Department
for Work &
Pensions

Updated impact of the single-tier pension reforms

Update following 2014 Fiscal Sustainability Report

July 2014

Contents

Introduction

Fiscal Sustainability Report 2014

On 10th July the Office for Budget Responsibility (OBR) published their latest Fiscal Sustainability Report (FSR), setting out their view of the sustainability of the public finances over the next fifty years. The report includes new projections of expenditure on state pensions and other pensioner benefits. The 2014 FSR is available on the OBR website at http://budgetresponsibility.org.uk/fiscal-sustainability-report-july-2014/.

Pensions Act 2014 and new State Pension

The Pensions Act 2014 legislated for the 'single-tier' reforms of state pension system, introducing a new flat rate pension system (now referred to as 'new State Pension') for people reaching State Pension age from April 2016 onwards.

Further details of these reforms are available at https://www.gov.uk/government/publications/the-single-tier-pension-a-simple-foundation-for-saving--2.

During the passage of the Act, the Department published several iterations of the Impact Assessment for these reforms, the latest edition of which is available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/311316/pensions-act-ia-annex-a-single-tier-state-pension.pdf.

This document updates the key pieces of analysis from the Impact Assessment to bring them into line with the assumptions used in the new Fiscal Sustainability Report. In doing so, it makes the analysis consistent with Budget 2014 medium term forecasts and with the 2012-based population projections published by the Office for National Statistics in November 2013.

Methodology and assumptions

Economic and demographic assumptions

Medium and long term economic and demographic assumptions are consistent with Budget 2014 and Fiscal Sustainability Report 2014.

Expenditure projections are based on the low migration variant of the 2012-based population projections published by ONS at http://www.ons.gov.uk/ons/rel/npp/national-population-projections/2012-based-projections/index.html.

Pensim2-based impact analysis has mortality and longevity consistent with the latest ONS projections but does not account for migration, and does not include pensioners living overseas.

Policy assumptions

Policy assumptions are consistent with Budget 2014 over the medium term. Over the long term they are consistent with the Fiscal Sustainability Report, with two exceptions.

Firstly, no account is taken of potential further increases to State Pension age (SPa) associated with the Pensions Act 2014 review mechanism. In their principal projection the OBR assume that SPa will rise in line with longevity under the 'third of adult life in retirement' principle set out by the Government at Autumn Statement 2013[1]. This document uses the legislated State Pension age timetable[2] as the baseline for considering the impact of the introduction of new State Pension, as this maintains consistency with the previous impact assessments, and any further changes to State Pension age will be both legislated and implemented after the introduction of the new State Pension.

Secondly, expenditure on disability benefits, Winter Fuel Payments and free TV licences is assumed to grow over the long term in line with current uprating policy, whereas the OBR assume that they will grow in line with average earnings. This has no effect on the assessment of the impact of the reforms, but gives a lower figure for total expenditure over the long term.

For full details of the methodology and other assumptions, see chapter 7 and annex A of the full Impact Assessment.

[1] https://www.gov.uk/government/policies/reviewing-the-state-pension-age

[2] Equalisation in 2018, 66 by 2020, 67 by 2028 and 68 by 2046.

Summary of key results

This section restates the main results quoted in the executive summary of the full impact assessment, updated to make them consistent with the 2014 Fiscal Sustainability Report.

Means testing: Currently 35% of pensioner households are estimated to be eligible for Pension Credit. By 2020 eligibility among new pensioners is halved compared to the current system, and falls to below 5% by the 2060s.

Over the longer term, the number of pensioner benefit units eligible for means-tested benefits is reduced by around 300,000 compared to the current system.

Gender inequalities: Under the current system it would take until the 2050s for female state pension outcomes to equalise with those of men. Under the reformed system this will happen over a decade earlier, in the early 2040s.

Around 650,000 women reaching State Pension age in the first ten years will receive an average of £8pw (in 2014/15 earnings terms) more due to the new State Pension valuation of their National Insurance record.

State pension outcomes: In 2016 most people will receive the same amount of state pension as they would have done under the current system. Around 20% will have a higher outcome. By 2020 around 75% of people who reached state pension age under the new system will have a higher outcome. This proportion gradually diminishes over time, falling to around two thirds by 2040 and 55% by 2050.

End of contracting out: Some people will pay higher National Insurance Contributions (NICs) due to the end of contracting out, but will be able to build a larger state pension. Of people paying more NICs in the first twenty cohorts of new pensioners from April 2016, around 90% will gain enough state pension over and above what they would have received under the current system to offset the extra NICs and any adjustments to their workplace pension scheme.

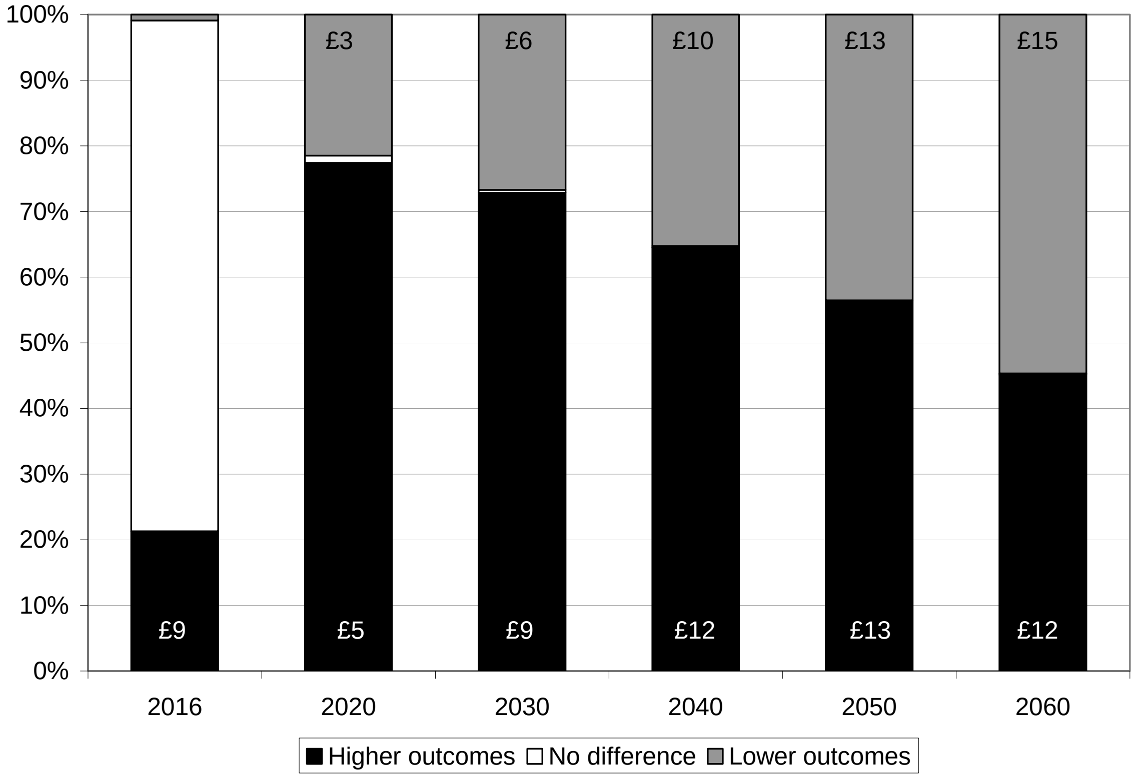
Benefit expenditure: Expenditure on pensioner benefits is projected to be broadly the same under the new system (within 1% of total expenditure, and within 0.1% of GDP) until the 2040s. Over the longer term expenditure growth is slower and by the early 2060s expenditure is projected to be lower by 0.5% of GDP compared to running the current system forward over the long term.

