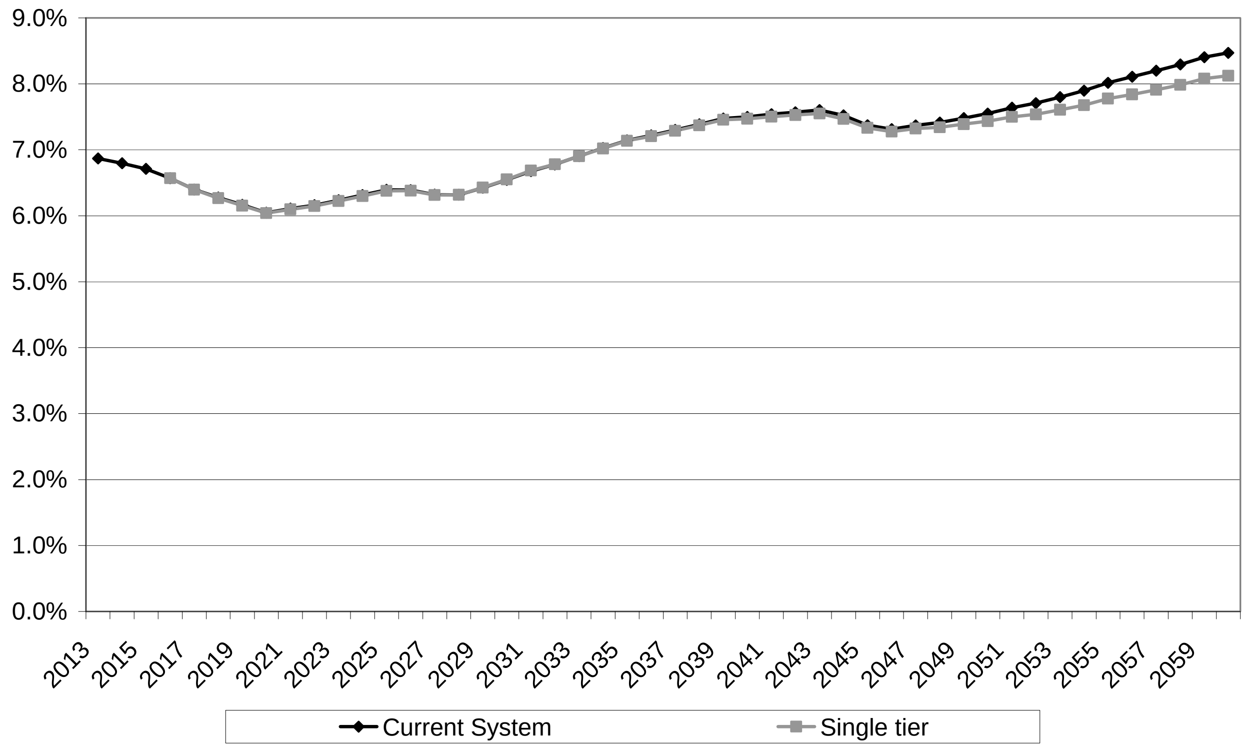
6.1 Overall impact of single tier on pensioner benefit expenditure

153. 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 single tier than for the basic State Pension, but also elements that decrease costs, for example the changes to inheritance rules.

154. 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).

155. Chart 6.1 below shows the projected spending on pensions and pensioner benefits under the current system and single tier (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



Note: The baseline includes BSP, AP, Pension Credit, Universal Credit (where paid to households where someone is over State Pension age), HB/CTB, AA/DLA, other benefits (Winter Fuel Payments, free TV licences, Christmas bonus, Age Addition, Category D pensions). 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. NICs revenues are excluded.

