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A single-tier pension: what does it really mean?

Launch event, 11 July 2013

Funded by the Joseph Rowntree Foundation

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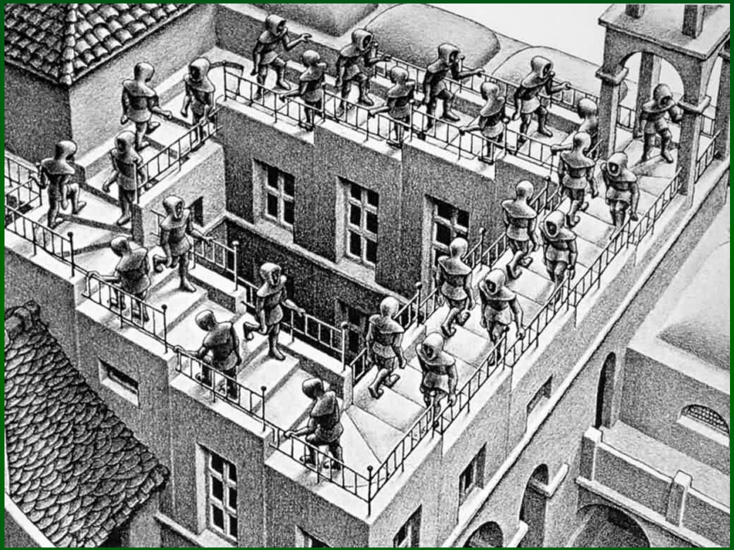

Introduction and overview of reforms

Gemma Tetlow

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Outline

1. Overview of the proposed reforms
2. How do the latest reforms fit with other state pension reforms over the last 40 years?
3. How does the proposed system compare to the current system (in theory) in the short- and long-run?

Proposed reforms: Pensions Bill 2013

- State pension
  - Basic State Pension (BSP) and State Second Pension (S2P) to be replaced by a single-tier pension
  - 35 years of contributions required to receive full amount
  - Provisionally set at £146.30 per week (in 2013–14 earnings terms)
  - Wide range of activities will earn entitlement to the single-tier pension: employment, self-employment , unemployment, disability, caring...
- Pension Credit
  - Currently has two components: guarantee credit (tops income up to a fixed level), savings credit (‘rewards’ saving by providing top-up for those with incomes in excess of the BSP)
  - Savings credit to be abolished

How does this reform fit into the long history of state pension reforms in the UK?

- Latest step on a long and rather circular journey since 1974
- 1975 Social Security Act
  - Introduced the State Earnings-Related Pension Scheme (SERPS) to provide a significant earnings-related top-up to the BSP
  - Also introduced credits for unpaid activities, including Home Responsibilities Protection for those looking after children
  - From an early stage, commentators pointed out that SERPS seemed unaffordable: Hemming and Kay (1982)

“In her introduction to the White Paper describing the new state pension scheme which came into effect in Britain in 1978, the then Secretary of State for Social Services wrote: ‘The cost of the commitments...has been very carefully considered in relation to the capacity of the country to support it’....

“...We can find little to indicate that this is a true statement”

How does this reform fit into the long history of state pension reforms in the UK?

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  - Also introduced credits for unpaid activities, including Home Responsibilities Protection for those looking after children
  - From an early stage, commentators pointed out that SERPS seemed unaffordable: Hemming and Kay (1982)
- Reforms since then have
  - Reduced generosity of the state pension system to higher earners
  - Introduced even more extensive credits for unpaid activities
- Single-tier proposals return us to a state pension that looks rather similar to the 1974 system
  - But with much more extensive crediting

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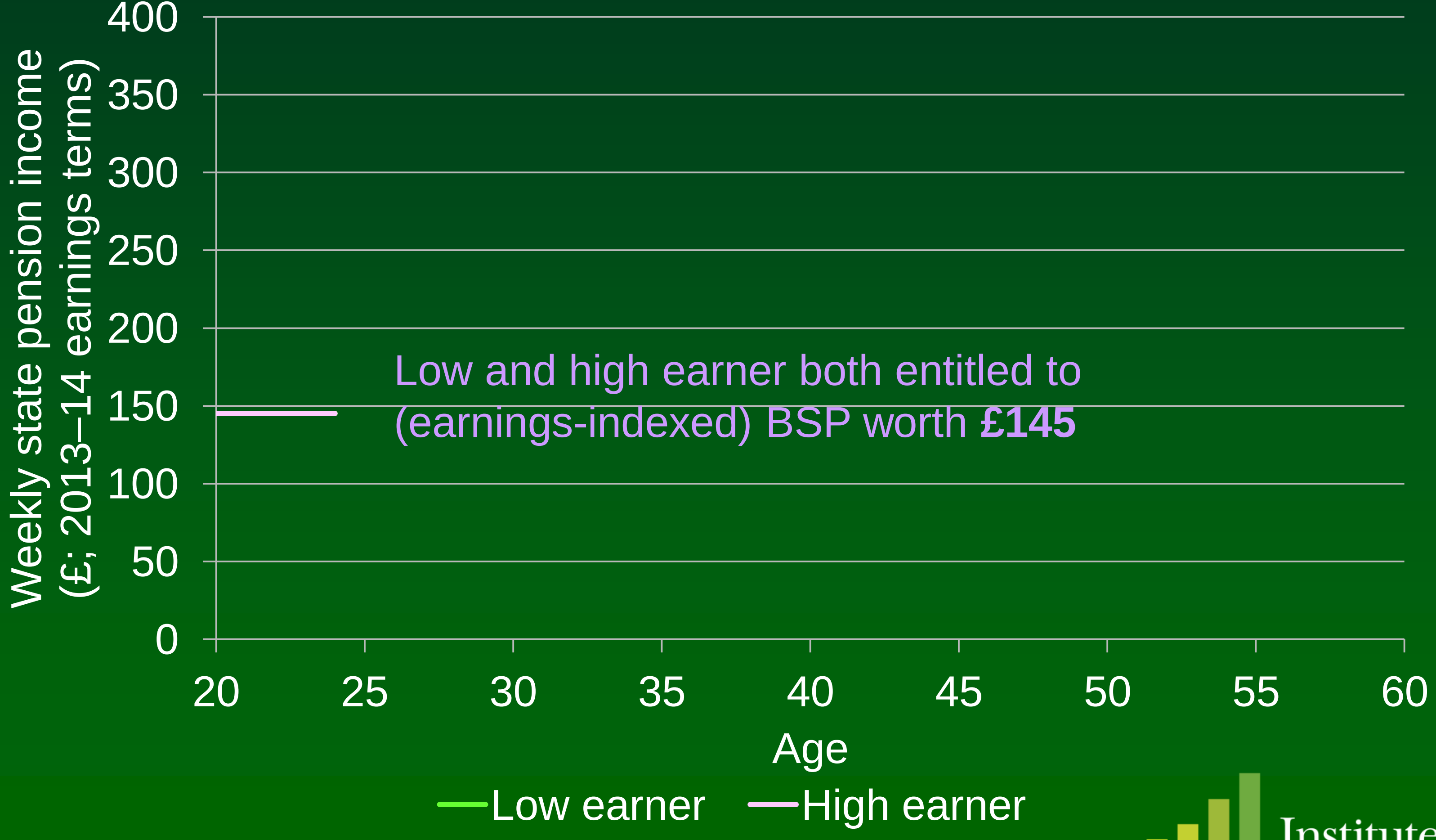
A long and circular road?

Example high- and low-earners born in 1950 who expect to work for 49 years



Source: Figure 6.1

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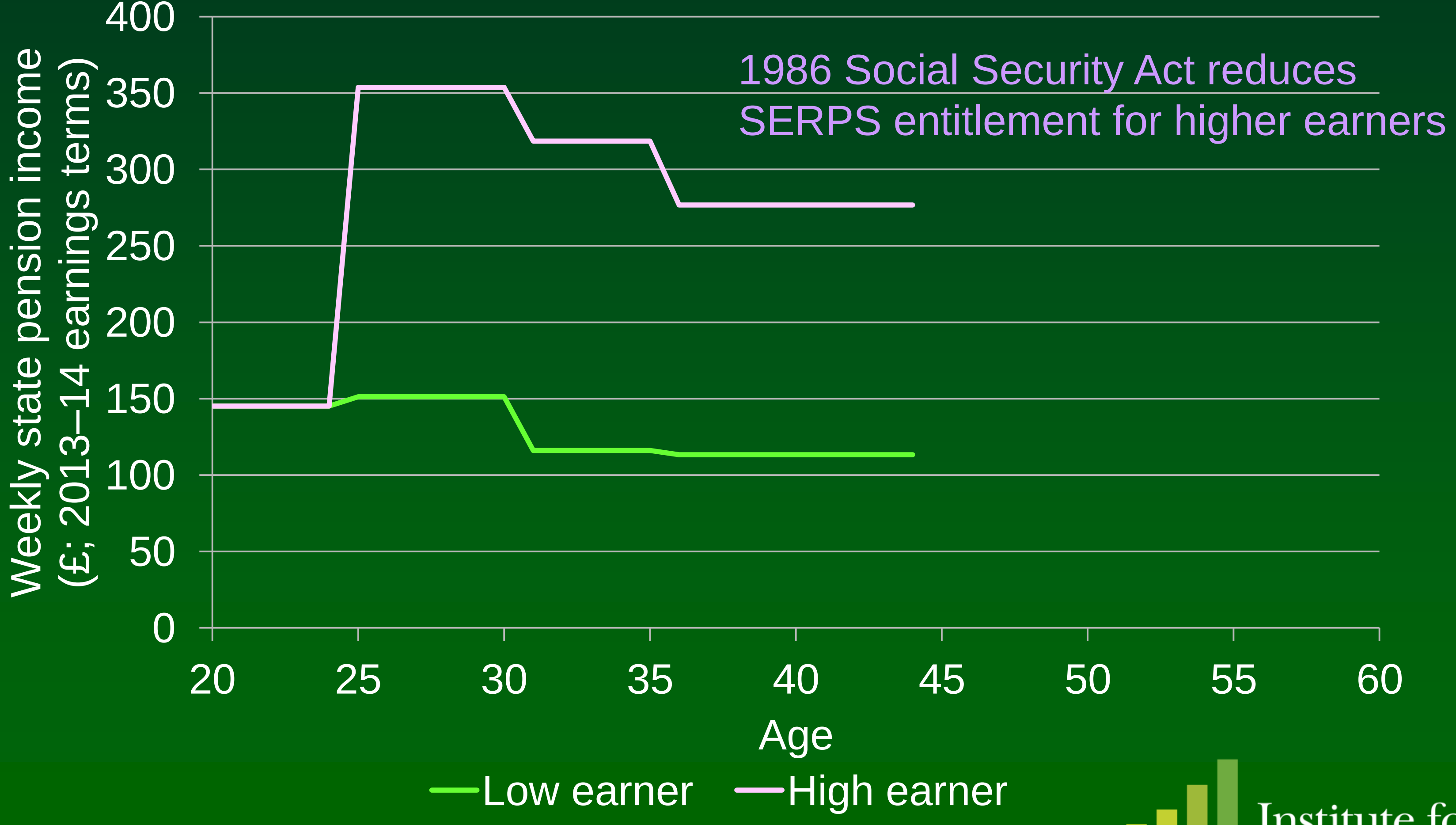

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A long and circular road?