Impact on individuals

Impact on individual state pension outcomes

Figure 1 below shows that within a few years of implementation, single-tier pension reform leads to most new system pensioners having a higher State Pension than under the baseline of the current system. For each year the chart shows all living pensioners who have reached State Pension age since the implementation of the new State Pension.

Figure 1: Proportion of pensioners with changed notional State Pension outcomes under single-tier; median weekly amounts (2014/15 earnings terms)



In 2016, the first year of reform, most people receive the same level of State Pension income as they would have done had the current system continued. Around 20 per cent of people will have a better outcome as a result of the single-tier transition valuation. Small numbers of people may receive a lower outcome due to the removal of the ability to derive pension from their spouse's National Insurance record.

Even in 2050 over half will have an outcome that is higher than under the current system.

Impact on overall state support at household level

We now widen the picture to include the impact on means-tested benefits. As eligibility for means-tested benefits is assessed at benefit unit level, this means that the unit of analysis is now households rather than individuals.

Figure 2 below shows that a majority of households reaching State Pension age under the new system (the cumulative number of pensioner benefit units where someone has reached State Pension age since 6th April 2016) have the same or notionally higher outcomes than in the baseline of the current system rolled forwards, until the 2040s. The median changes to outcomes are relatively modest; for example a £10 change in 2040 represents a three per cent change in household income.

Figure 2: Proportion of benefit units with changed notional outcomes (net household income), median weekly difference (2014/15 earnings terms)

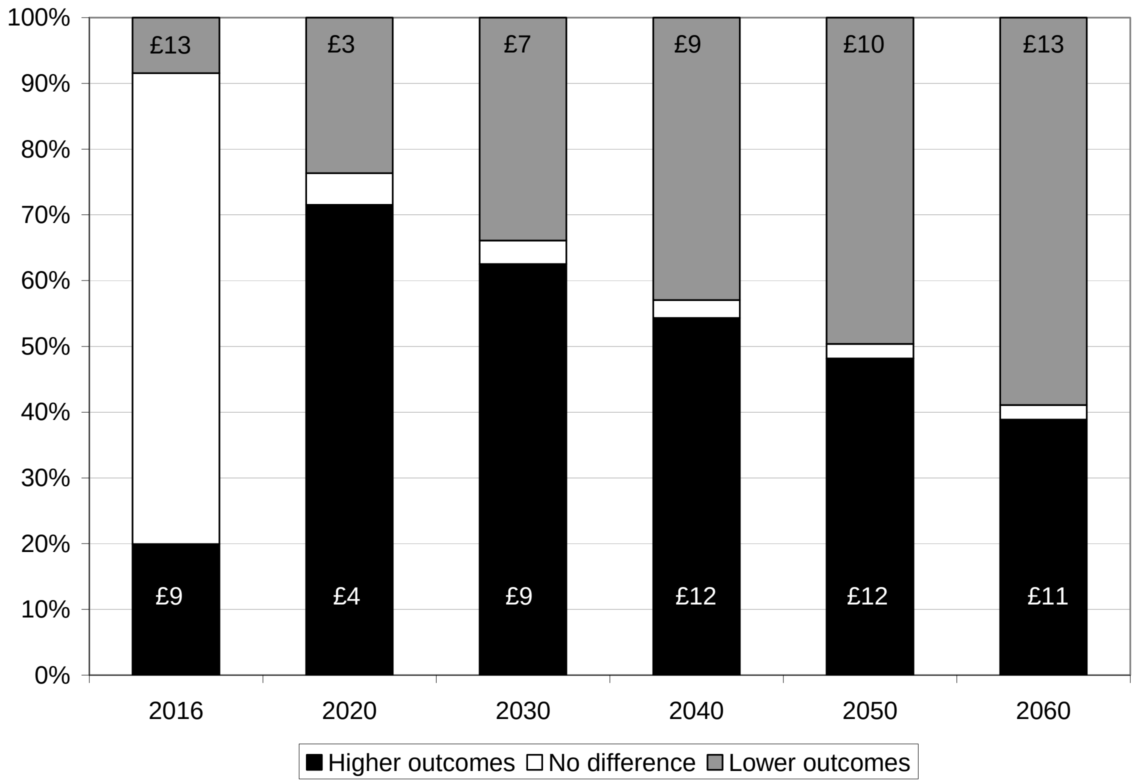


Figure 3 below shows the proportion of households (the cumulative stock) with notionally changed outcomes by income quintile. The reforms have a progressive impact in later years, with households in the lower income quintiles more likely to have a higher net income under the new system.