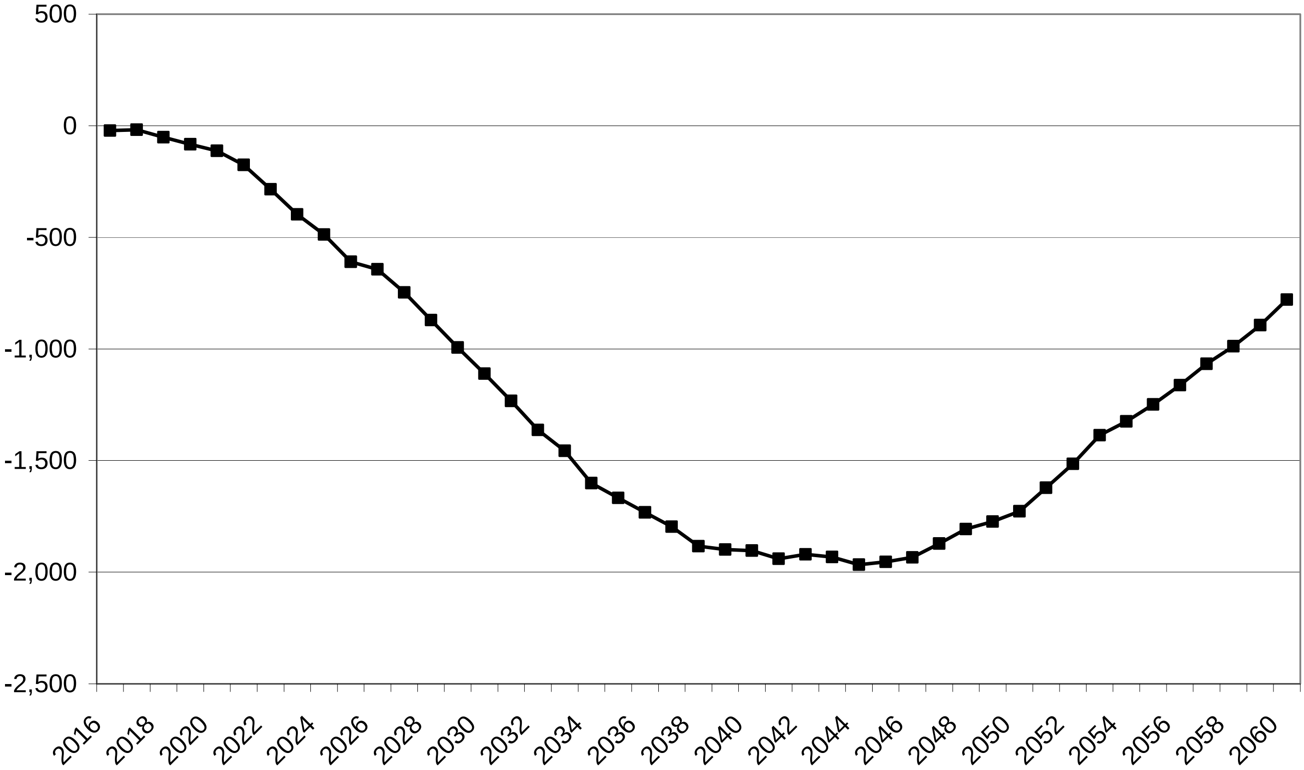
[34] Note that DWP forecasts differ slightly from OBR forecasts, see Chapter 7.

156. The chart shows that the overall costs for single tier are broadly in line with expenditure on the current system as a proportion of GDP until the late 2040s. From the late 2040s, the rise in pensions expenditure is smaller under the single tier than under the current system (pensions expenditure is reduced from 8.5 per cent of GDP to 8.1 per cent of GDP by 2060)[35], primarily because it will no longer be possible to build up large amounts of State Second Pension but also as savings from other aspects of the policy start to accumulate (such as from ending Pension Credit and introducing a Minimum Qualifying Period).

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

157. Single tier will reduce reliance on means-tested benefits to provide a minimum level of income, leading to a reduction in expenditure on Pension Credit, Housing Benefit and Council Tax Benefit. Chart 6.2 demonstrates the saving on means-tested benefits compared with the current system.