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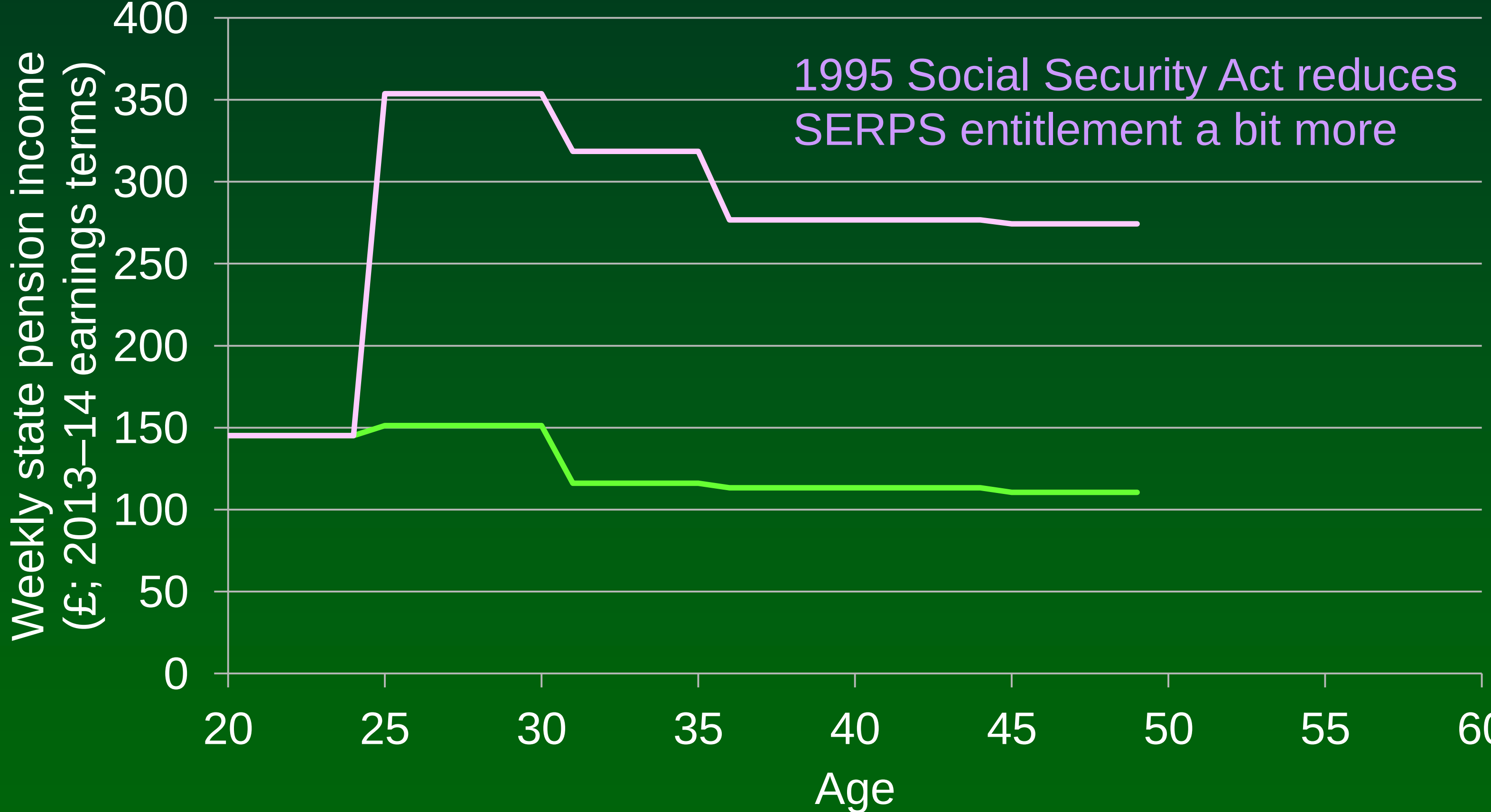

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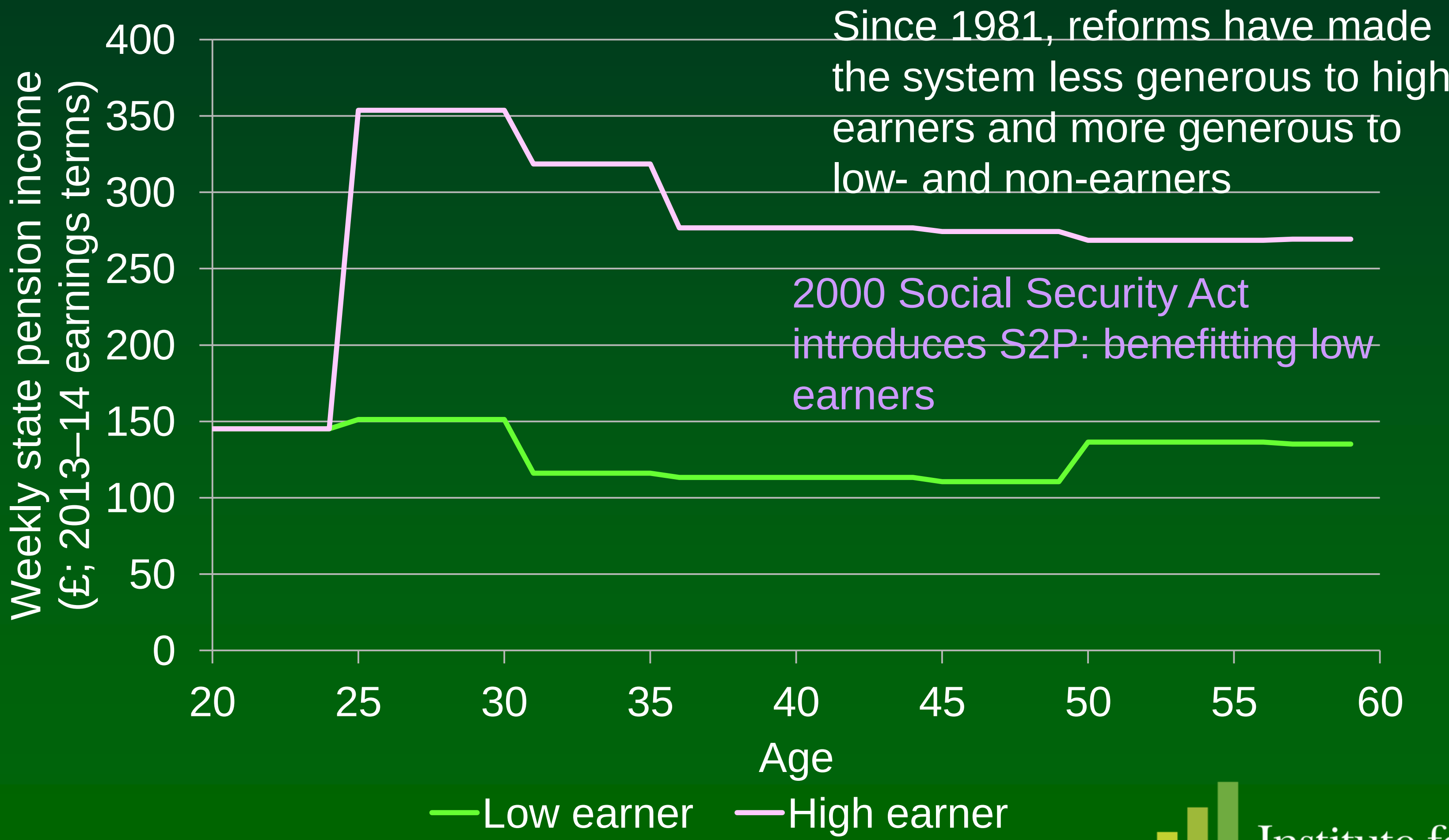

Source: Figure 6.1

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How does new pension accrual under proposed system compare to current system?

	Current system		Proposed system
	BSP	S2P	Single-tier

Notes: Chapters 2 and 3, in particular Table 3.1.

How does new pension accrual under proposed system compare to current system?

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Years required for full entitlement	30	Up to 52	35

Notes: Chapters 2 and 3, in particular Table 3.1.

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Years required for full entitlement	30	Up to 52	35
Activities that earn entitlement:			
Employment	✓	✓	✓
Caring	✓	✓	✓
Disability benefits	✓	✓	✓
Self-employment	✓	✗	✓
[Universal Credit]	✓	✗	✓

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£ figures in 2013–14 earnings terms, where relevant	Current system		Proposed system
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Maximum amount (£ per week at SPA)	£109		

Notes: Chapters 2 and 3, in particular Table 3.1.

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Maximum amount (£ per week at SPA)	£109	Depends on year of birth (1986 cohort: £100+)	£146

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[Universal Credit]	✓	✗	✓
Maximum amount (£ per week at SPA)	£109	Depends on year of birth (1986 cohort: up to £XXX)	£146
Year of accrual in 2016–17 (£ per week at SPA)	£3.60	At least £1.70	£4.20

Notes: Chapters 2 and 3, in particular Table 3.1.

Accrual under proposed and current systems: some examples

All £ figures are in 2013–14 earnings terms

- Lucinda
  - 35 years old, employed, earning £900 a week in 2016–17
  - Current system: accrues extra state pension income of £6.20pw
  - Proposed system: will accrue extra state pension income of £4.20pw
- Jacob
  - 29 years old, employed, earning £115 per week in 2016–17
  - Current system: accrues extra state pension income of £5.30pw
  - Proposed system: will accrue extra state pension income of £4.20pw
- Yousef
  - 58 years old, caring for 35 hours a week in 2016–17; previously spent 35 years in self-employment
  - Current system: accrues extra state pension income of £1.70pw
  - Proposed system: accrues no further entitlement

Source: See Box 2.1 and Box 3.1

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Other differences between the proposed and current systems in the long-run

- State second pension currently has an earnings-related element
  - But this is set to disappear for new accruals from 2030
- How the level of state pension income is increased through retirement
  - Basic state pension: earnings indexed (triple-locked until 2015)
  - State second pension: price indexed
  - Single-tier pension: earnings indexed
  - Single-tier pension amount will grow more quickly after State Pension Age than combined BSP+S2P income

Historic differences that still affect state pension income from current and proposed systems

- SERPS was much less generous than S2P to low earners and those doing unpaid activities accrued no SERPS
  - Many individuals who have been on low earnings and/or had periods out of paid work will have accrued only BSP entitlement in the past
- Derived rights
  - Under current system may receive a higher pension based on (former) spouse's contributions if own contributions inadequate
  - Abolished under proposed system (some transitional protection)

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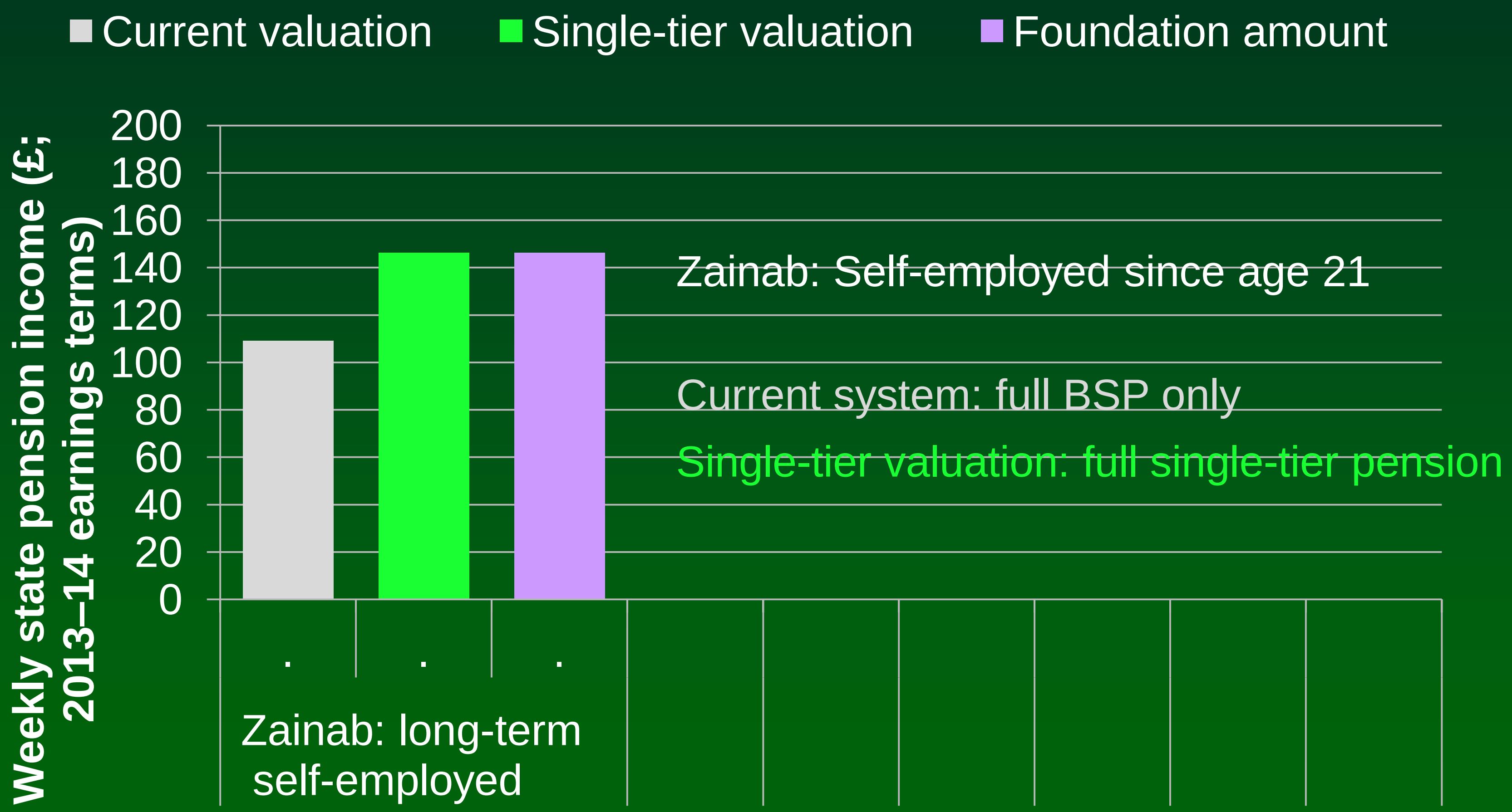
Mechanics of transition: basic idea

