Institute for Fiscal Studies

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

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Preface

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Executive Summary

A significant reform of the UK's state pension system is currently being enacted. From 2016–17, the basic state pension and state second pension will be replaced by a new single-tier pension for everyone below the state pension age (SPA). This will bring an end to earnings-related state pension accrual in the UK. This marks the latest step on a long, tortuous and rather circular journey – a journey that started in the early 1970s with a basic state pension worth about £145 a week (in current earnings terms) and that has finally ended up in much the same place. The major difference between the 1974 system and the proposed new system is that the new system will be essentially universal, with considerably more extensive crediting of unpaid activities than was available in 1974.

Short-run effect of the proposed reform

We have been able to use a unique data set combining lifetime National Insurance contribution histories with detailed micro data from the English Longitudinal Study of Ageing to look at who will benefit from these reforms among the first generations of those reaching SPA from 2016. Of those living in England who will hit state pension age between 6 April 2016 and 5 April 2020, we estimate that:

- 18% of individuals (6% of men and 44% of women) would gain from the retrospective crediting of activities that, at the time, only gave entitlement to the basic state pension or to a low level of SERPS. This includes periods of self-employment, and periods of caring activities, childcare or low earnings before 2002.

- Overall, 35% of men and 61% of women (43% of individuals) would see their pension income at SPA increased as a result of the proposed reform. Many of these individuals will be benefiting from the ability to 'work off' previous periods of contracting out.

- 19% of individuals (21% of men and 14% of women) will find that the income they can expect at the state pension age under the proposed system is lower than they could have achieved under the current system.

- The average change in pension income at SPA across all individuals is an increase of £2.74; 7% of men and 26% of women would see an increase of at least £10 per week.

- Gains are largest among those who have spent periods out of the labour market caring for children and those who have had long periods of self-employment. The average gain among women is £5.23 per week; the average gain among those who have had more than 10 years in self-employment is £7.51 per week.

- Taking into account the more generous indexation of the state pension in retirement under the proposed system, 98% of individuals would benefit from the proposed reform over the whole of their life beyond SPA. Only 2% would lose; this is confined to those with fewer than 10 years of contributions and those who lose out from the abolition of derived pensions based on a partner's contribution record.

- However, some gains in state pension income will be offset by reductions in means-tested benefit entitlements, including those arising from the abolition of the pension credit savings credit. While 64% of individuals in the lowest wealth quintile would receive higher pension income as a result of the reforms, only 40% of them would find that their household's net income would be higher after taking into account reductions in means-tested pension credit.

Long-run effect of the proposed reforms

In the longer term, the new system will be less generous to just about everyone than the system that it is replacing. This certainly includes anyone born in 1986 or later and potentially includes cohorts born as early as 1966. That is because the accrual rate will be lower than the combined accrual rate of the basic state pension and state second pension, and because almost all the same activities create entitlement under the current regime as under the new one. Particularly worse off are those who contribute for longer, whether through paid employment, caring or receiving disability-related benefits.

Although the more generous indexation arrangements under the proposed system would narrow the gap between income under the current and the proposed system through retirement, most people would have to live to over 100 to be better off overall.

The only significant exceptions will be the long-term self-employed and people who will start to receive credits to the basic state pension (but not the state second pension) under universal credit. However, it remains to be seen whether the self-employed will be asked to pay higher National Insurance contributions, which could offset this gain.

Wider implications of the proposed reforms

The proposed reform may encourage private saving for three reasons. First, it will result in a reduction in the state pension income most younger individuals can expect, and therefore they may wish to increase their private saving to compensate for this. Second, the reform should also increase clarity about what individuals can expect to get from the state in retirement. This could lead to an increase in private saving either if it enables individuals to better engage with decisions about pension saving or if it makes individuals more aware of how little they can expect from the state.

The new system will be cheaper and simpler than the system it is replacing. The Department for Work and Pensions estimates that the new single-tier pension will reduce spending on state pensions by 0.4% of national income by 2060.[1] The new single-tier pension may therefore have a better chance of surviving than the multitude of reforms that have gone before, thereby ending a long period of large and frequent upheaval in the design of state pensions. But exact contributory conditions and indexation rules are still subject to change. Changing the latter in particular could substantially change the structure and generosity of the scheme. It is to be hoped that future governments refrain from such changes.