Figure 3: 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, 2014/15 earnings terms)

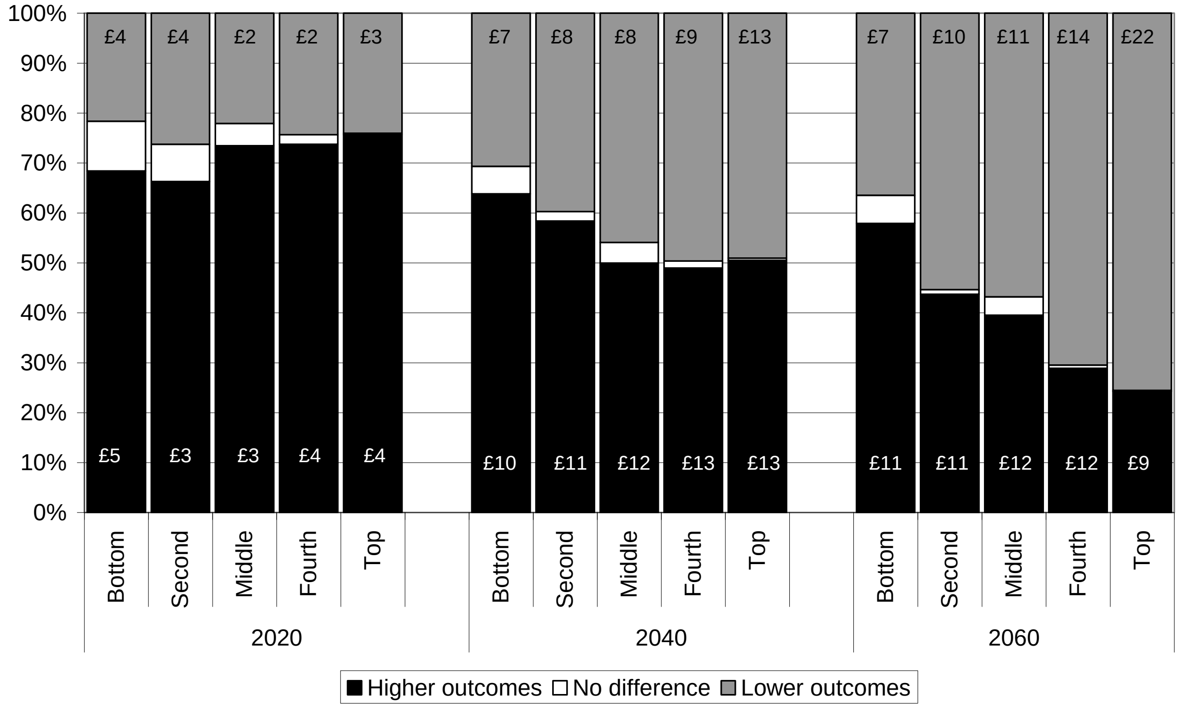
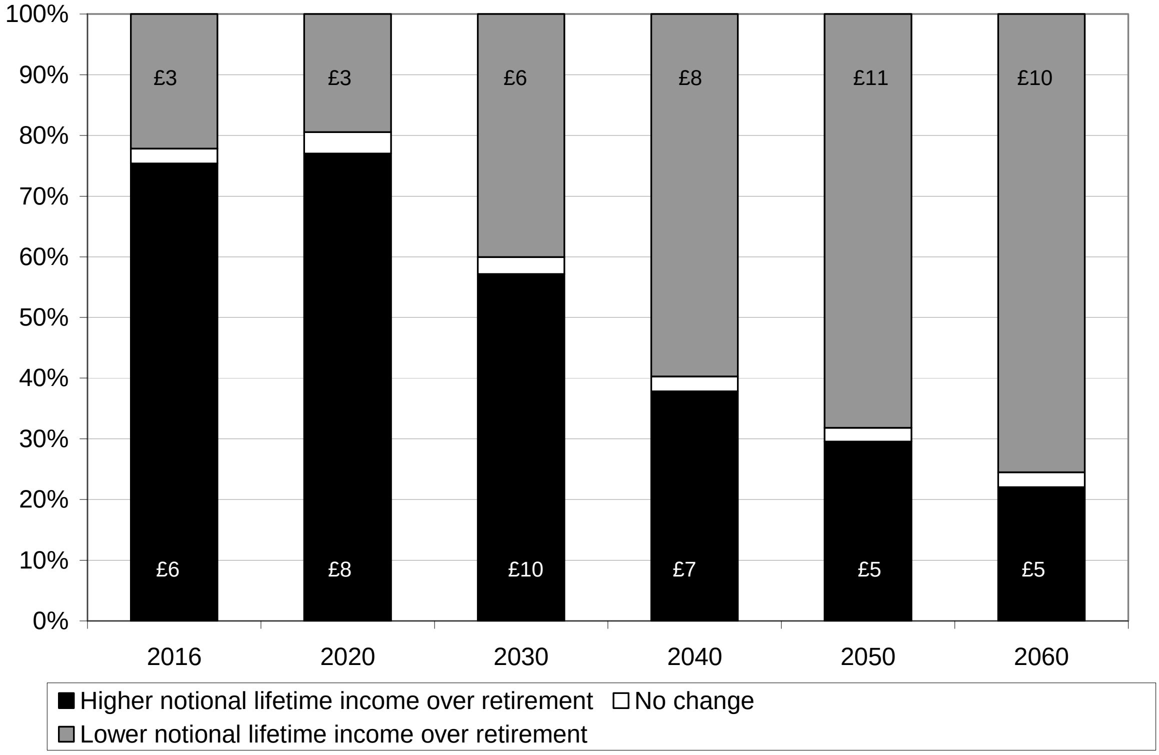


Figure 4 below shows the proportion of benefit units that receive higher and lower notional incomes over the whole of their retirement under the new system than they would have received under the current system.

The majority of households in each cohort reaching State Pension age up to 2030 receive a higher total income over retirement under the new system. Initially the majority of households gain over retirement through the single-tier valuation and having the full value of the new State Pension uprated at least in line with earnings. For cohorts reaching State Pension age from the mid-2030s the proportion with a higher income over retirement falls below 50%. This is because if the current system was rolled forward they would have been able to become entitled to large amounts of State Second Pension which will not be available under the new system.

On a cumulative basis, more than half of those reaching State Pension age before 2050 will have higher total retirement incomes under the new system.