- In 2016, DWP will calculate
  1. Accrue entitlement under current rules (‘current valuation’)
  2. Entitlement assuming single-tier system had always been in place (‘single-tier valuation’)
- ‘Foundation amount’ calculated as the maximum of these: existing rights “protected”
- From 2016 onwards, can accrue additional entitlements until reach £146.30

Transition: some examples

Example individuals born in 1957



Source: See Figure 3.1

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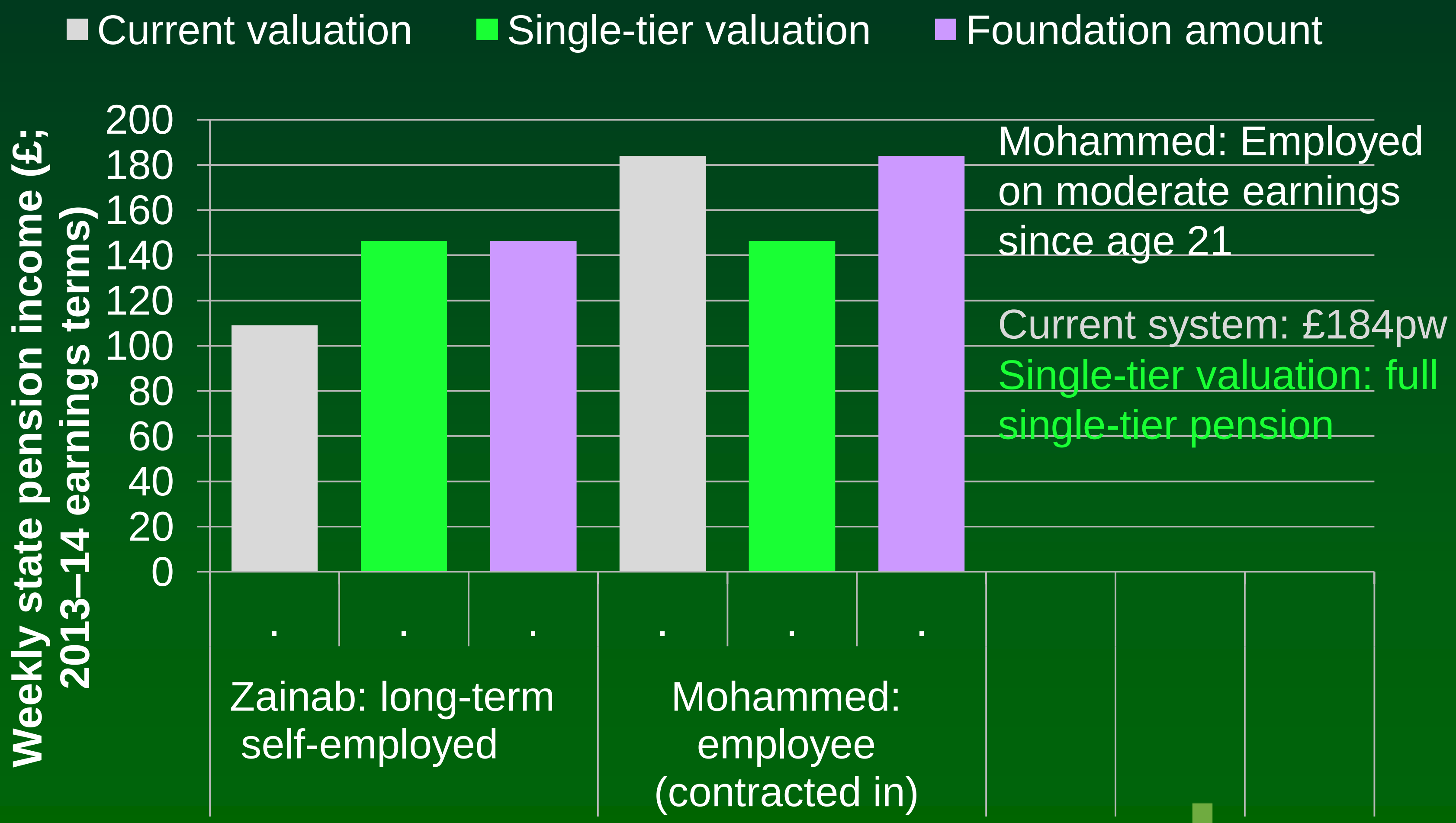
Transition: some examples

Example individuals born in 1957



Source: See Figure 3.1

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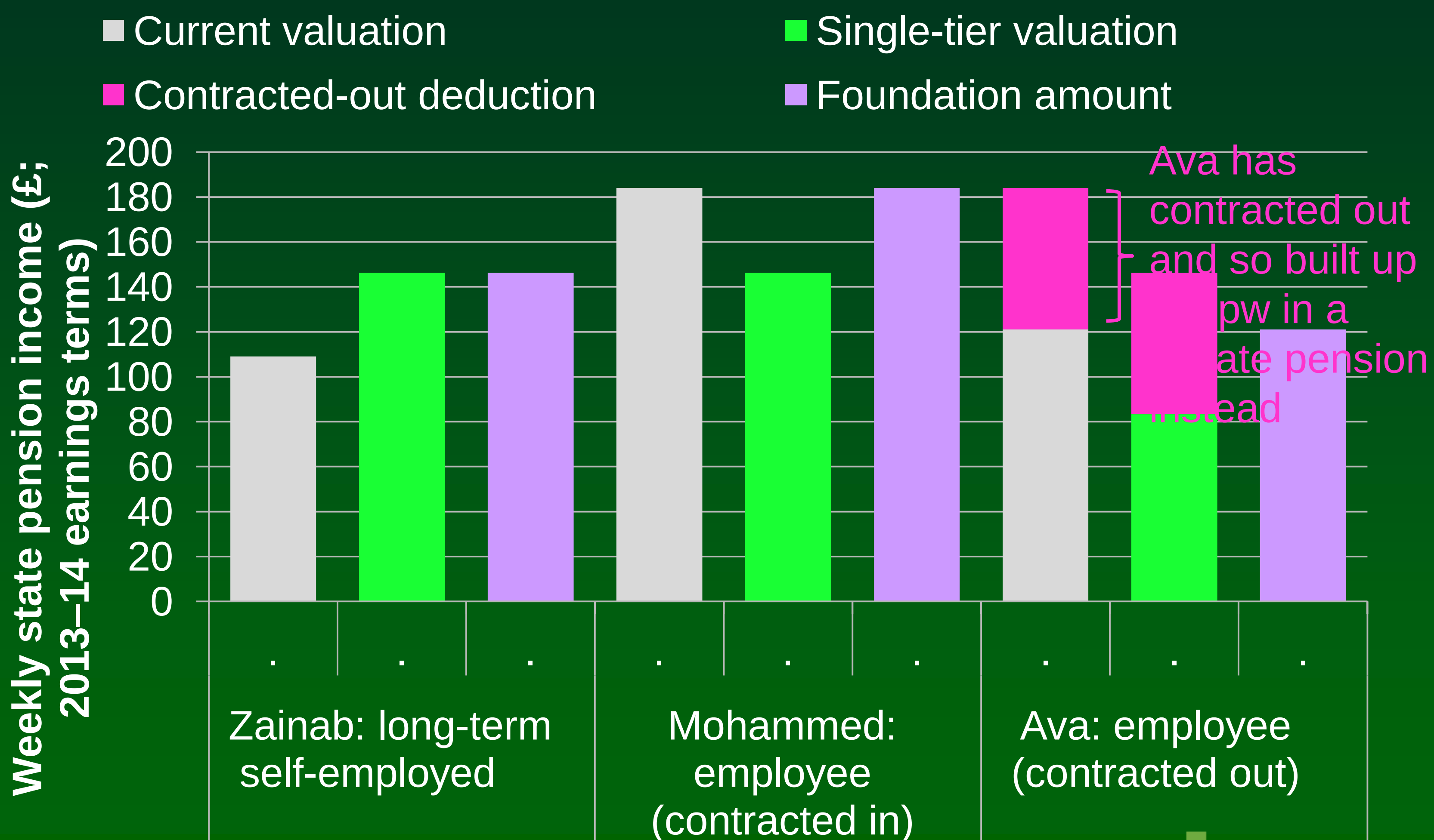
Mechanics of transition: contracting out

- Since 1978 people have been able to 'contract out' of second tier state pension
  - Pay lower net National Insurance contributions
  - Do not accrue entitlement to SERPS/S2P
  - Required to accumulate private pension saving worth at least as much as SERPS/S2P forgone
- Complicates transition to simple flat-rate pension
- Under single-tier system, people who have been contracted out in the past will...
  - Have a 'contracted out' reduction incorporated into their 'foundation amount': may give a foundation amount (well) below £146.30
  - Be able to "work this off" if continue to contribute after April 2016

Transition: some examples

Example individuals born in 1957



Source: See Figure 3.1

Current and proposed pension systems: Summary of differences

- For new accruals
  - Both systems provide credits for unpaid activities and low earnings
  - BSP+S2P worth more than single-tier; but single-tier worth more than BSP on its own
  - Current system rewards every additional year of contribution; single-tier system provides no further reward after 35 years
- Legacies of past pension systems still affecting accrued rights
  - SERPS was less generous to low- and non-earners; single-tier will provide retrospective credits for some people
  - People who have been contracted out will be able to “work this off”: potentially receive higher total income than otherwise identical people who remained contracted in

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Effect of the proposed reforms on individuals in the short- and long-run

Soumaya Keynes

JRF JOSEPH ROWNTREE FOUNDATION

Overview

- Short-run
  - Use unique dataset linking household survey responses to administrative data
  - Focus on those reaching SPA between 6 April 2016 and 5 April 2020
- Long-run
  - Describe implications for later cohorts
  - Main conclusions apply to all those born since mid-1980s (and many born post-1966)

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Short-run analysis: data

- English Longitudinal Study of Ageing (ELSA) linked with National Insurance records
- ELSA
  - Representative sample of residents of England aged 50+ in March 2002
  - Information on earnings and benefits received up to 2010-11
  - Information on a wide variety of circumstances, including: Socio-economic characteristics, household demographics and wealth
- National Insurance records up to 2003
  - (Self) employment, earnings
  - Periods of caring, receipt of out of work benefits
  - 85% of ELSA sample linked
  - 76% of ELSA sample and their partners linked

Cohorts affected in the short-run

- Focus on individuals reaching State Pension Age between 6 April 2016 and 5 April 2020
  - Men born between 6 April 1951 and 5 July 1954
  - Women born between 6 April 1953 and 5 July 1954
- ELSA contains a representative sample of people born before 1 March 1952
- We simulate cohorts born between 1 March 1952 and 5 July 1954
  - Using observed behaviour of slightly older cohorts
  - Essentially assumes that these cohorts have behaved in the same way as each other (see Appendix B)
- Our sample is representative of those resident in England
  - Excludes those who receive UK state pensions outside the country, who DWP suggest are some of the main losers from the reform in the short-run

Estimating gains and losses from the reforms

- ELSA provides information on contributions and credits up to 2010-11
- Exactly how much individuals win/lose will depend on behaviour after 2010-11
- We need to make an assumption about contributions after 2010-11
  - We present results on two bases...

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Analysis of short-run winners and losers

- Change in state pension entitlement considering...
  - Contributions up to the implementation date
  - Contributions continuing until SPA
- Four key questions:
  1. How does state pension income at SPA compare under the current and proposed systems?
  2. How does this change when we consider state pension income over the whole of retirement?
  3. How does this change when we include means-tested pension credit entitlement?
  4. Which groups win or lose the most as a result of the reforms?

