

The Pensions White Paper: Who wins and who loses?



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Executive summary

The Pensions White Paper set out the Government's proposed reforms to pension provision in the UK in light of the Pensions Commission's recommendations. It proposed reforms to state pensions and the introduction of new personal accounts to encourage private pension saving. This article examines the proposed changes to state pensions and assesses who will win and who will lose from their implementation. The largest gainers, on average, are women: they will gain more from changes to credits for both the Basic State Pension and the State Second Pension, and – because they tend to live longer – also from the earnings indexation of the Basic State Pension. Those on higher earnings will see a smaller increase in their state pension as a result of cuts to the State Second Pension, while those on lower incomes will lose from a cut to the generosity of the Pension Credit Savings Credit. There is still substantial uncertainty over whether these reforms will last, particularly as they are likely to have significant tax consequences from 2020 onwards.

Who wins and who loses from the proposals set out in the Pensions White Paper will depend in part on how the increases in spending implied by the proposed reforms will be financed. This has not yet been announced. Despite the Secretary of State for Work and Pensions John Hutton stressing the importance of a pension reform package “that does not involve the suggestion that taxes would have to rise” the overall package is actually projected by the DWP to result in higher spending on pensioner benefits in 2050 than in 2006. The reforms to state pensions outlined in the White Paper involve public spending on state pensions and the Pension Credit increasing by 1.5% of national income between now and 2050–51, with all of the increase occurring after 2020. This is equivalent to £19.2 billion in today's terms, or £280 per person per year. To fund this would require a significant increase in taxation or borrowing. The proposed abolition of contracting out for defined contribution pension schemes, which would raise revenues worth just under 0.2% of national income in 2050–51, could cover only part of this cost.

For now we ignore the possibility that future Governments might not be prepared to meet this extra expenditure, and assess who stands to gain or lose from the changes to state pensions and the pension credit proposed in the White Paper. Who wins and who loses, particularly in the short term, depends in many instances on complicated changes to state pension rules and interactions with other benefits. To fill out the details of the complicated picture, we begin by considering changes to the Basic State Pension (BSP) and then broaden the discussion to consider the State Second Pension (S2P) and the Pension Credit.

The White Paper outlined three main reforms to the BSP. First, BSP is to be increased in line with earnings (rather than prices) from 2012 onwards (or at the latest from 2015 onwards). Second, maximum entitlement to the BSP will (from 2010) be awarded to anyone with at least 30 years' contributions or credits (currently men require 44 years' and women 39 years' contributions). Finally, Home Responsibilities Protection (HRP) will be replaced with credits awarded on a weekly basis to those carrying out certain types of caring.

Earnings indexation would gradually make the BSP considerably more generous than it would become under the current policy of price indexation. A standard full BSP is currently worth £84.25 per week (approximately 15.5% of average earnings) to a single pensioner. Under price indexation, by 2050–51 this would become just 6.5% of average earnings (or £35.25 in current earnings terms). Under earnings indexation from 2012–13, the BSP would instead be worth 14.6% of average earnings (£76.31 in current earnings terms). Those who will benefit most from earnings indexation are those who expect to live for longer – on average, women and those in good health. However, those receiving means-tested benefits will see some, and potentially all, of the increase in the BSP tapered away through benefit reductions. Women (particularly those currently aged 45–56) also benefit more than men on average from the reduction in the number of years of contributions or credits required to accrue a full BSP, as women are less likely than men, on average, to have accrued a full BSP.

The reforms to S2P proposed in the White Paper will accelerate the transition from a state pension system in which some earnings-related contributions ‘buy’ a retirement benefit related to working-life earnings, towards a system where, essentially, payroll tax pays for welfare benefits. Under current policy, new accruals of S2P will become flat-rate in about 2056. The proposed reforms would bring this forward to about 2030.

Accelerating the transition to a flat-rate S2P will reduce the second tier state pension income of many higher earners. However, these losses will be offset by increases in BSP income. Figure 1 shows how the total first year of state pension income (BSP plus S2P) of individuals who reach SPA in various years will compare under the proposed new system to what they would have received under the current system. The figure is drawn for individuals who were always in paid work until age 65 but who are at different points in the lifetime earnings distribution.

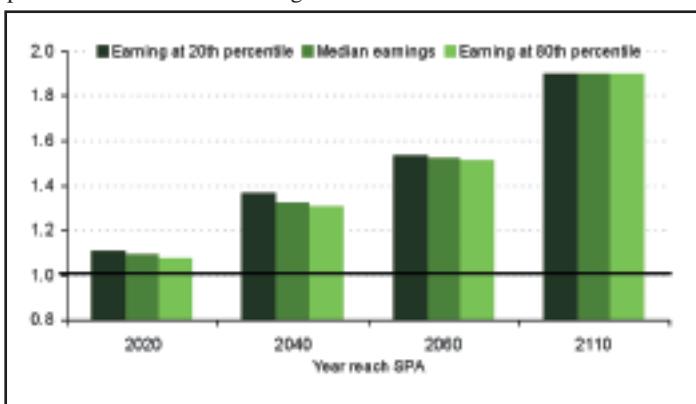


Figure 1: State pension income following implementation of the White Paper proposals compared to state pension income under the current system, by year reach SPA, and position in earnings distribution.

Source: Authors' calculations.