Figure 4: Proportion of benefit units with changed notional outcomes over retirement, by year of SPa. Median change in net weekly income averaged over retirement (2014/15 earnings terms)

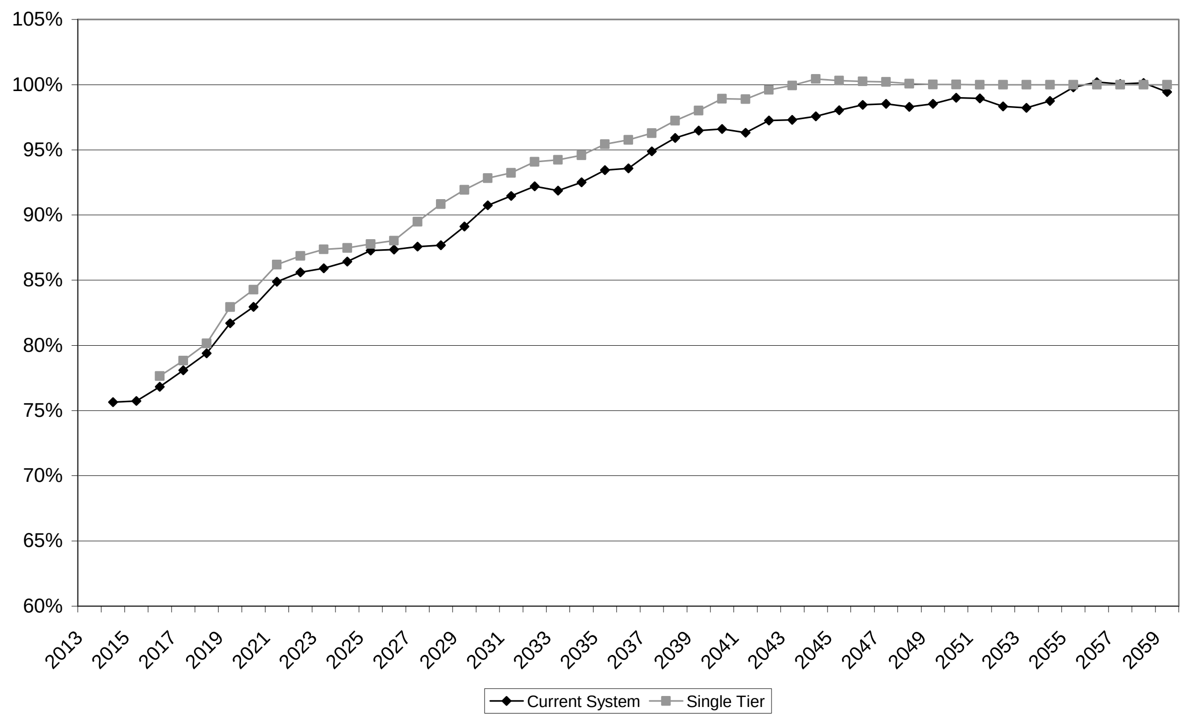


Impact of reform on outcomes for women

Historically, women have tended to have lower outcomes from the state pension system. While the 2007 Pensions Act delivered improvements, the proportion of women in Great Britain qualifying for a full basic State Pension would not have equalised with men until around 2020, and it would have taken over 30 years more for State Second Pension outcomes to equalise (according to DWP forecasts).

The new State Pension reforms bring forward by a decade the point at which women get equivalent State Pension outcomes to men, as illustrated in Figure 5 below. As there is a period of transition from the old system, inequalities take time to be fully removed.

Figure 5: Median female gross State Pension income as a proportion of median male gross State Pension income, for those reaching State Pension age in each year, under the current and new pension systems



The gender gap closes due to the closure of the earnings-related State Second Pension, and also because a qualifying year under the new system is worth more than a current basic State Pension qualifying year. As a consequence, the median female amount of gross[3] state pension is projected to align with that of men around a decade, in the early 2040s rather than the 2050s.

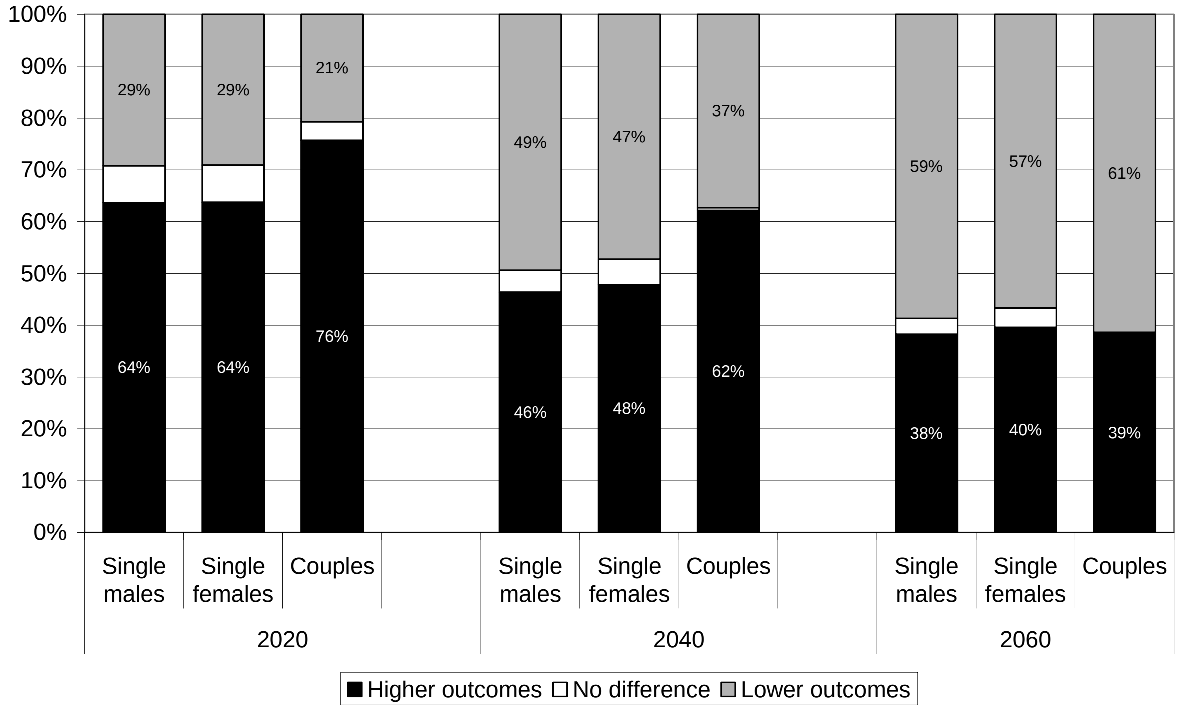
The main reason that notional outcomes for women improve more quickly in the early years is that the single-tier valuation benefits lower paid and part-time workers, who

[3]The 'gross' measure of state pension includes any private pension associated with having been contracted out.

are predominantly women. In 2016 around 40% of women reaching State Pension age would get a notionally higher State Pension as a result of the single-tier valuation, with around one in six 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.