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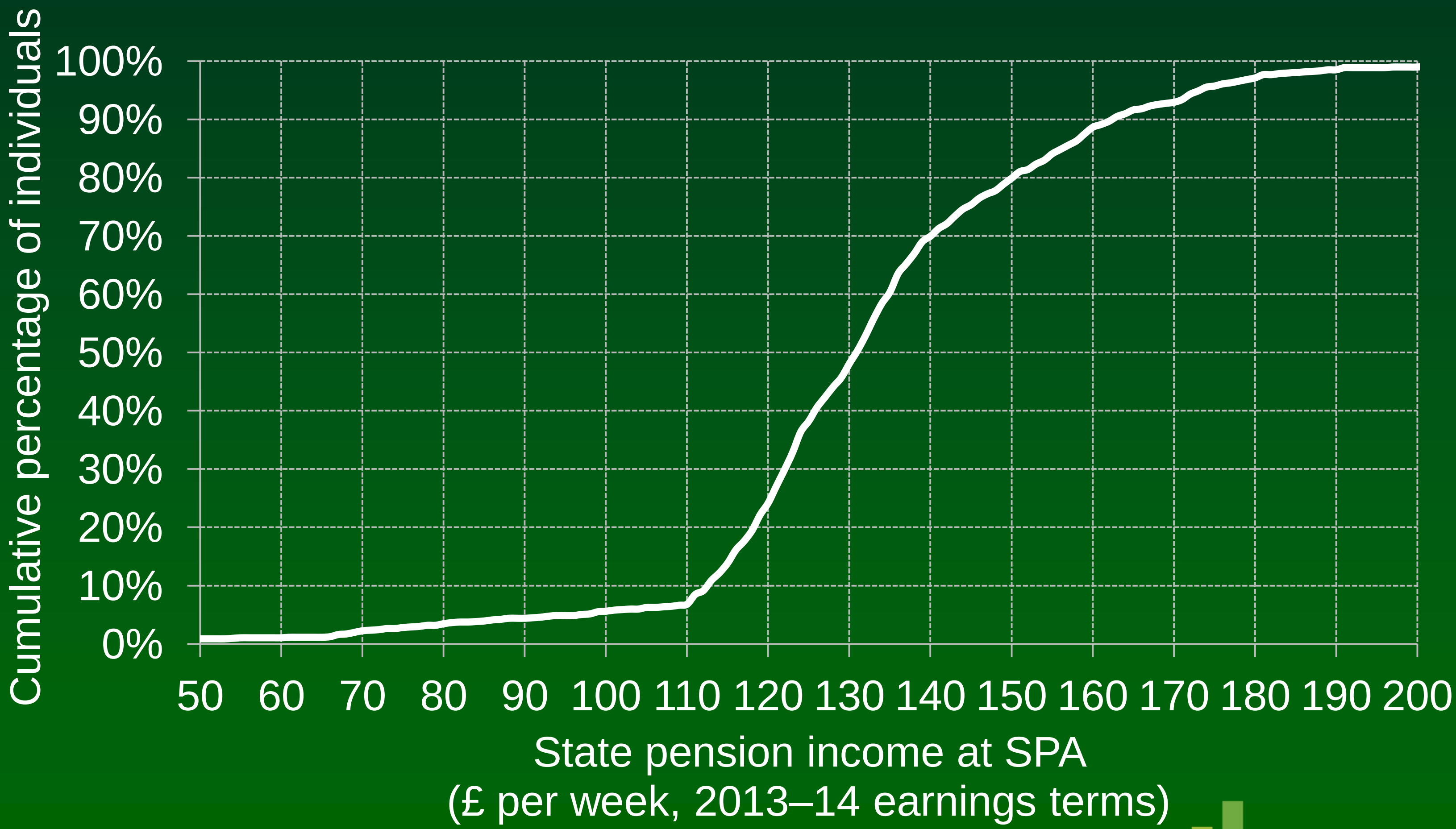
Entitlement under the current system: contributions up to implementation date



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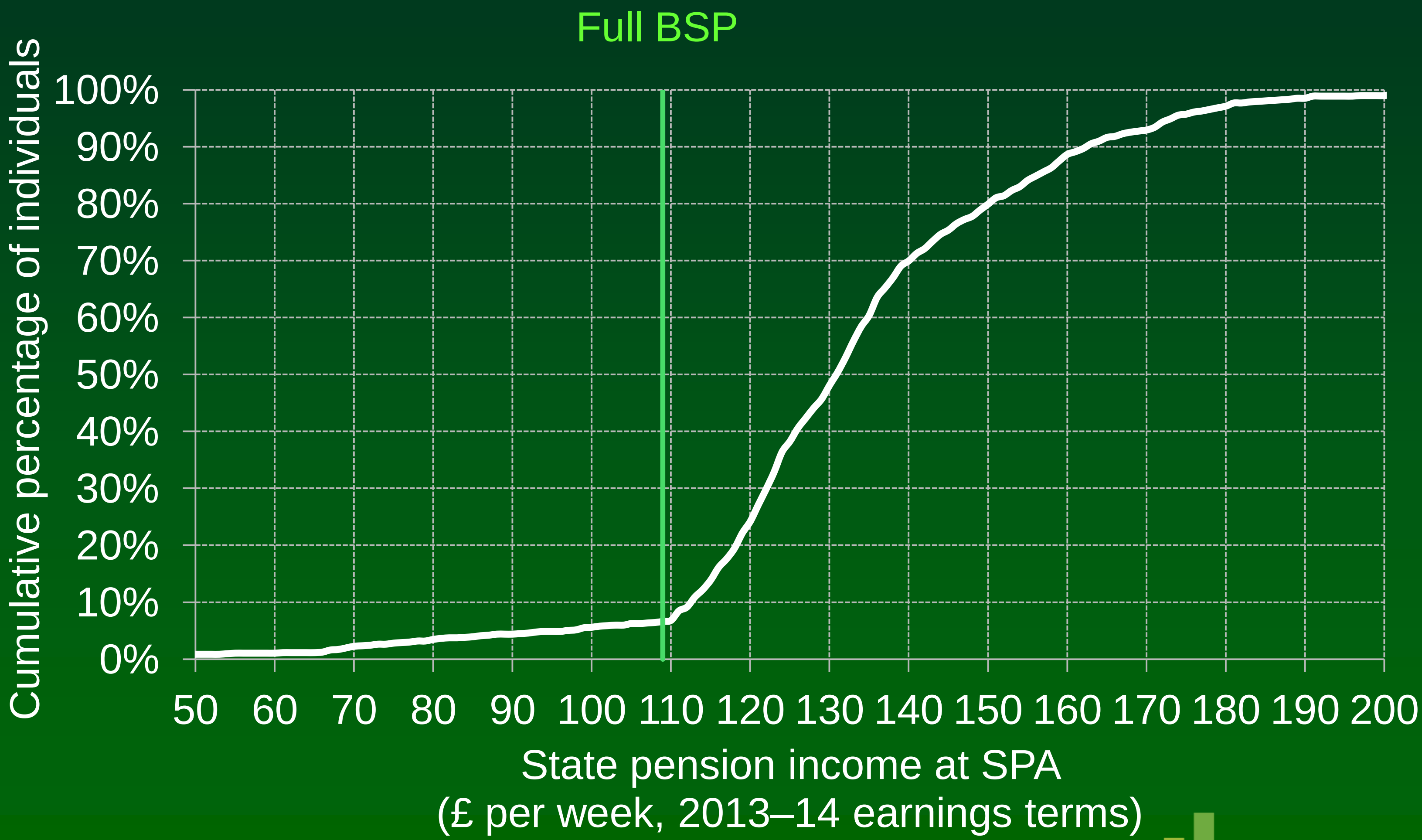
Entitlement under the Current system: contributions up to April 2016



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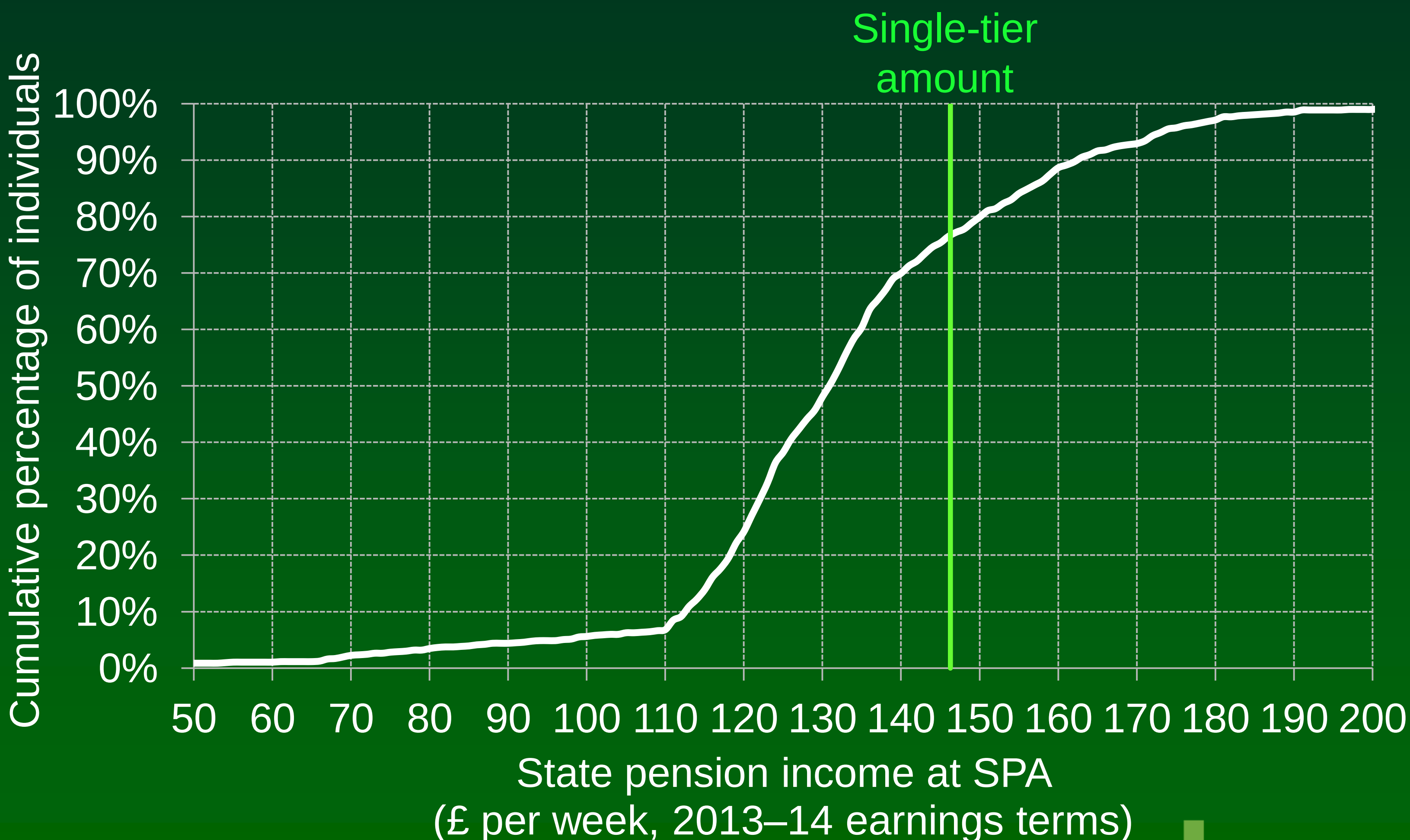

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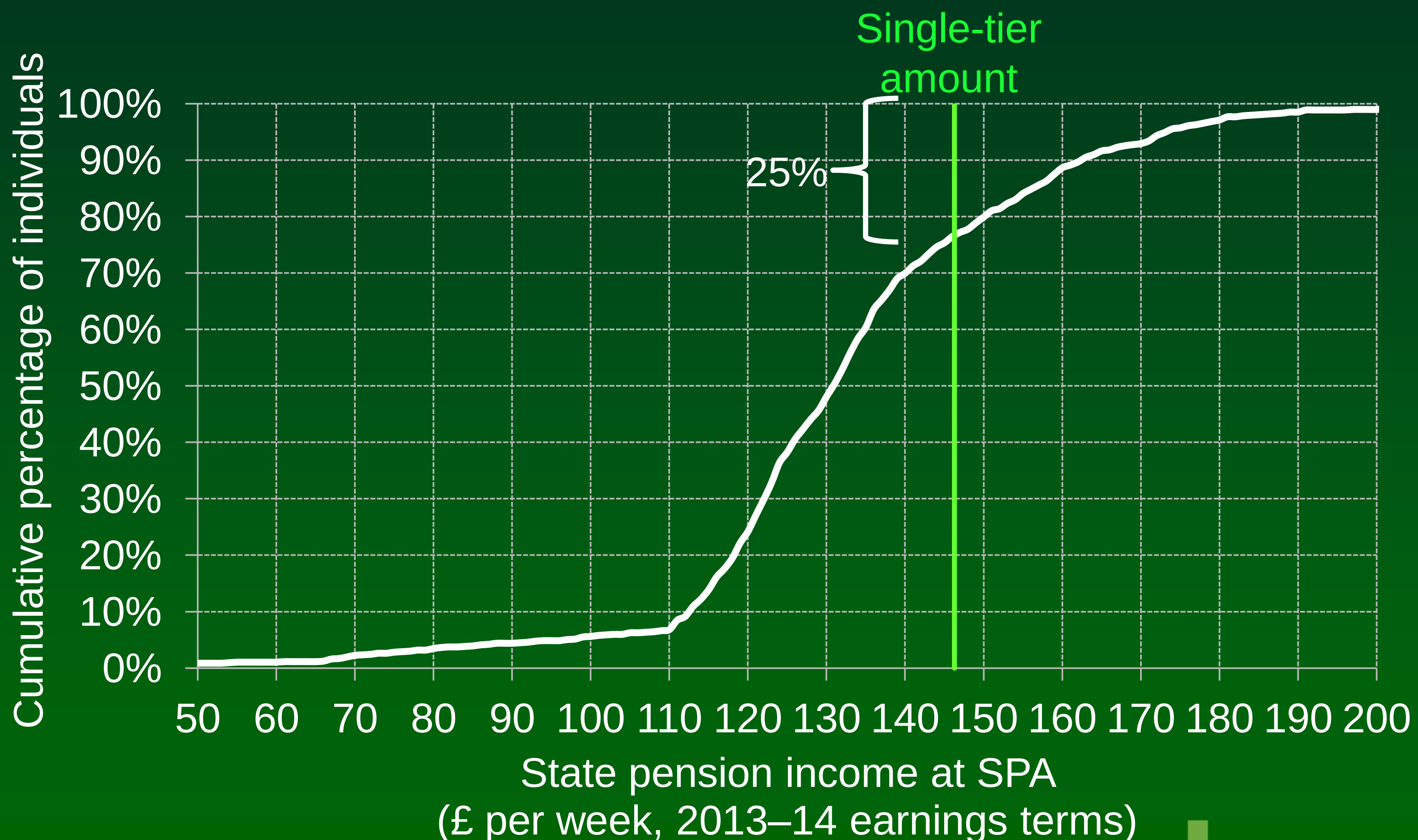