[1] This assumes that the triple lock continues beyond this parliament. (Department for Work and Pensions, 2013b.)

1. Introduction

In a White Paper published in January 2013, the Department for Work and Pensions (DWP) set out proposals for major reforms to the UK state pension system.[2] These proposals have now been developed into the Pensions Bill 2013–14.[3] The main part of the legislation is to combine the basic state pension (BSP) with the state second pension (S2P) to create a new 'single-tier' pension, which would be set at a level high enough to ensure that anyone with full entitlement would not qualify for the means-tested pension credit guarantee.[4] This single-tier pension is set to be implemented from April 2016.[5]

The government has said that these proposals will increase certainty, reduce inequality and take people out of means testing.[6] This report examines the proposals in detail and discusses how they compare with the existing pension rules and how they will affect different groups of people. We also discuss the wider implications of these reforms for individuals and for the current and future governments.

Chapter 2 starts by describing the current state pension rules, before Chapter 3 describes the proposed reforms in more detail. Readers who are very familiar with the current and proposed pension systems or those who are merely interested in the main results may wish to skip these chapters.

Complex transition issues mean that the short- and long-run effects of the proposed reforms are likely to be very different. Chapter 4 examines how the two systems would compare in the short run, making use of a unique new data set that links individuals' National Insurance contribution histories with detailed information about their socio-demographic, financial and health circumstances. Chapter 5 examines how the two systems compare in the long run. Chapter 6 discusses some of the broader implications of the proposed reforms – beyond income from the state in retirement – and discusses what the important lessons are for individuals and the current and future governments. Chapter 7 concludes.

This report focuses on the direct effects of the reforms on individuals' incomes in retirement. We therefore ignore some other important aspects of the reforms, such as the potential impact of the ending of contracting out on defined benefit pension schemes and their members.

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[2] Department for Work and Pensions, 2013a.

[3] http://services.parliament.uk/bills/2013-14/pensions.html.

[4] Specifically, the single-tier pension is expected to be set at £146.30 per week (in 2013–14 earnings terms). This is above the level of the pension credit standard minimum guarantee, which is £145.40 for a single adult in 2013–14.

[5] Page 5 of HM Treasury (2013).

[6] Department for Work and Pensions, 2013a.

2. Current State Pension System

To understand the effects of the proposed reforms, one first has to understand how the current state pension system operates. Therefore, we start by describing – as clearly as possible – how state pension entitlements under the current system are calculated and clarify in particular those features that are important when describing the proposed reforms in the next chapter.

The current state pension system is complicated: exactly how much state pension someone is entitled to at state pension age (SPA) depends not only on what economic activities they undertook during their working lives, but also on the years in which they did those activities and the date at which they reach SPA. These complications arise because, historically, when new pension policy has been introduced, existing pension rights accrued under old legislation have often been at least partially protected. In this chapter, we describe both how new pension entitlements are built up under current legislation (Section 2.1) and previous policies that still affect the state pension entitlements of some working-age adults (Section 2.2). Section 2.3 briefly describes what level of state pension income those who have recently reached state pension age receive.

2.1 Current accrual under the existing state pension system

The UK state pension system currently consists of two (notionally contributory) components: the basic state pension (BSP) and the state second pension (S2P). These are payable from the SPA. The SPA is currently 65 for men; it is increasing gradually for women and will reach 65 in 2018. Thereafter, the SPA for both men and women will increase, reaching 66 in 2020.[7]

Each year, people engaged in a range of paid and unpaid activities accrue entitlement towards both of these systems. As shown in Table 2.1, this includes anyone earning above the lower earnings limit (LEL, currently £109 per week), receiving child benefit for a child aged 11 or under, caring for a sick or disabled adult for at least 20 hours a week, or in receipt of employment and support allowance (ESA). In addition, a further, smaller group of people accrue entitlement only to the BSP. This includes the self-employed and those in receipt of short-term unemployment benefits (jobseeker's allowance, JSA).