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



Note: savings reduce from around the mid 2040s onwards as projected expenditure in the baseline is lower (so there is less to save).

158. Expenditure on Pension Credit will fall 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.

159. The single tier 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.

[35] These figures are based on DWP projections. These differ from projections in the OBR Fiscal Sustainability Report 2012 because they are based on Great Britain only, use different uprating assumptions for some pensioner benefits, and use the OBR Autumn 2012 medium term economic forecast. See Chapter 7 for further details.

6.3 Reform implications for the National Insurance rebate

160. Chapter 5 described the impacts of ending Defined Benefit contracting out as a result of the ending of the State Second Pension under single-tier reform. The chapter details the increase in National Insurance for employers and individuals as a result of the ending of DB contracting out. The result of these increases is a rise in National Insurance revenue for the Exchequer. The profile of the increase in National Insurance is shown for selected years in Table 6.1 below.

161. 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
Public sector employers	3.7	3.7	3.0	2.7	3.4	4.2
Public sector employees	1.5	1.5	1.3	1.1	1.4	1.7
Private sector employers	-	-	-	-	-	-
Private sector employees (includes private sector employers passing on costs)	0.9	0.4	0.1	< 0.1	0	0

Source: DWP analysis

Note: These figures are different to those set out in Budget 2013 as they are presented in 2013/14 prices rather than on a National Accounts basis (cash terms). In addition, the table above includes the impact on private sector employers within the totals for private sector employees. This shows where the impact lies, while the figures in Budget 2013 set out the source of the revenue and how it is reflected in the National Accounts.

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 Single tier administrative cost

162. The estimated costs of implementing Single Tier are around £390m in current prices. These are best estimates of implementation costs (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.

163. 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 departmental 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.

Chapter 7) Risks and assumptions in the impact assessment

7.1 Assumptions

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

Differences from OBR Fiscal Sustainability Report

165. The GDP ratios in this paper are based on DWP projections. These have been updated to reflect the OBR medium term forecasts which were released alongside the 2012 Autumn Statement. However, DWP current system estimates for pensioner benefit expenditure by 2060 are around one per cent of GDP lower than OBR estimates because of:

a) **Different uprating of some benefits:** DWP policy is to uprate Attendance Allowance and Disability Allowance by CPI to 2060 whereas OBR assume earnings uprating in the longer-term (there are similar differences with some other smaller benefits). 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 Bill is for Great Britain only, so these costs are presented. This reduces DWP estimates by around a further 0.2 per cent of GDP by 2060 compared to the OBR estimate.

166. Note that Council Tax Benefit expenditure beyond 2013 is no longer presented in DWP benefit expenditure publications, as it will be locally administered, but it is still included in the analysis in this Impact Assessment and in the White Paper.

Economic assumptions

167. 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 is 2.0 per cent in the long-term
- RPI is 3.4 per cent in the long-term
- Earnings growth is 4.76 per cent in the long-term

168. A triple lock of 0.26 percentage points above earnings has been used. This is consistent with GAD modelling based on historical figures which suggest that in the long-term the triple lock should be modeled as being on average worth 0.26 percentage points above earnings.

169. All values that are shown in 2013/14 prices have been deflated using the GDP deflator.

Demographic assumptions

170. The demographic assumptions for fertility, life expectancy and migration are consistent with the latest ONS population projections. For fertility and life expectancy the central projection is used but for migration the lower estimated is used, as consistent with the projection used by the OBR.

Policy assumptions

171. 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 these proposals on changes to SPA.

172. 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.

173. 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

174. 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.

175. The proportion of pensioners that 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. (These are cautious assumptions).

176. For single tier, the cost to business is based on the assumption that additional costs accruing to private sector employers are passed onto employees in full immediately (see chapter 5).

7.2 Risks

177. 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.