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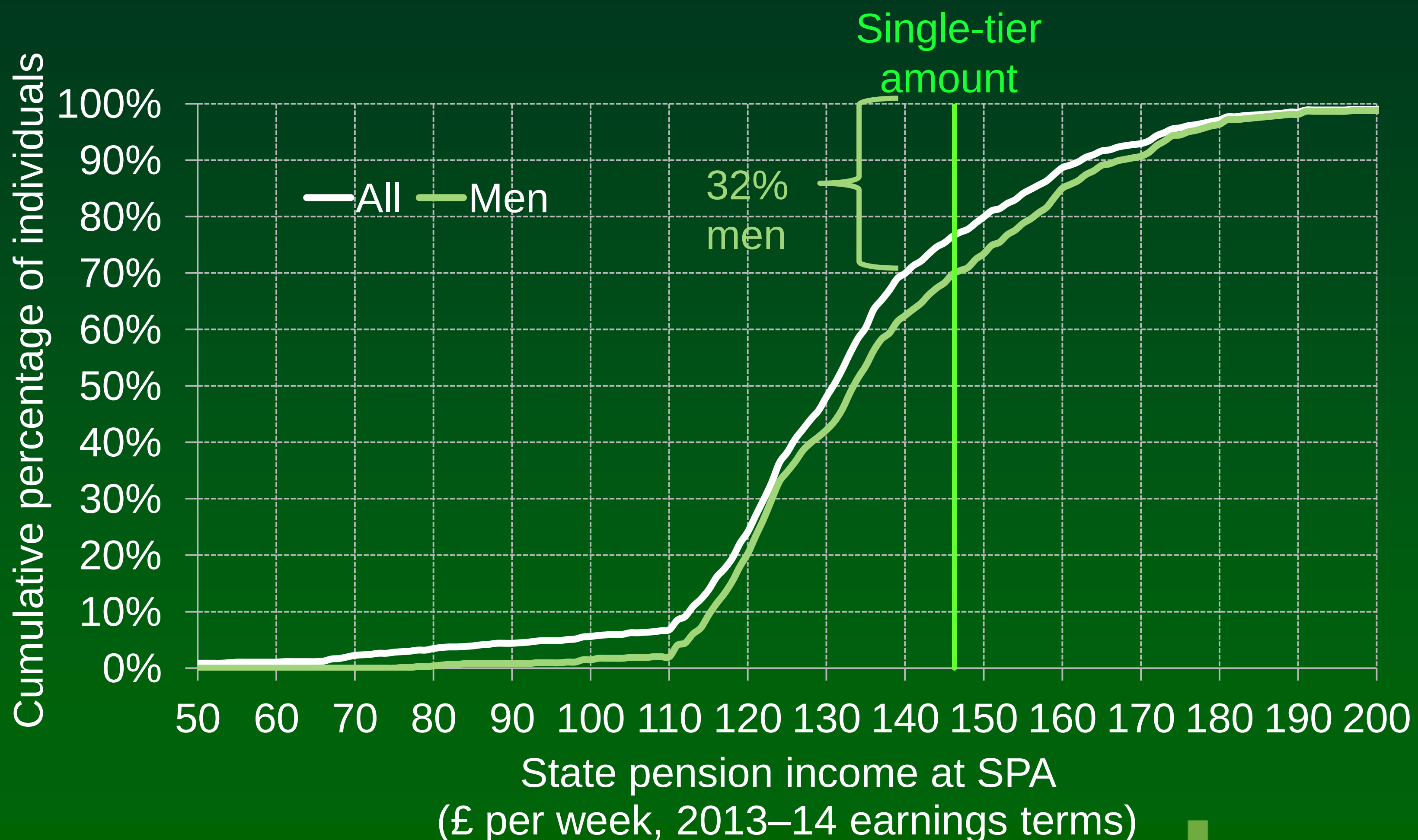

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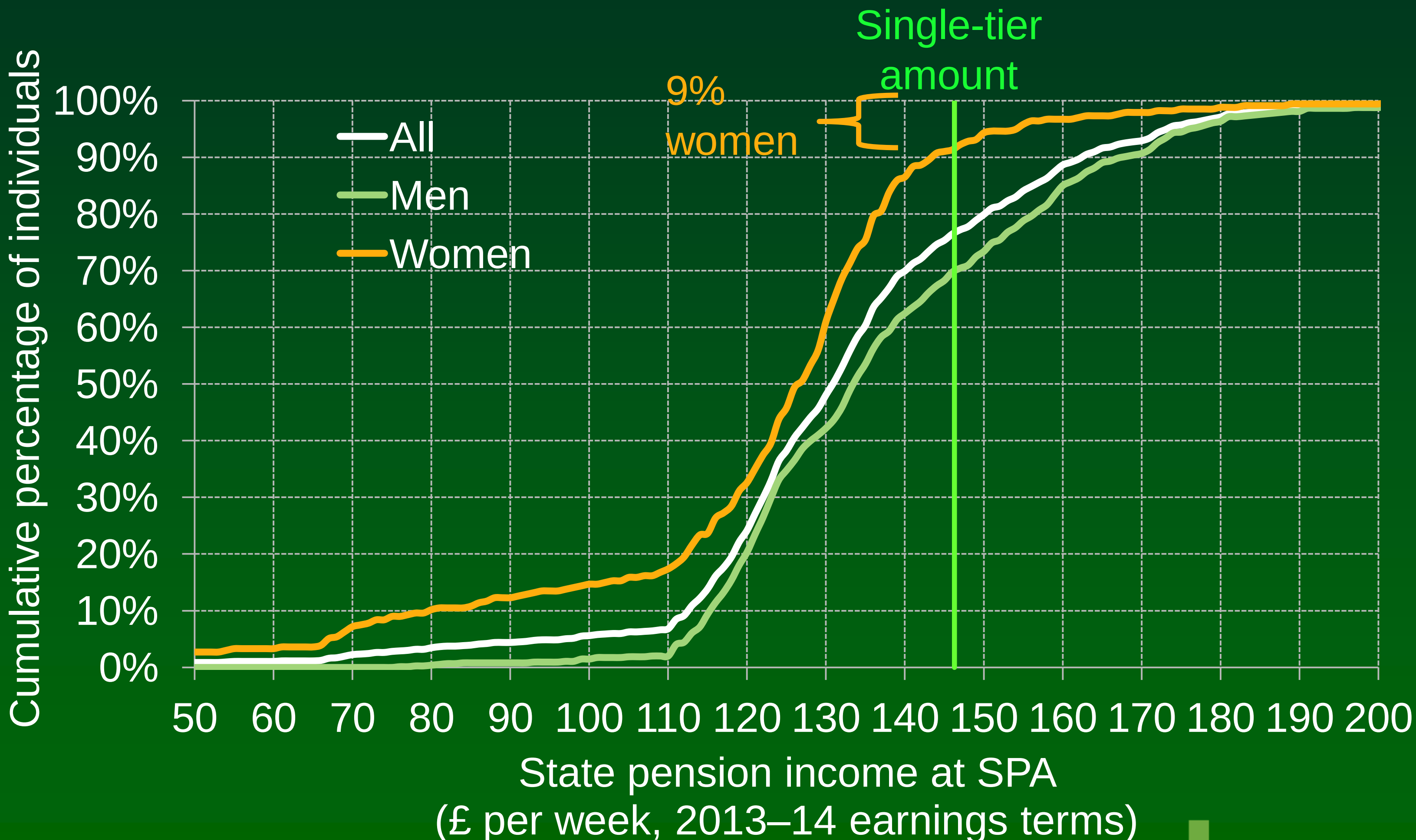

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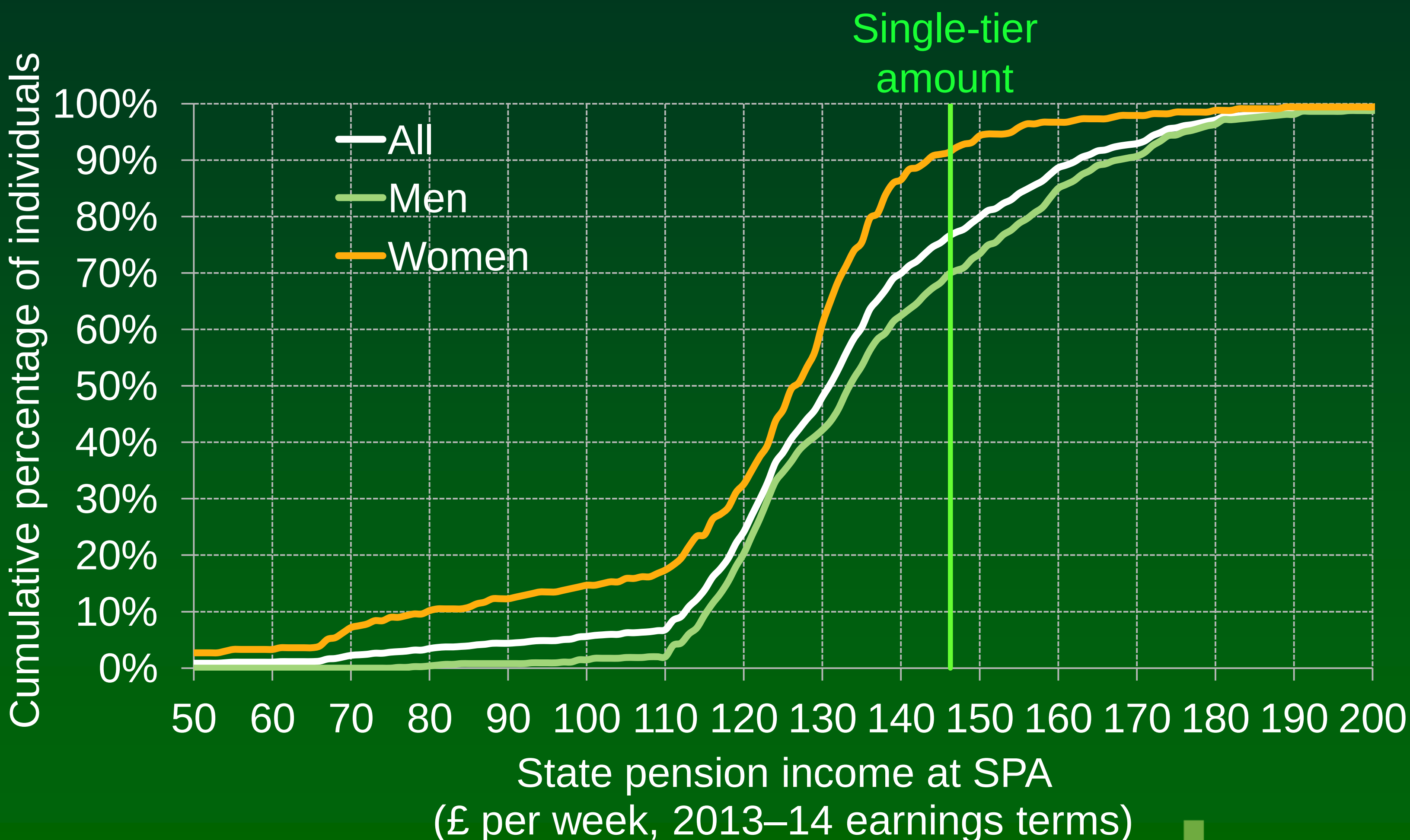

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How will single-tier affect state pension income?

Gains and losses following the reform: contributions up to 2015-16

Group affected by the single-tier reforms	% gain	% lose	% no change
All			
Men			
Women			

How will single-tier affect state pension income?

Gains and losses following the reform: contributions up to 2015-16

Group affected by the single-tier reforms	% gain	% lose	% no change
All	18%	4%	78%
Men			
Women			

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How will single-tier affect state pension income?