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[7] There are further increases to the SPA planned in 2026–2028 (to 67), and then again in 2044–2046 (to 68). For the government's timetable, see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181343/spa-timetable.pdf.

Table 2.1. How different activities are currently treated by the state pension system

Activity	Earns entitlement to BSP?	Earns entitlement to S2P?
Earning > LEL	✓	✓
Caring for child aged ≤ 11	✓	✓
Foster carer	✓	✓
Caring for sick or disabled adult (20+ hours per week)	✓	✓
Incapacity or limited capability for work[a]	✓	✓
Maternity allowance	✓	×
Statutory maternity/paternity/ adoption/sick pay	✓	×
Working tax credit	✓	×
Jobseeker's allowance	✓	×
Self-employment	✓	×
Universal credit[b]	✓	×

[a] Entitlement to severe disablement allowance earns individuals entitlement to both BSP and S2P. Entitlement to incapacity benefit and employment & support allowance earns individuals entitlement to BSP and, with some extra conditions, to S2P.
[b] Once universal credit is rolled out, some of those who would not otherwise be credited under existing crediting arrangements, and who receive housing benefit or child tax credits, or whose partner receives working tax credit, will earn credits towards the BSP. All members of benefit units receiving universal credit will earn credits towards the BSP.
Note: In addition to the activities listed in the table, the following activities also earn entitlement towards the BSP: jury service, wrongful imprisonment, being the partner of a member of the armed forces posted overseas, being on an approved training course.
Source: Department for Work and Pensions, 2013c.

The BSP is a flat-rate pension, currently worth £110.15 per week, which is payable to all individuals with 30 or more years of National Insurance (NI) contributions or credited activities. Individuals with fewer than 30 years of accrual are entitled to the BSP on a pro-rata basis. For example, an individual with 10 years of contributions would be entitled to a pension of $^{10}/_{30}$×£110.15 = £36.72 per week. Each additional year of entitlement is therefore worth £3.67 per week of extra pension ($^{1}/_{30}$×£110.15) until the maximum entitlement is achieved.

The second component, S2P, is somewhat more complicated since the entitlement accrued for a given year of activity is (currently) related to an individual's earnings in that year:[8]

[8] In each year, pensions are uprated with lagged earnings/price growth. For example, in 2014–15, existing S2P accrual will be revalued according to average earnings growth between 2012 and 2013. When we present figures in 2013–14 earnings terms, we are deflating by contemporaneous earnings growth. As average earnings growth is projected either to increase or to be flat over the next few decades, this means that when we present future parameters of the pension system in

- Anyone earning between the LEL and the lower earnings threshold (LET) or engaged in other creditable activities (as detailed in Table 2.1) accrues entitlement to a flat-rate amount of S2P income. A year of flat-rate accrual is equal to approximately £1.70 of weekly pension income.[9]
- Anyone earning above the LET accrues entitlement to this same flat-rate amount but also accrues additional entitlement that is proportional to the level of their earnings between the LET and the upper accrual point (UAP). The maximum S2P entitlement one can currently accrue in 2013–14 terms is approximately £2.76.

Additional S2P entitlement can be accrued for every year of working life. The maximum potential length of working life depends on one's SPA: for example, someone who turned 16 in 1978[10] (with a SPA of 67 under the latest proposals) has a potential working life of 51 years (from age 16 to age 66, inclusive).

To illustrate how accruals operate under the current system, Box 2.1 describes three example people and explains how much extra state pension income they

Box 2.1. Examples of future state pension accrual under current legislation

The following examples describe hypothetical individuals in the year 2016. All monetary figures are expressed in 2013–14 earnings terms.

Lucinda is 35 years old, is employed and earns £900 a week. She regularly saves money into a personal pension and also receives a pension contribution from her employer. In return for paying National Insurance contributions on her earnings for a year, Lucinda will accrue extra state pension income worth £6.20 per week, which she will receive from the age of 68.

Jacob is 29 years old, is employed and earns £115 per week. He does not save in a private pension. In return for paying NI contributions on his earnings for a year, Jacob will accrue extra state pension income worth £5.30 per week, which he will receive from the age of 68.