The figure reflects that individuals gain from the more highly indexed flat-rate BSP. This makes up a larger part of total state pension income for the lower earners than for the higher earners. The higher earners also lose some S2P income, compared to what they would have got, as a result of the acceleration towards a flat-rate system.

The fact that gains become more even across the earnings distribution over time reflects the evolution of S2P in the two systems. For those who reach SPA in 2020, the S2P is partially earnings-related under both systems. For those reaching SPA in 2040, new S2P accrual will have become flat-rate under the proposed new system but it would not have been flat-rate under the current system. In both cases, the proportionate gains from the new system are greatest for lower income individuals for whom the BSP is a larger proportion of their total state pension income. By 2060, new S2P accruals will have become flat-rate under both systems and so the gains are more similar for all income groups. Individuals retiring early in the next century would accrue all their S2P entitlements in the flat-rate scheme, even under the current system, and so for these cohorts the gains would be identical at all points in the earnings distribution.

In the medium term, however, amongst individuals who have

accrued the same number of years' entitlement to BSP and S2P, the largest proportionate gains in annual state pension income will go to lower earners. However, for those currently aged less than 47, the White Paper also proposes increasing the age at which individuals can start drawing their state pensions. Therefore, whether these individuals gain will depend on how many years they receive their state pension income for.

The proposed increase in the SPA (from 65 in 2024 to 68 by 2046) is the main cost-cutting measure announced in the White Paper. This increase in the SPA would mean that forecast growth in pensioner numbers over the next half a century would be equivalent to the forecast growth in public spending on pensioner benefits as a share of national income: i.e. the current generosity of the state per pensioner would be maintained, albeit with an increased SPA. Amongst those who expect to live to age 65, this change would reduce expected state pension entitlement more for those with lower life expectancy than for those who expect to live longer. A median earner reaching the SPA (age 67) in 2040 would need to receive his state pension income for about 6 years beyond this date in order to receive as much state pension income as under the current system. In addition, those who would in any case have had earnings at ages 65, 66 and 67 (after the point at which employee National Insurance Contributions (NICs) currently cease to be payable) would lose as they would become liable to pay employee NICs on their earnings during these years.

The White Paper also proposed reforms to the means-tested Pension Credit. The White Paper confirmed a long-standing Government aspiration to earnings index the Pension Credit Guarantee beyond April 2008, which would benefit those on lower incomes. In addition, the White Paper proposes increasing the Pension Credit Savings Credit (PCSC) threshold more quickly than the BSP from 2008 onwards. The White Paper states that this will “ensure that...means-tested provision continues to be focused on those with small savings”¹. However, as figure 2 shows, it will in fact result in some individuals with small amounts of saving facing a 100% withdrawal of means-tested benefits for any private saving that they have, compared to the 40% withdrawal rate they would face under the current system.

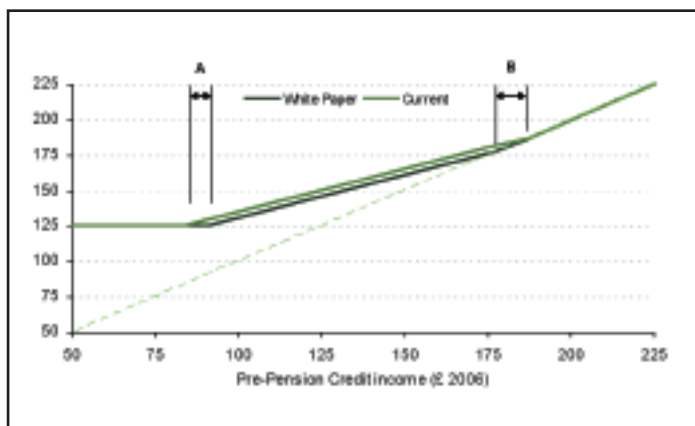


Figure 2: Pension Credit income for a single pensioner in 2011 under the current system and under the White Paper proposals

Source: Authors' calculations.

Individuals in region A (those with the lowest levels of private saving) would, under the current system, lose 40p of Pension Credit income for every £1 of income from private saving, whereas under the White Paper proposals they will face a 100% taper. So for these people the reward to private saving has decreased. The converse is true for people in region B who would no longer be affected by the 40% taper after the reforms. The fact that the White Paper version of the PCSC is represented by a lower line than the current policy, indicates that the accelerated indexation of the PCSC threshold reduces the generosity of the savings credit relative to the situation in which the threshold remains aligned with the BSP. This could make some low to middle income pensioners worse off. We have attempted to identify the main winners and losers from the reforms to state pensions and the Pension Credit proposed in the recent pensions White Paper. It is not always straightforward to identify these individuals because of the ways that reforms to different elements of the complicated current pension system interact. In the longer term, if fully implemented, the reforms would simplify the extremely complicated UK state pension system. This could in itself be a major source of benefit for individuals

planning their retirement saving. However, we noted at the outset that the full implementation of the reform package implies increased public spending. It is concerns about expenditure that have led the Government to propose delaying the earnings indexation of the BSP for between 2 and 5 years, relative to the original proposal of the Pensions Commission (despite the fact that this would have relatively little impact on the long-run cost of the policy). Such delay at the outset hardly inspires confidence that future Governments will not make similar judgements to save on pension spending in order to either avoid increased taxes or borrowing, or to free up resources for other spending priorities. Such considerations suggest that we are still far from having the systemic certainty and stability that could be a major help to individuals planning and saving for retirement.

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FOOTNOTE

¹DWP (2006), p.122