As a result of the single-tier valuation, around 650,000 women who reach State Pension age in the first ten years after the single-tier pension is implemented will receive an average of £8 per week more in State Pension (in 2014/5 earnings terms). As a consequence, reliance on means-tested benefits to provide a minimum level of income will fall.

Figure 6: Notional impacts on the net household income of the cumulative stock of post 2016 pensioners, by type of benefit unit



Changes to means-tested benefits

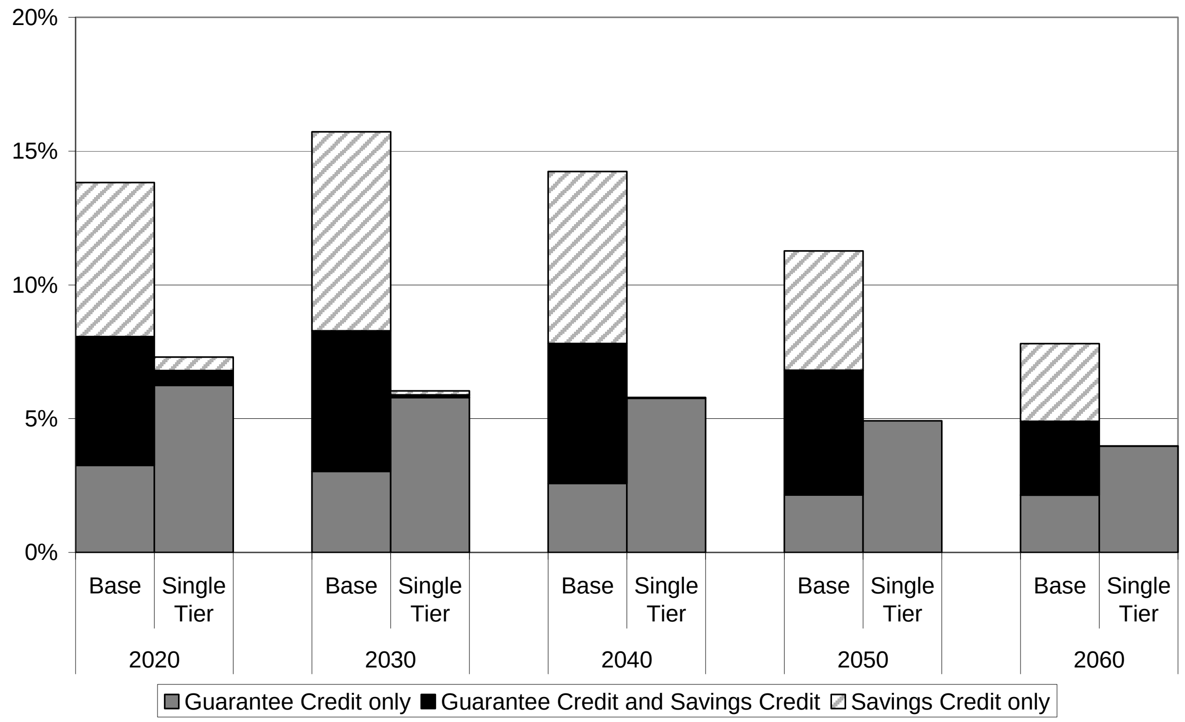
Eligibility for Pension Credit

The introduction of the single-tier pension leads to a reduction in the scope of Pension Credit for two reasons: a higher basic pension means that fewer pensioners require Guarantee Credit to top up their income under the single-tier pension and Savings Credit is no longer required to ensure that people benefit from additional saving. The scale of the expected reduction in eligibility is shown below in Figure 7.

Under the current system, eligibility for Pension Credit (or Universal Credit where only one member of a couple is above the qualifying age for Pension Credit) amongst the single-tier population is expected to peak at around 15 percent around 2030 and fall to below 10 per cent by 2060. Under the single-tier pension, eligibility for Pension Credit is halved compared to the current system in the first few years following implementation, and ultimately falls to around five per cent by 2060.

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 new system having a State Pension above the level of the Standard Minimum Guarantee.

Figure 7: Eligibility for Pension Credit amongst the population reaching State Pension age after implementation of the new State Pension



Support with housing costs or council tax bills

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 Figure 8, with and without the new State Pension.

Figure 8: Entitlement to housing and council tax support (amongst the population reaching State Pension age after April 2016)

		2020	2030	2040	2050	2060
Housing Benefit	Base	12%	15%	15%	13%	11%
	New State Pension	12%	15%	15%	13%	11%
Council tax support	Base	34%	36%	33%	29%	24%
	New State Pension	33%	34%	31%	28%	24%

Entitlement to support with rent and council tax bills is affected by the implementation of the single-tier pension because an increase in State Pension income means that individuals are less likely to need help with housing costs and also because the cut off point for support will be lower following the removal of Savings Credit.