178. The expenditure estimates in this impact assessment are based on current policies remaining unchanged. However in the long term there may be changes to policies that alter these costs.

179. Demographic change different to that modelled is another variable that could affect projected costs.

7.3 Monitoring and Evaluation

180. Any state pension reform undertaken by the Government will be subject to thorough formal evaluation. Through analysis of administrative data, surveys and other sources, DWP will continue to monitor:

- state benefit and pensions caseload and take-up;
- the level and distribution of pensioners’ total incomes; and
- the level of understanding of the state benefit and pensions system.

181. 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 GB household population 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 current 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 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 1000) 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 pension 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.
- 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 a 60,000 sample of 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. International migration is still being developed in Pensim2 so is not included in the modelling. 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 NICs impacts of reform.
- 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. These projections feed into the National Insurance contributions model and underlie the National Insurance rebate projections shown within relevant analysis in this IA.

A2. Methodology

Calibration

5. Both the single tier and faster flat rating policy options have been modelled in Pensim2 to analyse how these policies change the state pension and means-tested benefits of those retiring once the policies have come into being. 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 expenditure figures estimated in Pensim2 and applying this ratio to the baseline forecasts. Calibration is done separately for state 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 single tier by around half a percent of baseline pensioner expenditure by around 2040 and by around 1 per cent by 2060.

10. The analysis in Annex B also uses calibration to analyse how changes in demographic and 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 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 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 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 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 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 (single tier). This proportion is applied to single-tier 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 overseas people reaching State Pension age in 2040 would be saved under the single tier scheme if a 10 year Minimum Qualifying Period were introduced.

15. A Minimum Qualifying Period would also apply to GB residents. However, it is assumed that those 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 zero.

Uprating of basic State Pension and single tier – safeguard in the triple lock

16. To estimate the future expenditure on the basic State Pension and single tier, 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 will be equal to earnings growth plus 0.26 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 single tier by earnings growth for the long term may be underestimating the future state pension expenditure.

18. The additional 0.26 per cent growth is derived from applying the triple lock and earnings growth to the value of the basic State Pension and single tier over recent decades and then calculating the average difference at the end of the period. Restricting the analysis to the past 20 years[36] gives a sufficient time series of data on which to base future projections and is consistent with the inflation-targeting period introduced after the UK's exit from the European Exchange Rate Mechanism.

Assumed start value for Single Tier

19. For consistency with the White Paper, we still refer in presentational terms to "£144 in 2012/13 earnings" 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 current level of the Standard Minimum Guarantee (£145.40 for a single person from April 2013). The start level of the full single tier pension will be decided by the Government nearer to implementation.

[36] Note that this derivation does not include the most recent inflation and earnings growth statistics, which have led to the triple lock being invoked in the April 2013 uprating of BSP.