Gains and losses following the reform: contributions up to 2015-16

Group affected by the single-tier reforms	% gain	% lose	% no change
All	18%	4%	78%
Men	6%	4%	91%
Women			

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How will single-tier affect state pension income?

Gains and losses following the reform: contributions up to 2015-16

Group affected by the single-tier reforms	% gain	% lose	% no change
All	18%	4%	78%
Men	6%	4%	91%
Women	44%	6%	50%

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Group affected by the single-tier reforms	% gain	% lose	% no change
All	18%	4%	78%
Men	6%	4%	91%
Women	44%	6%	50%

- If individuals continue to contribute after April 2016 this picture will change...
- Some could lose from the reforms
  - Those who would have been able to continue accruing above the single-tier amount (£146.30)
- Some could gain from the reforms
  - Those who can ‘work off’ past contracting out

Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms	% gain		% lose		% no change	
	Up to 2016	Up to SPA	Up to 2016	Up to SPA	Up to 2016	Up to SPA
All	18%		4%		78%	
Men	6%		4%		91%	
Women	44%		6%		50%	

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms	% gain		% lose		% no change	
	Up to 2016	Up to SPA	Up to 2016	Up to SPA	Up to 2016	Up to SPA
All	18%	43%	4%	19%	78%	62%
Men	6%		4%		91%	
Women	44%		6%		50%	

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Men						
Women						
Contracted-out years						
None						
More than 10						

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All	18%	43%	4%	19%	78%	62%
Men						
Women						
Contracted-out years						
None	53%	54%				
More than 10						

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	Up to 2016	Up to SPA	Up to 2016	Up to SPA	Up to 2016	Up to SPA
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Men						
Women						
Contracted-out years						
None	53%	54%				
More than 10	5%	39%				

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Men	35%	21%	
Women	21%	14%	

Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms	% gain	% lose	Mean change (£)
All	43%	19%	2.74
Men	35%	21%	
Women	21%	14%	

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms	% gain	% lose	Mean change (£)
All	43%	19%	2.74
Men	35%	21%	1.62
Women	21%	14%	

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Gains and losses following the reform: contributions up to SPA

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All	43%	19%	2.74
Men	35%	21%	1.62
Women	21%	14%	5.23

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Self-employment	Never			
	> 10 years			

Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Self-employment	Never > 10 years	41%	20%	2.19

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Self-employment	Never	41%	20%	2.19
	> 10 years	55%	10%	7.51

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Quintiles of total household net wealth	Lowest			
	2			
	3			
	4			
	Highest			

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Quintiles of total household net wealth	Lowest	51%		
	2	34%		
	3	50%		
	4	39%		
	Highest	39%		

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Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Quintiles of total household net wealth	Lowest	51%	22%	
	2	34%	34%	
	3	50%	19%	
	4	39%	11%	
	Highest	39%	10%	

Gains and losses following the reform: contributions up to SPA

Group affected by the single-tier reforms		% gain	% lose	Mean change (£)
All		43%	19%	2.74
Quintiles of total household net wealth	Lowest	51%	22%	3.97
	2	34%	34%	1.82
	3	50%	19%	3.55
	4	39%	11%	2.19
	Highest	39%	10%	2.18

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How much state pension income will people actually get under the single-tier system?

- The legacy of past pension systems means that very few people reaching SPA shortly after 2016 will actually get £146.30
- 17% of all those reaching SPA between 6 April 2016 and 5 April 2020 will receive £146.30
  - 12% of men
  - 27% of women
- 23% will get more than the ‘full’ single-tier amount
  - 29% of men
  - 8% of women
- 61% will get less than the ‘full’ single-tier amount
  - 58% of men
  - 66% of women

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Beyond income at SPA

1. Single-tier pension is indexed more generously through retirement
   - 98% win from the reforms when we consider the value of pension income stream throughout retirement
2. Changes to means-tested benefit (MTB) entitlement could offset some of the gains/losses in state pension income

   Of the 20% living in least wealthy households:
   - 64% gain extra state pension income from the reform...

     ...falling to 40% accounting for Pension Credit entitlement
   - 14% lose household state pension income due to the reform...

     ...rising to 38% accounting for Pension Credit entitlement

Short-run effects: summary

- Substantial fraction will see an increase in their state pension income at state pension age
  - Women and the self-employed more likely to gain
- Some will lose relative to what they could have accrued under the current system
  - But taking into account state pension income received through the whole of retirement, virtually everyone wins
- The reform appears to benefit most the least wealthy if we only look at changes to individual state pension income...

  ...but loss of means-tested Pension Credit reduces these net gains to the least wealthy

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The long-run effects: summary

- The long-run effects are very different to the short-run effects
- Current system of BSP + S2P credits many activities more generously than the proposed system will, in 2016-17:
  - A year of single-tier pension accrual will equal £4.20
  - A year of entitlement towards the BSP will equal £3.60
  - A year of S2P entitlement will equal at least £1.70

  Total = £5.30
- Single-tier will only credit up to 35 years of activity; current system continues crediting throughout working life
- Current system is less generous towards those who would only accrue entitlement towards the BSP
  - The self-employed
  - Those who will newly qualify for the BSP through Universal Credit

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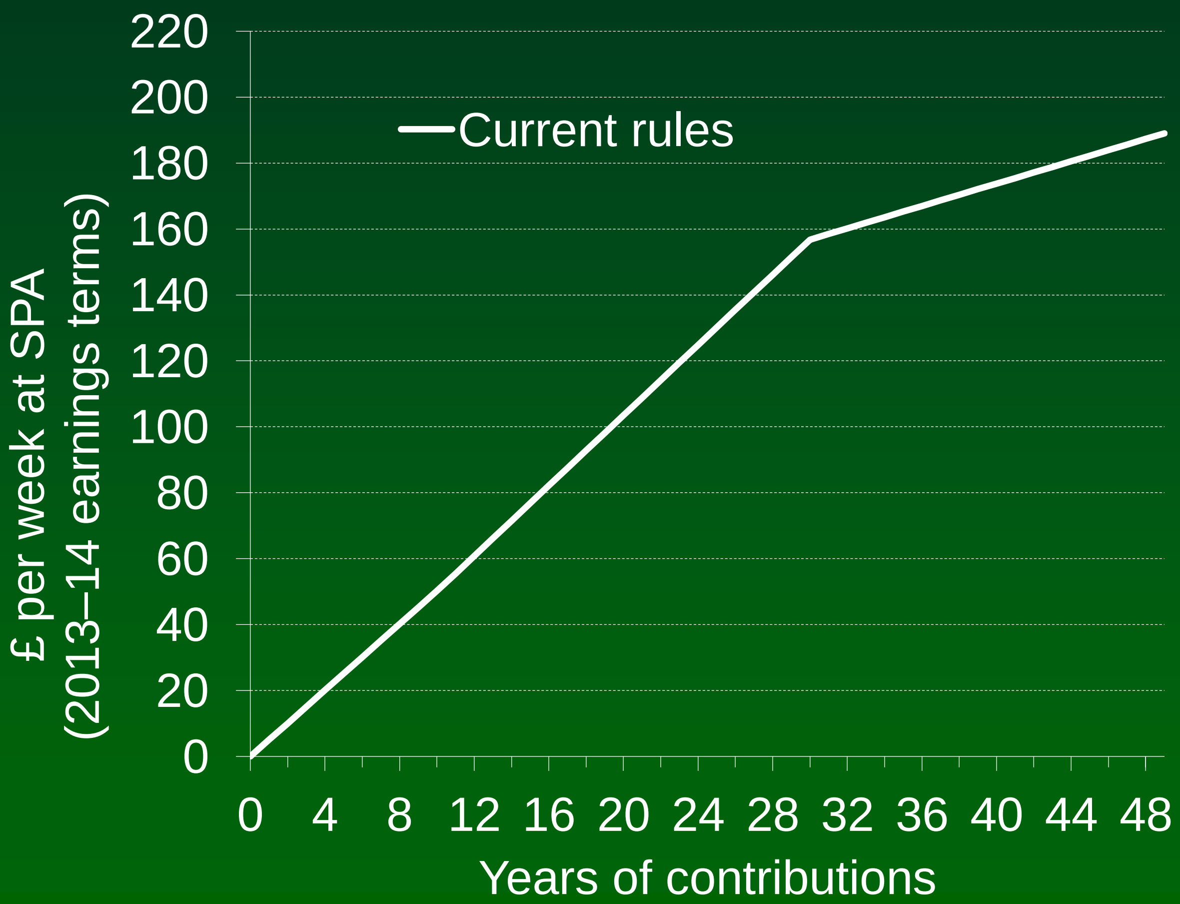
Weekly state pension income at SPA under current and proposed systems

Low earner or someone doing unpaid activity, born 1986



Notes: See Figure 5.1

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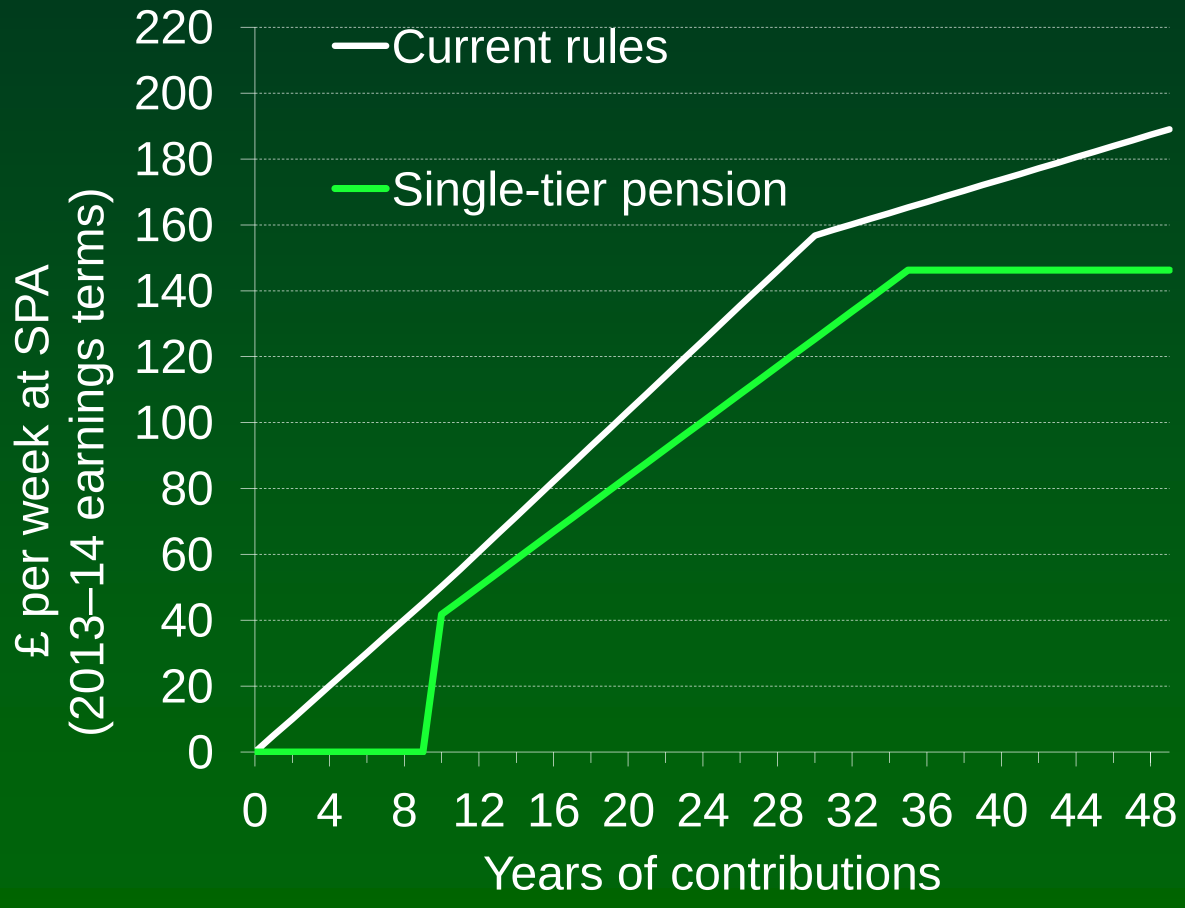
Weekly state pension income at SPA under current and proposed systems

Low earner or someone doing unpaid activity, born 1986



- Current system is more generous
- No entitlement with fewer than 10 years under the proposed system
- No incentive to make additional contributions after 35 years
- Differences larger for high earners