Yousef is 58 years old and spends 35 hours a week caring for his mother. Between the ages of 20 and 55, he was self-employed and paid class 2 NI contributions; he therefore already has full entitlement to the BSP. In recognition of his caring responsibilities, Jacob will accrue extra state pension income worth £1.70 per week, which he will receive from the age of 66.

2013–14 earnings terms, they will appear to be slightly lower than the nominal thresholds today. We assume that average earnings growth evolves as forecast by the Office for Budget Responsibility (Q2 average earnings growth from the Economy Supplementary Tables accompanying Office for Budget Responsibility (2013)).

[9] This 'flat-rate accrual amount' is set in legislation and uprated with average earnings growth each year.

[10] Earnings-related state pension accrual began in April 1978.

would be able to get given their behaviour. We will return to these people again in Chapter 3 when we describe the new system.

Going forwards, thresholds within the S2P system are set to evolve in such a way that, eventually, new accruals will be entirely flat-rate. This is set to be the case from about 2030 onwards. At this point, anyone qualifying for S2P accrual in a year will accrue the same flat-rate amount, equal to £1.69 in 2013–14 earnings terms.[11]

Accrued entitlements to the BSP and S2P are uprated from the year in which they are earned to SPA in roughly the same way as each other – that is, both are by default uprated by growth in average earnings.[12] However, from the SPA onwards, the two components of state pension income are currently indexed differently: S2P income is by default increased in line with growth in the consumer price index (CPI), while the BSP is increased at least in line with the growth in average earnings.

At the moment, there are four key differences between how S2P and BSP are accrued and how they are each uprated:

1. The number of years for which one can contribute and earn extra entitlement to the two components differs: extra entitlement to the BSP can be earned for up to a maximum of 30 years, whereas extra entitlement to the S2P can be earned for each year of working life.

2. The range of activities that are regarded as 'creditable' towards the two components differ slightly, as described in Table 2.1.

3. The amount of S2P accrued depends on how much an individual earns in a given year.

4. The two components are indexed differently through retirement: the BSP is uprated at least in line with average earnings and S2P in line with prices.

There is one further major difference between S2P and BSP: members of employer-provided defined benefit pension schemes can 'contract out' of S2P – that is, they pay lower NI contributions in return for reduced rights to S2P. However, they are only able to do this if they belong to an employer-provided defined benefit scheme that is considered to offer a pension at least as generous as the S2P they are forgoing. Therefore, while these individuals receive lower state pension income, they are nonetheless required to build up the equivalent level of additional private pension income.

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[11] Throughout the remainder of this report, we will express all figures for state pension income in 2013–14 earnings terms – that is, cash amounts received in the future will be deflated by (forecast) growth in average earnings from the year in question to 2013–14.

[12] S2P entitlements are always uprated by growth in average earnings. The current government has committed to more generous indexation arrangements for the BSP for the duration of this parliament – namely, indexing the BSP by the greatest of growth in average earnings, CPI inflation and 2.5% (https://www.gov.uk/government/publications/the-coalition-documentation).

Since S2P is set to become flat-rate, in the long run the third of the differences listed above will disappear, leaving only really three differences between the BSP and S2P components that prevent the current state pension system from becoming de facto single-tier. New accruals will become flat-rate from about 2030, although the first cohort to experience entirely flat-rate accrual will not reach SPA until around 2082.

When considering the impact of the proposed new system, it is important to bear in mind that, even in the absence of the reforms proposed by the White Paper, the current state pension system will evolve into a near single-tier pension with extensive crediting for periods of unpaid activity. The long-run implications of the proposed pension reforms should be discussed relative to this baseline.

2.2 Historic pension legislation and its continuing implications

The differences between the proposed pension system and the current system have been overstated in some of the public debate, largely because of a short-run focus on how the accrued pension rights of those currently close to the SPA would change under the new system. These individuals' rights are significantly affected by old legislation. In this section, we describe briefly the important aspects of historic pension legislation that still affect working individuals' future state pension incomes.[13] These factors are important for the groups considered in Chapter 4.

Basic state pension

The BSP was first introduced in 1948. Changes over time since then have affected what activities are credited towards the BSP, how many years of contributions or credits are required to achieve the maximum BSP entitlement, and how the level of the BSP changes over time. In order to make comparisons between the pension entitlements of current working-age individuals under the existing and proposed state pension systems, it is only important to understand the first of these.