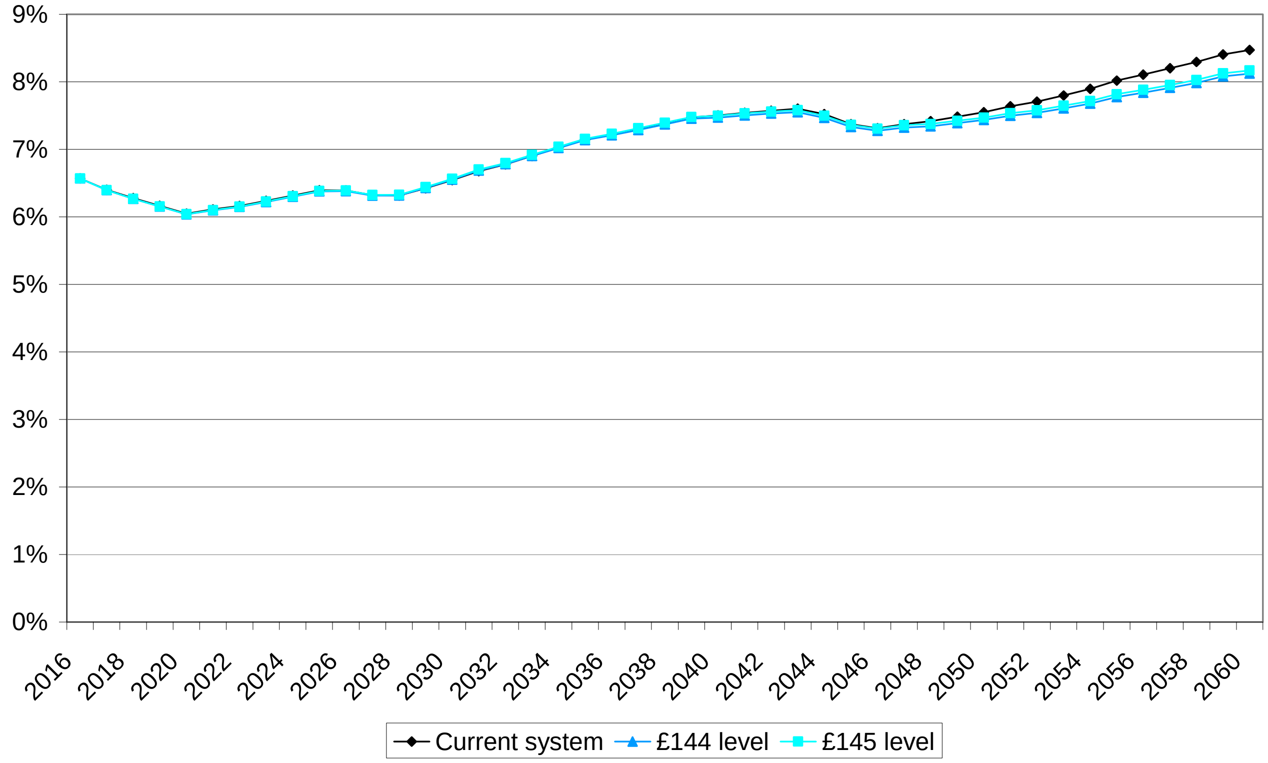
ANNEX B: SENSITIVITY ANALYSIS

In the report recently published at the end of the Work and Pensions Select Committee's pre-legislative scrutiny of the draft Pensions Bill, they recommended that the DWP published further information about the expenditure implications of changing the single-tier 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 single tier 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 terms (using the GDP deflator).

The aim of cost neutrality compared to 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 peak cost of single tier 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 (£144, £145 per week in 2012/13 earnings terms)