Notes: See Figure 5.1

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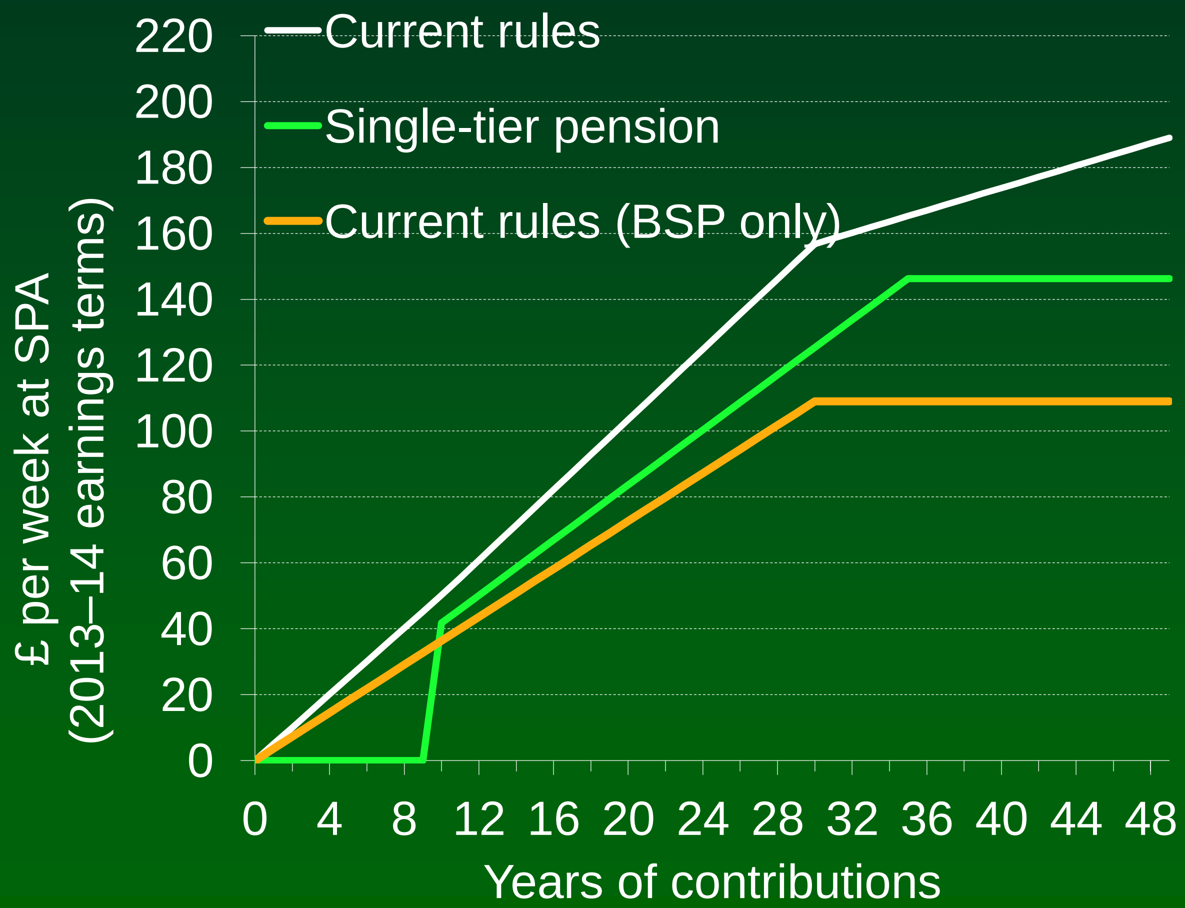
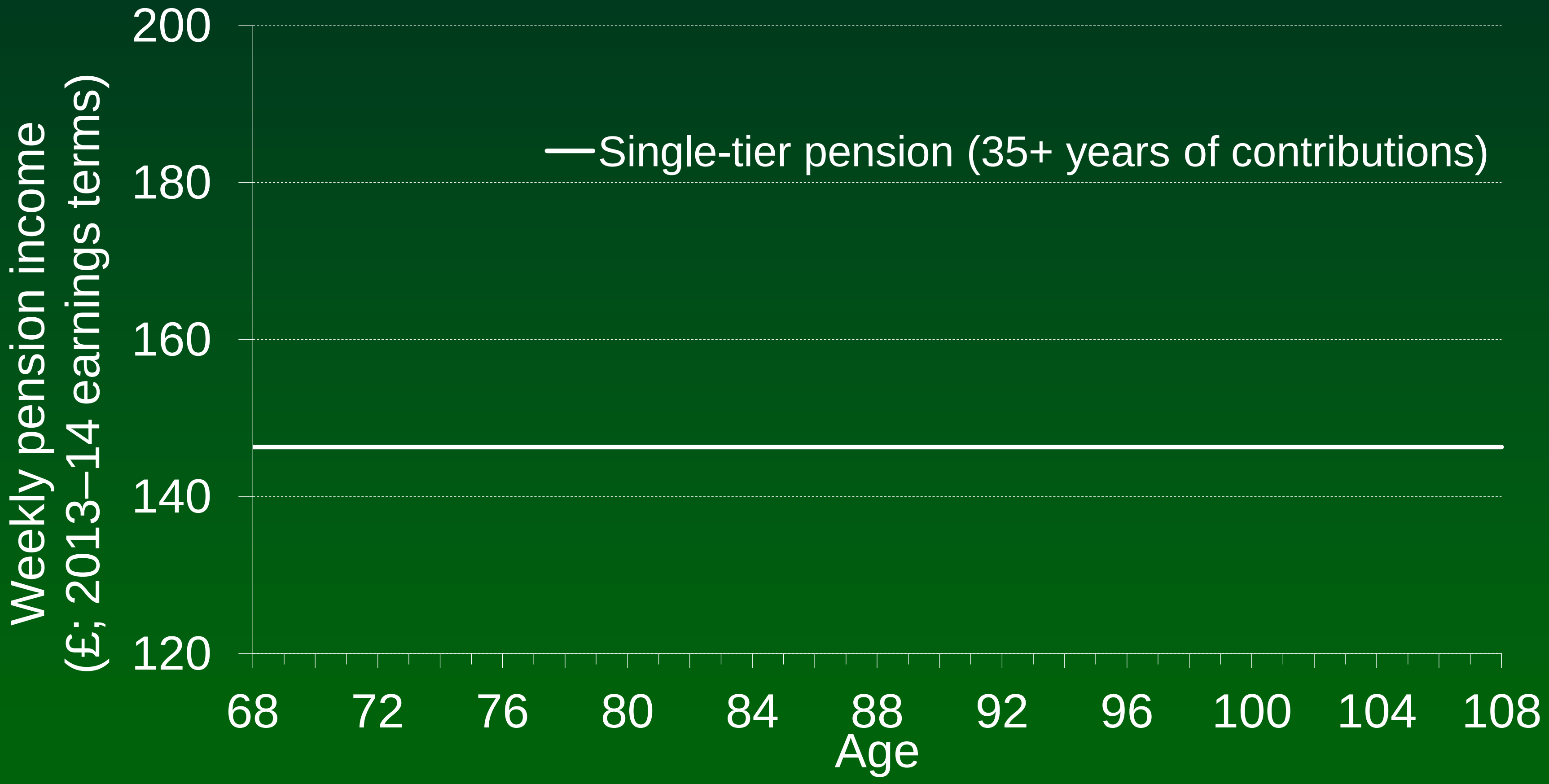
Weekly state pension income at SPA under current and proposed systems

Low earner or someone doing unpaid activity, born 1986



Notes: See Figure 5.1

Evolution of the state pension over retirement



Notes: See Figure 5.2

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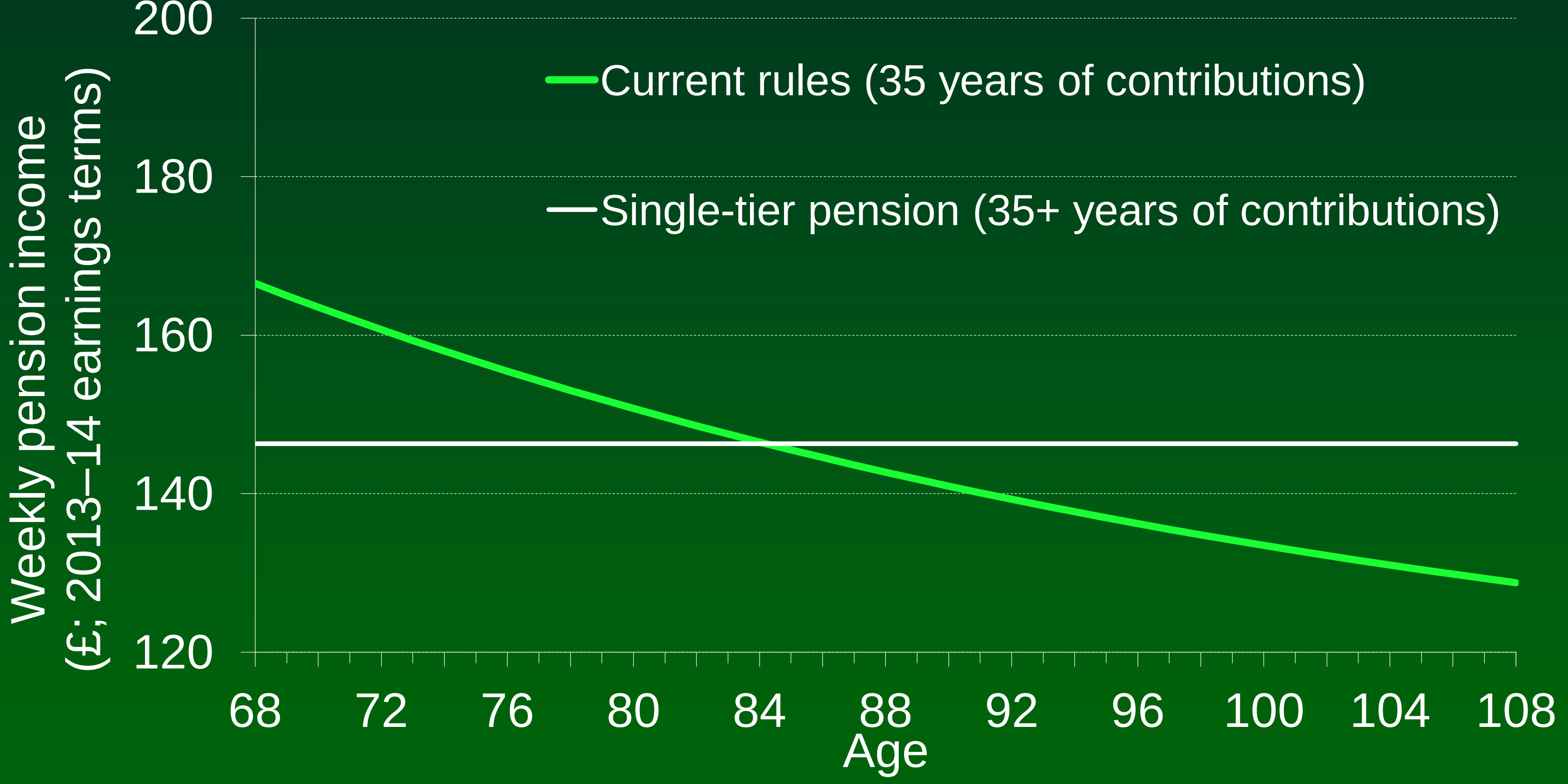
Evolution of the state pension over retirement