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

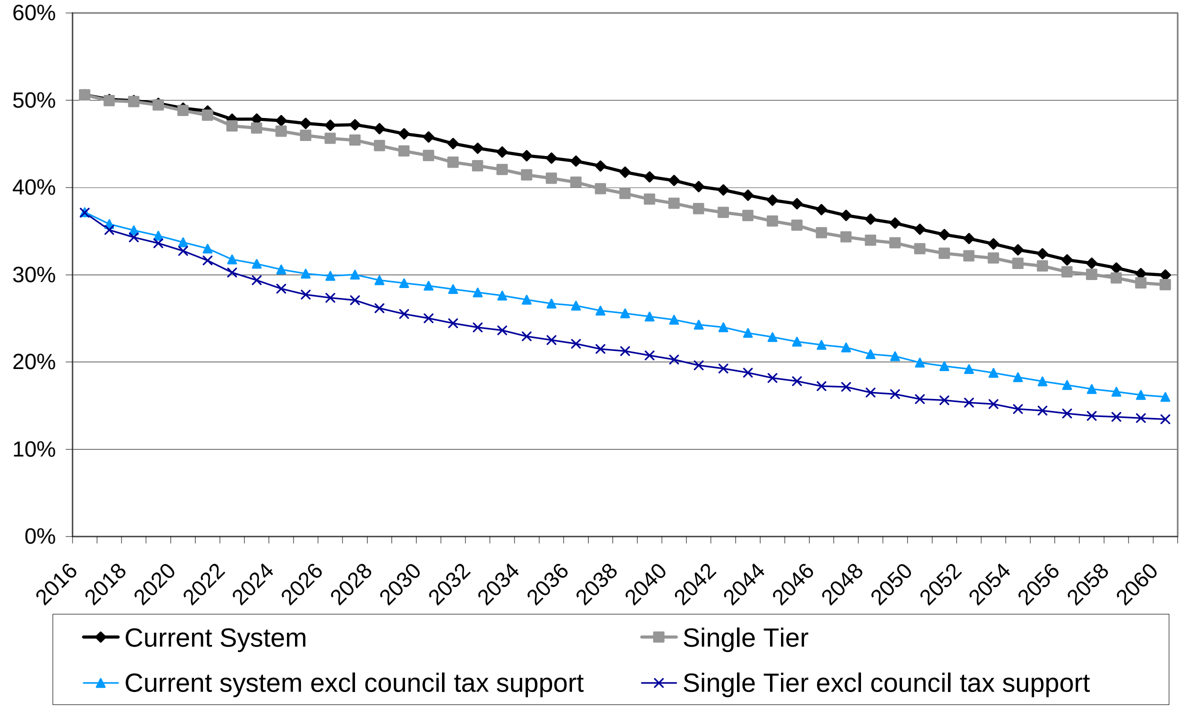
By 2040 the average weekly entitlement to support with Housing Benefit is notionally around £6 lower than in the current system, and notionally around £2 lower for council tax support. However, many recipients will have a higher pension under the system so may be better off overall.

Overall scope of means-tested benefits

Figure 9 below shows that eligibility for means-tested benefits is expected to fall over time. This reflects growth in pensioner incomes associated with the triple-lock, automatic enrolment, female labour market participation and previous pension reforms. It is also partly driven by the reduced scope of Savings Credit under current uprating policy and the introduction of Universal Credit.

In the early years the impact of the reforms is small since changes only apply to new pensioners. In the long term the impact of the reforms is to reduce eligibility for means-tested support by three percentage points, or around 300,000 pensioner benefit units by the mid-2040s. The bottom two series of Figure 9 show eligibility excluding council tax support, which is now locally administered.

Figure 9: Eligibility for any means-tested benefit (all pensioners), with and without council tax support



Ending Defined Benefit contracting out

Under the reforms, the State Second Pension 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.

Ending contracting-out is a key consequence of the 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 pension.

While a relatively low proportion of employees are currently contracted out, until the late 2030s over three quarters of people reaching State Pension age in any year will have been contracted-out at some point in their working lives. This will include people who were contracted-out when in a private sector DB or DC scheme (DC scheme members were able to contract out until 2012).

Impact on individuals

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 Lower Earnings Limit and the Upper Accrual Point), 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.

Figure 10 below shows that the impact of the loss of the rebate for contracted-out workers is £23 per month for an individual on approximately median earnings. Values in future years have been expressed in 2014/15 earnings terms.

Figure 10: Monthly increase in employee National Insurance contributions as a result of ending DB contracting-out in 2016, in 2014/15 earnings terms

Annual earnings	2016	2017	2018	2019	2020	2030
£10,000	£5	£5	£5	£6	£6	£6
£15,000	£11	£11	£11	£11	£11	£12
£25,000	£23	£23	£23	£23	£23	£18
£40,000*	£37	£36	£34	£33	£31	£18

Source: DWP modelling rounded to nearest £1.

Note: In our modelling, the Lower Earnings Limit has been uprated by CPI until 2019/20 and thereafter by average earnings. Costs fall over time for middle and higher earners due to the Upper Accrual Point being frozen through the 2020s.

*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

Figure 11 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 to build more pension through years worked or credited after 2016, up to the full amount of new State Pension.

Figure 11: Proportion of those who pay higher NI contributions who increase State Pension entitlement after 2016, by year they reach State Pension age