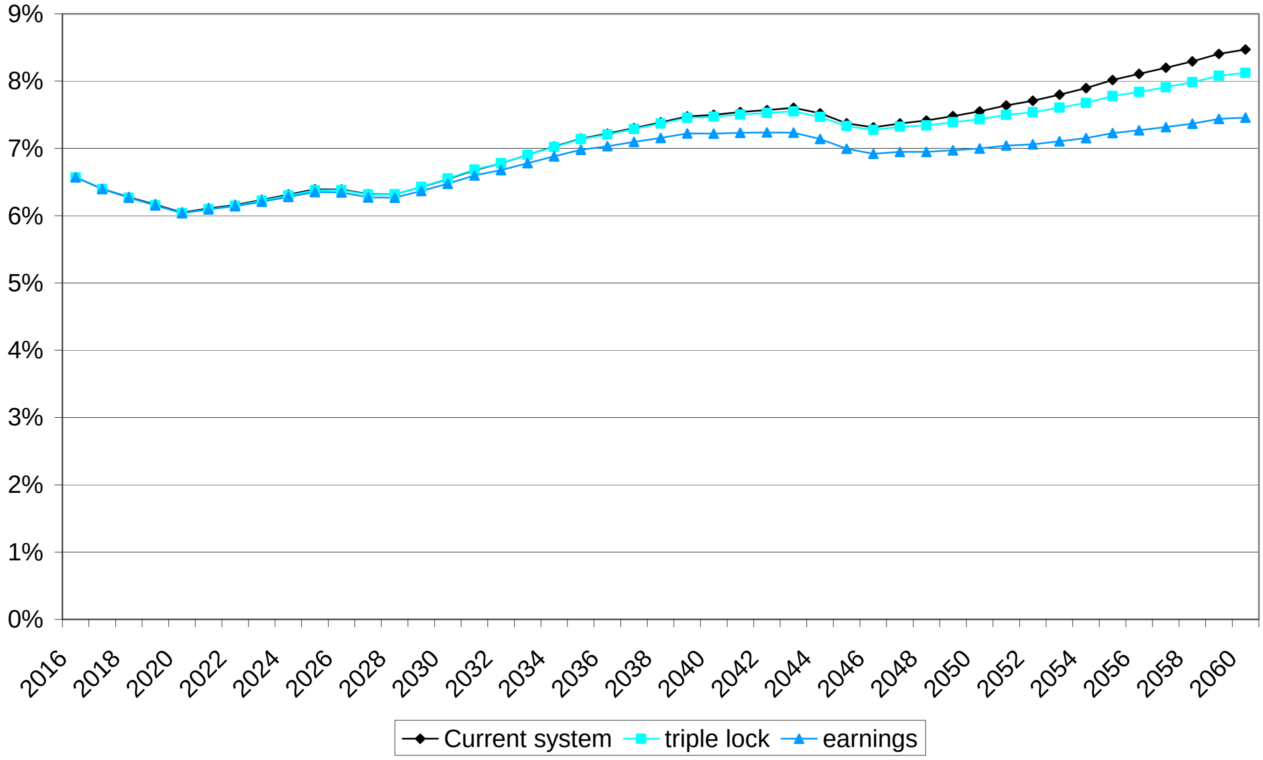
Note: The January 2013 version of this impact assessment showed £143.50 and £144.50 variants of the start level, not reproduced here for reasons of clarity.

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 0.26 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 7.5% of GDP being spent on pensioner benefits by 2060, compared to 8.1% under the triple-locked scenario[37].