Notes: See Figure 5.2

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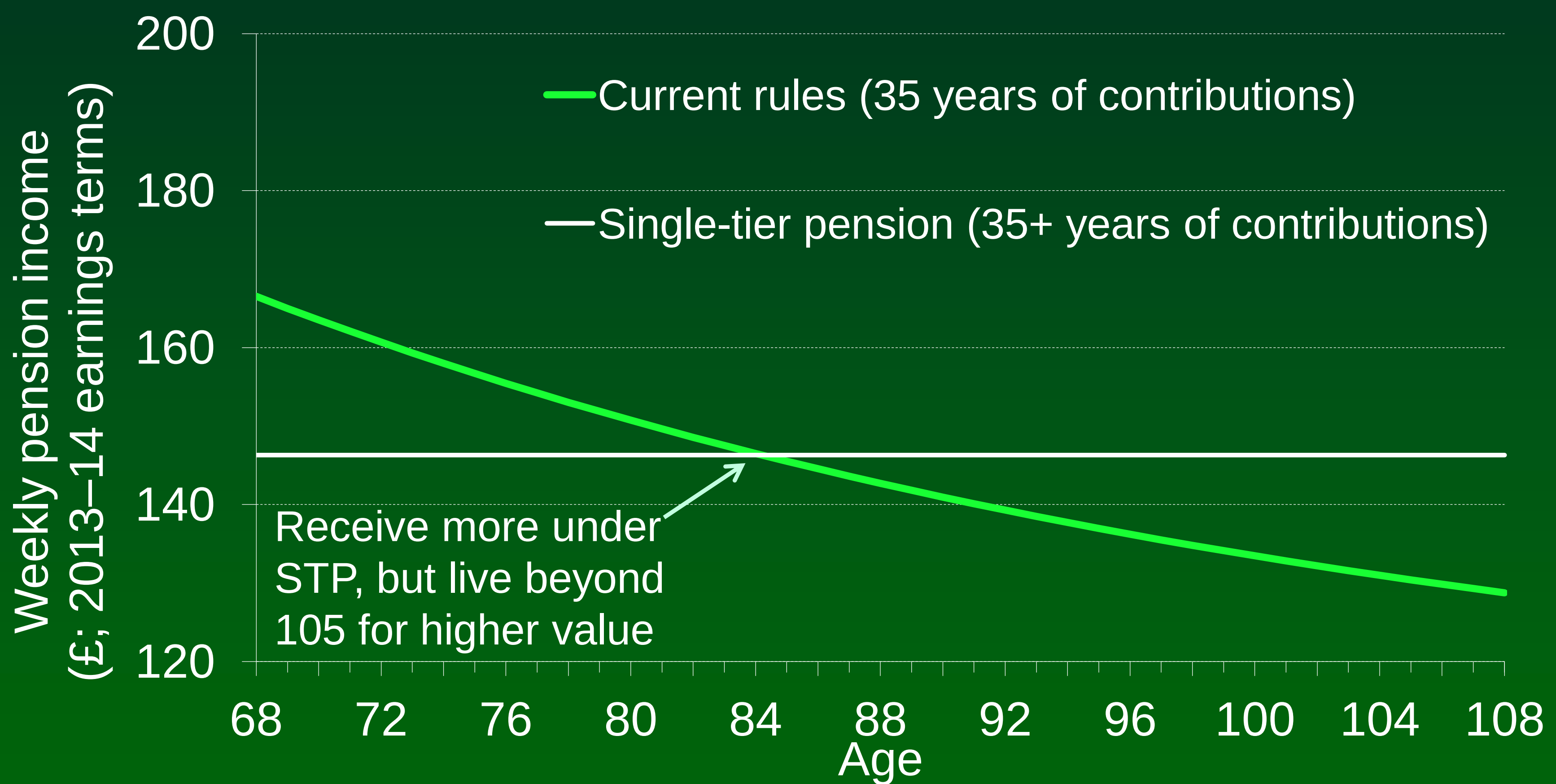
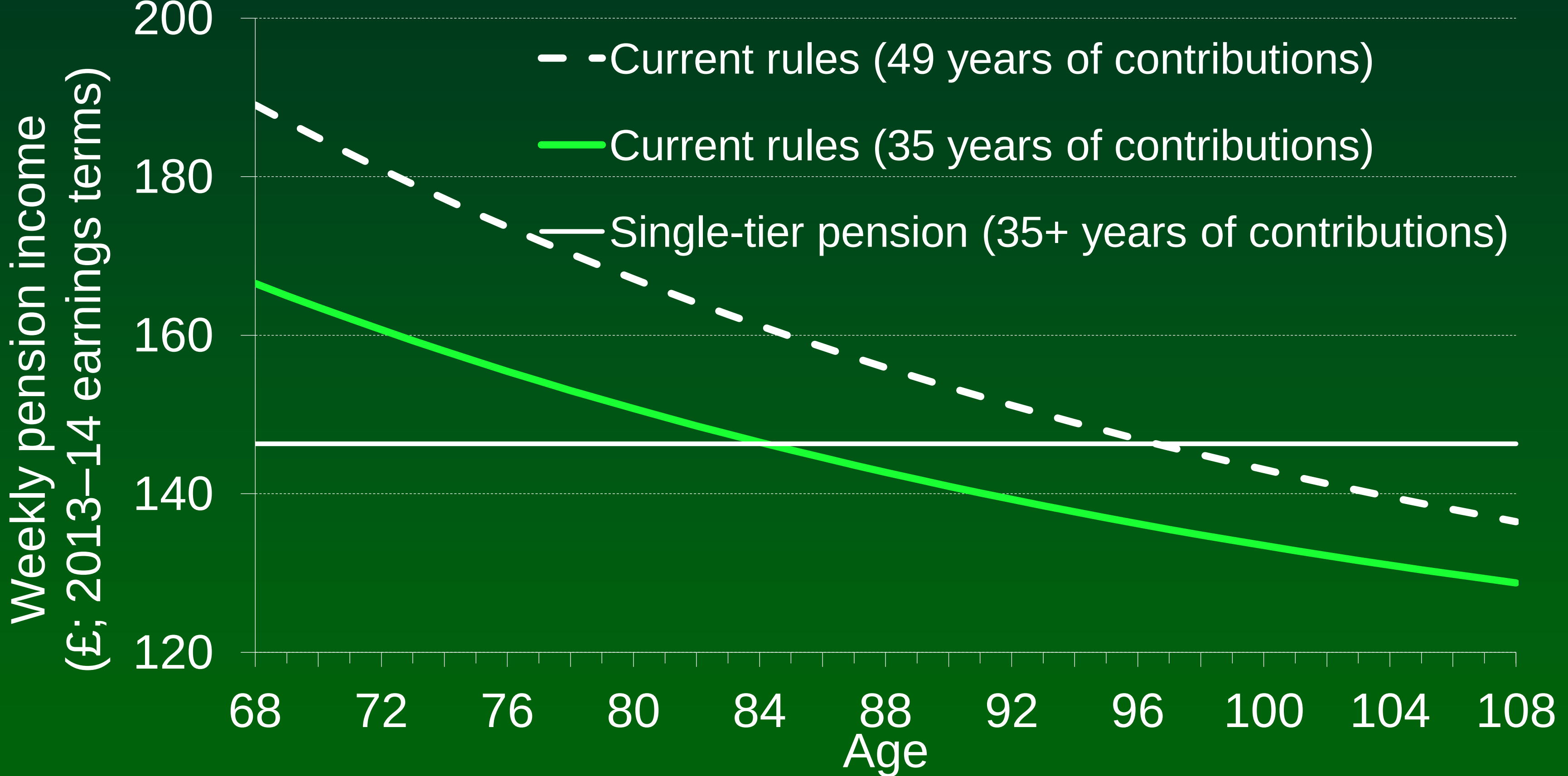
Evolution of the state pension over retirement



Notes: See Figure 5.2

Evolution of the state pension over retirement



Notes: See Figure 5.2

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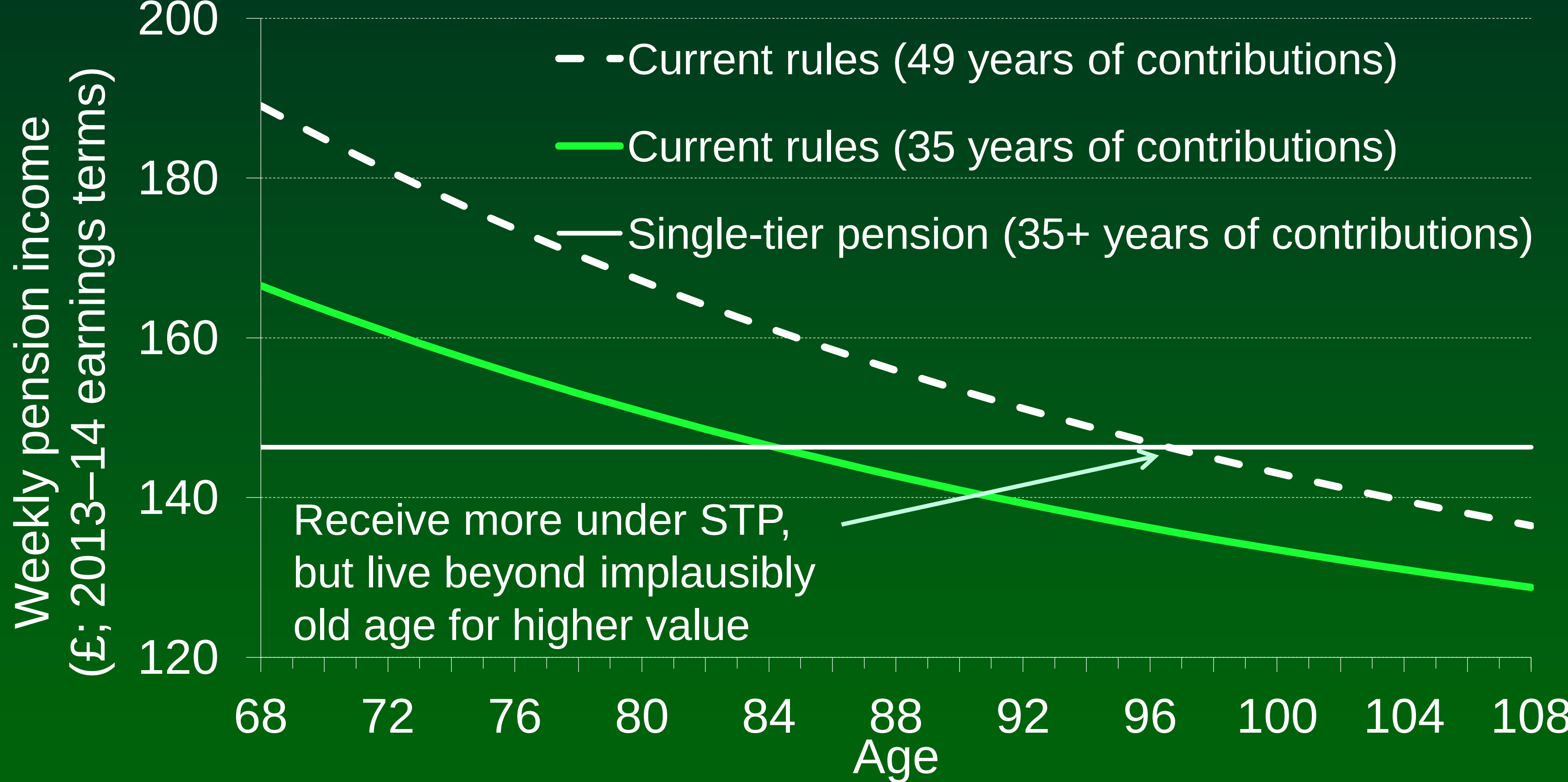
Evolution of the state pension over retirement



Notes: See Figure 5.2

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The self-employed

- Long-term self-employed could gain from the reforms, even in the long-run
- Extreme case of someone who would never accrue S2P:
  - £109 under current system
  - £146.30 under proposed system
- But...
- People rarely spend their entire lives in self-employment
  - Would need to have fewer than 31 years of other S2P-creditable activities (60% of working life)
  - Those born 1945-52 who were self-employed some time between 1975 and 2003, on average spent 55% of these years self-employed
- The self-employed currently pay lower NI contributions
  - Treasury yet to decide whether these should be aligned

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Means-tested benefits in the long-run: Pension Credit Savings Credit

- Being abolished as part of single-tier reforms
- But in the long-run it will become almost entirely irrelevant under the current system anyway as very few people likely to qualify
- Long-run abolition of PCSC is a coherent policy
  - As entitlement to S2P becomes more widespread among pensioners, PCSC effectively rewards ‘saving’ done through S2P.
- Further analysis in Section 5.4

Means-tested benefits in the long-run: Pension Credit Guarantee Credit

- For those who would qualify for BSP + S2P under current system
  - State pension income at SPA lower under proposed system
  - Would tend to increase fraction of people qualifying for PCGC
  - Between 28 and 34 years of entitlement: could qualify for PCGC under new system but not under current system
  - State pension income grows less quickly after SPA under current system: could fall on to PCGC later in retirement (after age 89 for low earner with 35 years under current system)
- For those who would only qualify for BSP under current system
  - Proposed reforms will increase state pension income (assuming at least 10 years of contributions)
  - Would tend to reduce number of people with sufficiently low income to qualify for PCGC

Wider implications in the long-run

- Our analysis suggests that in the longer-run, most people will receive less state pension income than they would under the current system
- Long-run fiscal projections suggest some further spending cuts or tax rises would be required to maintain sustainable debt level
- Single-tier proposals provide clarity about where at least some of the burden will fall
- Lower state pension income means those currently in their 20s and 30s will need to save more privately for retirement
  - Transparency and clarity of new system may aid decision-making

Conclusions

- Single-tier reforms are the latest in a long series of ‘radical’ reforms to state pensions in the UK since 1975
- These reforms will produce a state pension that looks rather like what was in place in 1974
  - Although with more crediting of non- and low earners
- In the short-run
  - Some people will gain: average gains larger for women and the long-term self-employed
  - Over the whole of retirement, virtually everyone gains something
  - Withdrawal of means-tested benefits reduces net gain to poorest
- In the long-run
  - Most people will receive lower state pension income than they would have done
  - Reduces Exchequer cost and improves fiscal sustainability
  - Those in their 20s and 30s will need to save more privately

A single-tier pension: what does it really mean?

Launch event, 11 July 2013

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