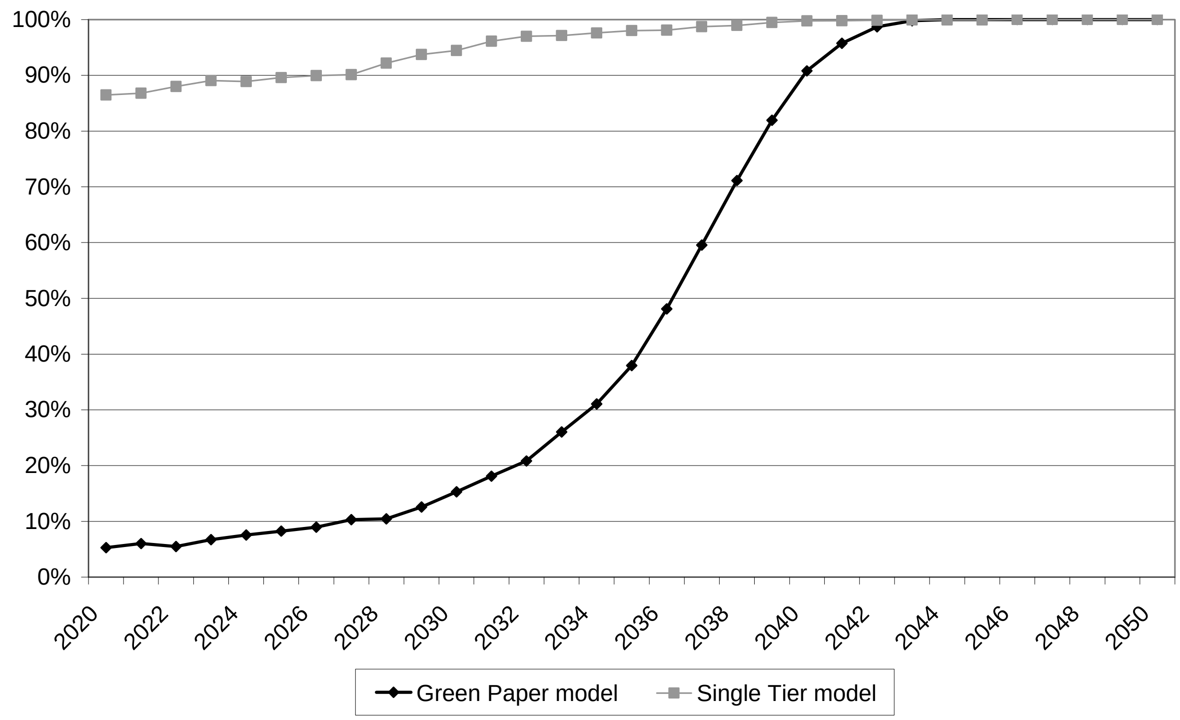
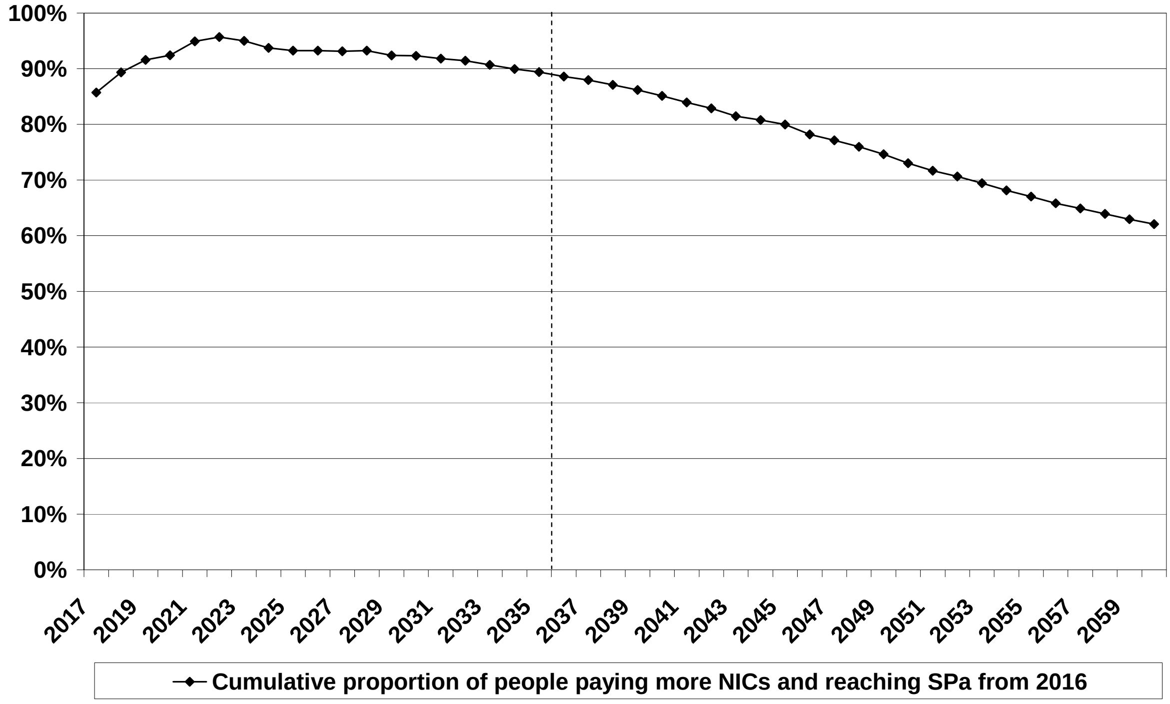


Figure 12 below shows that under the single-tier system around 90% of people who start to pay higher National Insurance contributions (NICs) and reach State Pension age over the first two decades after implementation will receive enough extra State Pension over their retirement to offset the increase in NICs, and any potential adjustments to their occupational pension schemes. If the analysis is restricted to people working in the private sector then the proportion is slightly lower, at 80%.

Figure 12: Proportion of people paying extra NICs who gain enough in extra State Pension to compensate



For further details of the potential impact of the reforms on individuals, pension schemes and businesses, see chapter 5 of the full Impact Assessment.

Impact on benefit expenditure

Overall impact on pensioner benefit expenditure

The new State Pension reform package has elements that increase costs to the Exchequer, such as the value of each qualifying year being worth more for the new State Pension than for the basic State Pension, but also elements that decrease costs, for example the closure of State Second Pension and changes to inheritance rules.

This section presents the total impact on overall expenditure on pensioner benefits. The results in this section cannot be derived by adding together analysis in previous 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[4].

Figure 13 below shows projected expenditure on pensions and pensioner benefits under the current and reformed systems as a proportion of GDP. Projected expenditure is broadly the same as under the current system until the 2040s, after which the reformed system is projected to spend less. By the early 2060s projected growth in pensions spending is reduced by around 0.5% of GDP.