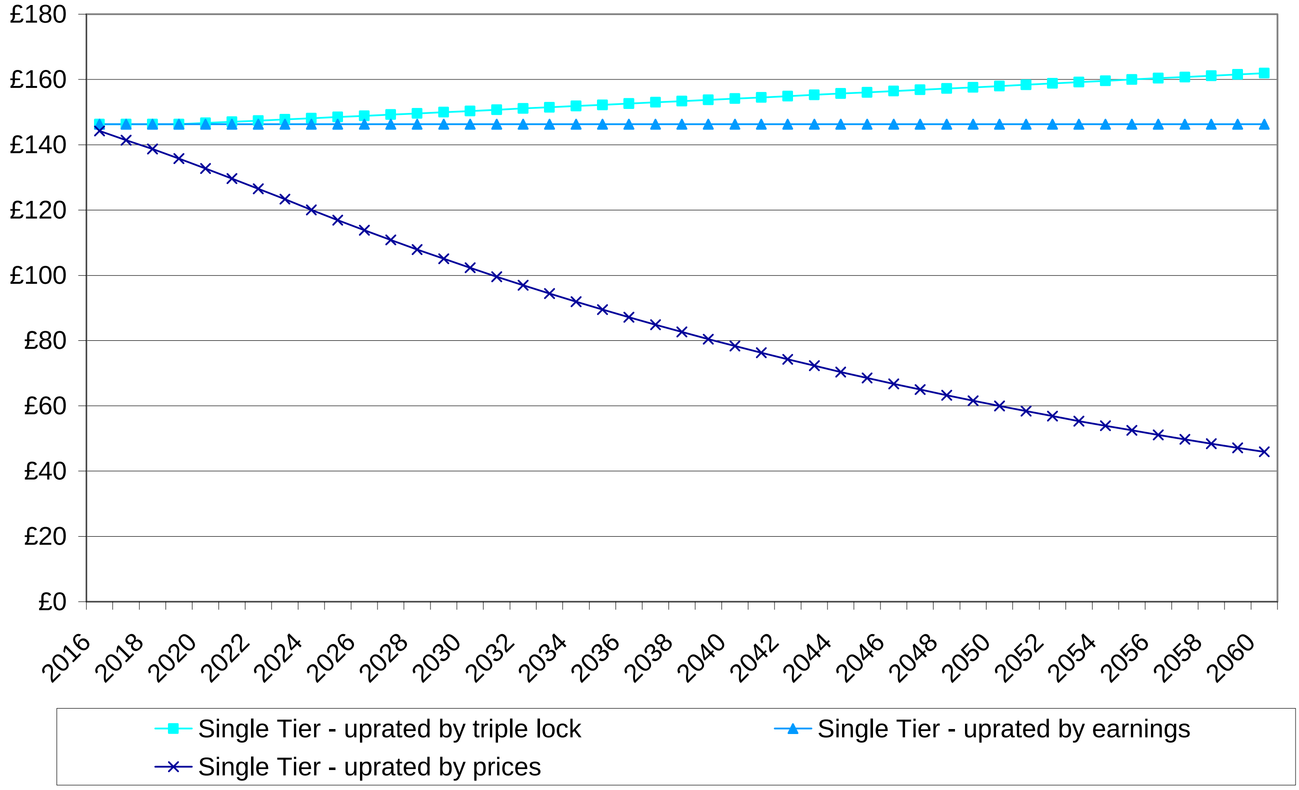
Note that in the earnings uprating scenarios below, basic State Pension for people who reached State Pension age before April 2016 is still assumed to use the triple lock.

Chart B2: Pensioner benefit expenditure as proportion of GDP under different uprating assumptions for the single-tier pension



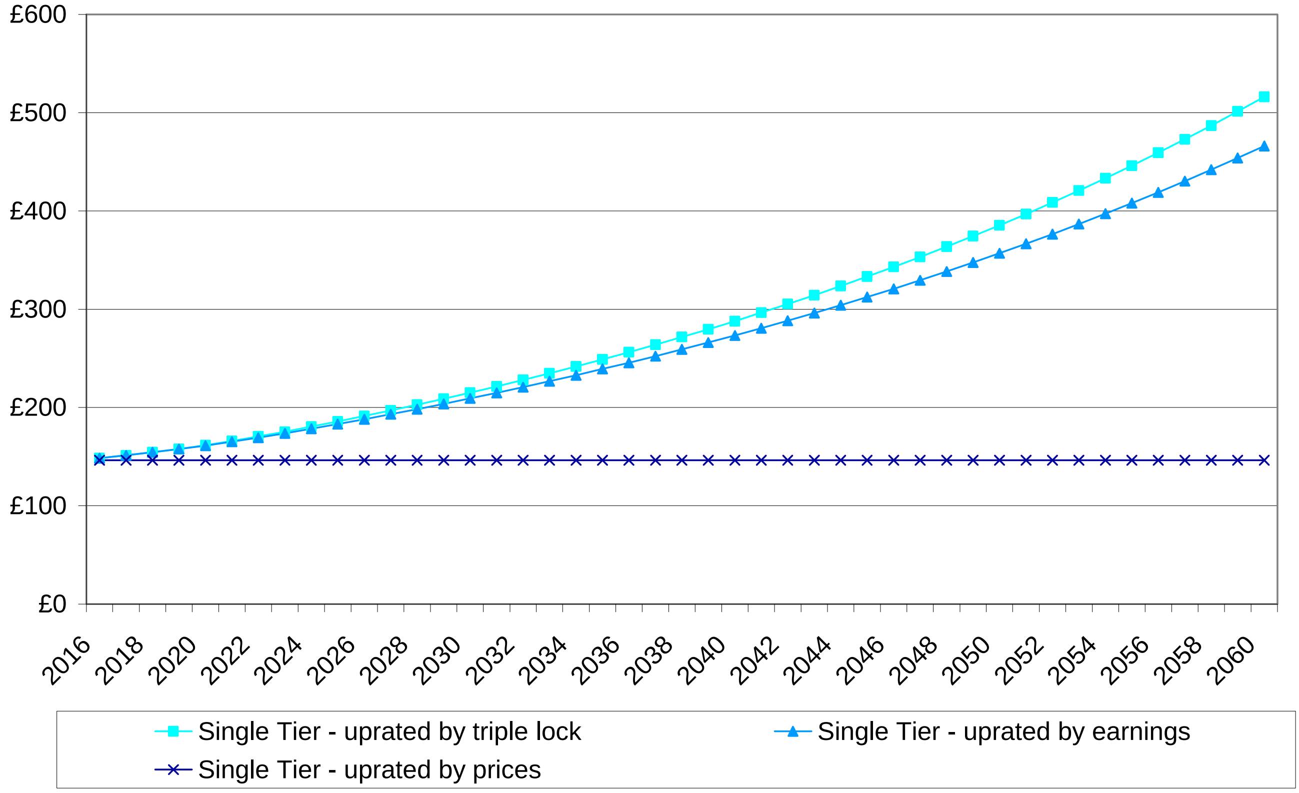
[37] Note that this is lower than the figure of 7.9% presented in the White Paper and the previous edition of the impact assessment. The earlier figure was based on a model in which the single-tier pension was uprated in line with earnings while in payment, but with the triple lock still applying to 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: HEADLINE AME IMPACTS OF SINGLE TIER

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

It is important to note that the cash 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 single tier

Current system	**2016**	**2020**	**2030**	**2040**	**2050**	**2060**
State Pension (BSP+AP)	87,700	92,200	133,100	203,200	269,500	392,700
Pension Credit (GC+SC)	6,300	5,300	4,200	3,600	2,800	3,000
Housing Benefit and Council Tax Benefit	7,400	7,000	8,900	10,800	11,100	11,000
Other pensioner benefits*	13,100	11,900	14,400	16,200	16,800	17,500
Total	**114,400**	**116,400**	**160,600**	**233,800**	**300,200**	**424,300**
Single Tier	**2016**	**2020**	**2030**	**2040**	**2050**	**2060**
State Pension (BSP+AP+ST)	87,600	92,100	134,300	204,300	266,700	376,100
…of which BSP + AP	*86,300*	*79,300*	*59,800*	*36,400*	*13,100*	*2,000*
…of which Single Tier	*1,300*	*12,800*	*74,500*	*167,900*	*253,600*	*374,100*
Pension Credit (GC+SC)	6,300	5,200	3,700	2,900	2,200	2,800
Housing Benefit and Council Tax Benefit	7,400	7,000	8,300	9,600	9,900	10,400
Other pensioner benefits*	13,100	11,900	14,400	16,200	16,800	17,500
Total	**114,400**	**116,300**	**160,700**	**232,900**	**295,600**	**406,900**
Change in expenditure	**2016**	**2020**	**2030**	**2040**	**2050**	**2060**
State Pension (% reduction of current spend)	0.0%	0.1%	-0.9%	-0.5%	1.1%	4.2%
Spend on all means tested pensioner benefits (% reduction of current spend)	0.2%	0.9%	8.5%	13.2%	12.4%	5.5%
Spend on all pensioner benefits (% reduction of current spend)	0.0%	0.1%	-0.1%	0.4%	1.5%	4.1%

Source: Pensim 2, numbers rounded

* Other benefits: Disability Living Allowance, Attendance Allowance, Xmas bonus, Winter Fuel Payments and Over 75 TV Licence