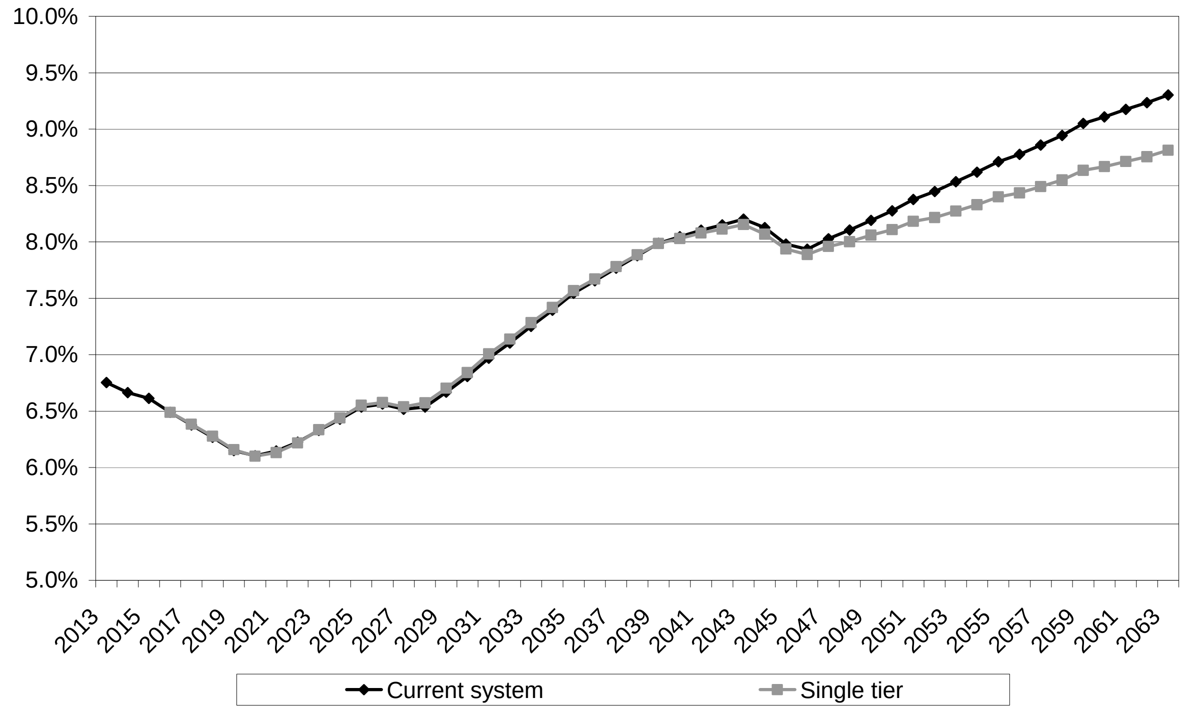
Note that these projections differ from those shown in the OBR's Fiscal Sustainability Report in that:

- They do not include expenditure in Northern Ireland
- They do not include the effect of any potential changes to State Pension age resulting from the Pensions Act 2014 review mechanism
- They have different assumptions on uprating of disability benefits and Winter Fuel Payments (as set out on page 4).

For the latest projections of benefit expenditure, including the new State Pension reforms, Northern Ireland, and potential State Pension age changes see: https://www.gov.uk/government/collections/benefit-expenditure-tables.

[4] For example, the Minimum Qualifying Period and changes to deferrals policy. See chapter 3 of the full Impact Assessment for further details.

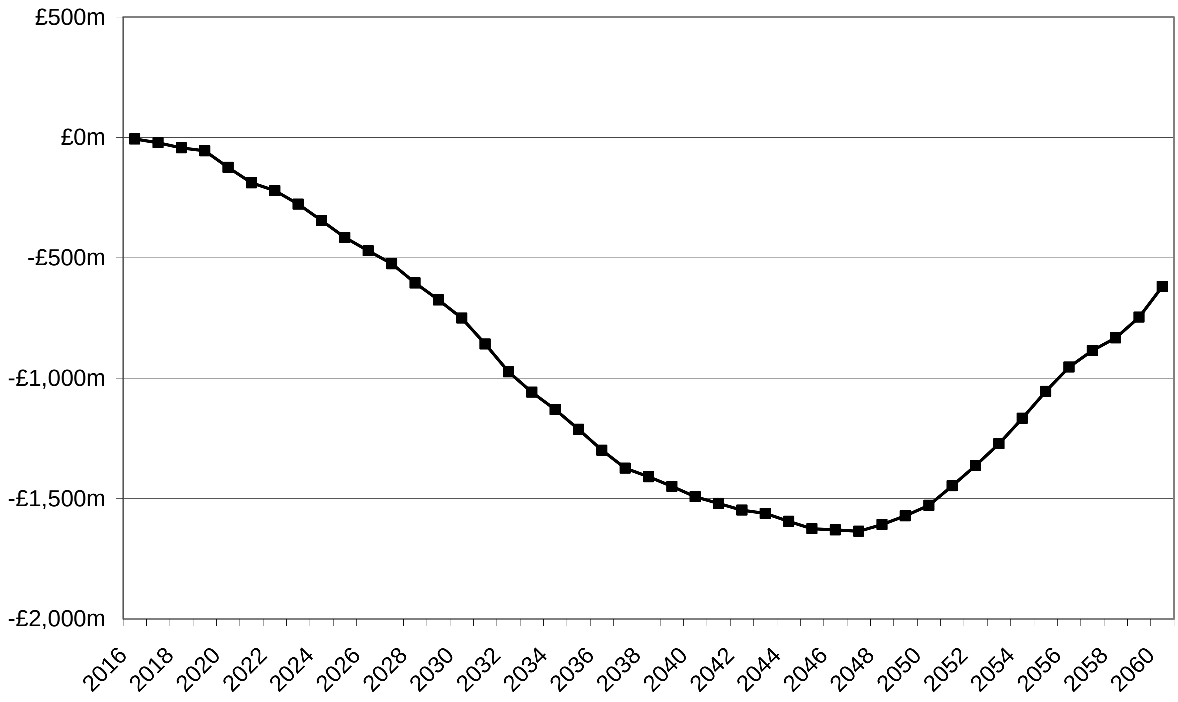
Figure 13: Overall expenditure on pensions and pensioner benefits under current system and new system as a proportion of GDP



Impact on means-tested benefit expenditure

The reformed system will reduce the need for means-tested benefits to provide a minimum level of income, leading to a reduction in expenditure on Pension Credit, Housing Benefit and council tax support. Figure 14 below projects the savings on means-tested benefits compared with the current system.

Figure 14: Change in projected expenditure on means-tested benefits due to the reforms (£millions 2014/15 prices)



Expenditure on Pension Credit will be lower in the medium-term because many recipients of new State Pension 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.

The new system will also reduce expenditure on Housing Benefit and council tax support because the majority of pensioners claiming these benefits will have a higher State Pension income and because the removal of the Savings Credit will lower the point at which income is tapered for these benefits. In the longer term, the gap narrows, partly because only a small proportion of pensioners would have been in receipt of these benefits under the current system.

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