Until 1975, individuals had to be making flat-rate NI contributions to accrue an entitlement to the BSP. Under various conditions, one could earn credits for unemployment and incapacity for work, and over time the range of activities for which one can earn credits has expanded; the most important of these changes are summarised in Table 2.3 later. From 1978, anyone who was caring for a child aged under 16 was afforded 'home responsibilities protection' (HRP).[14] For those

[13] We do not discuss here any features of previous pension legislation that do not affect the entitlements of people who are yet to reach the SPA. For a fuller description of the history of the UK state pension system, see Bozio, Crawford and Tetlow (2010).

[14] The individual had to be in receipt of child benefit for a child aged under 16 (or under 18 if the child was still in full-time education).

currently aged under the SPA, these years of HRP are counted as years of contributions towards the BSP.[15]

The implication of this change over time in crediting arrangements is that individuals who have spent their lives doing identical activities can have different BSP entitlements at retirement depending on when they did those activities. For example, women who spent time out of the labour market looking after children will have lower BSP entitlement if those child-caring years occurred before 1978 than if they occurred after 1978.

Earnings-related pensions

During the four decades between 1960 and 2000, additional elements were added to the state pension system (and subsequently amended) to provide a top-up to the BSP that was related to the level of individuals' earnings. The first of these was the graduated retirement pension (GRP), which was in place from 1961 to 1977, followed by the State Earnings-Related Pension Scheme (SERPS) from 1978 to 2001, and finally S2P, which has been in place since 2002.

Maximum GRP entitlements are very low, first because it was not in place for very long and second because accrued rights have not been fully uprated in line with prices over time. For those reaching SPA in 2013–14, the maximum amount of GRP that can be received is £11 per week.[16] Anyone reaching the age of 16 after 1977 (reaching SPA from 2028 onwards) will not have accrued any GRP. SERPS and S2P entitlements are much larger and more significant when considering what pension individuals will get under the current and proposed state pension systems.

SERPS accrual depended simply on the level of one's earnings in a given year. Individuals accrued SERPS entitlement equal to $^{1}/_{49}$[17] of 20% of earnings between the LEL and the upper earnings limit (UEL).[18] The key differences between SERPS and S2P are that S2P is more generous to lower earners and S2P also covers individuals engaged in some other unpaid creditable activities (illustrated in Table 2.2). S2P accrual operates as described in Section 2.1.

[15] The maximum number of years of HRP that any person can have accrued prior to 2010 is capped at 22 years. From 2010, individuals have been awarded National Insurance credits rather than a year of HRP, with no limit on the number of years of credits that can be accrued.

[16] Government Actuary's Department, 2013. One could have accrued at most 86 GRP units, each worth £0.1279 in 2013–14.

[17] The divisor actually depends on the length of working life since 1978: it is at most 49 for those reaching SPA at the age of 65, but increasing along with increases to the SPA (for example, to 51 for those reaching SPA at the age of 67).

[18] The accrual rate was originally 25%, when SERPS was introduced. However, the accrual rate was reduced to 20% for later cohorts and all those potentially affected by the single-tier pension proposals face an accrual rate of 20%.

Table 2.2. Key differences between SERPS and S2P

<table>
<tr><th></th><th>SERPS</th><th>S2P
2002–2012</th><th>S2P
2013–</th></tr>
<tr><td>Earn at the LEL, or receiving NI credits for particular activities</td><td>No entitlement</td><td rowspan="2">Credited earnings topped up to the LET, entitlement based on LET–LEL</td><td rowspan="2">Accrue flat-rate £1.70</td></tr>
<tr><td>Earnings between LEL and LET</td><td rowspan="2">Accrual based on earnings above the LEL</td></tr>
<tr><td>Earnings between LET and UEL</td><td colspan="2">Earnings-related entitlement based on earnings above the LET[a]</td></tr>
</table>

[a] S2P accruals are based on earnings up to the UAP (£770 per week in 2013–14) from 2009. This earnings-related component of S2P is set to disappear for new accruals after about 2030.

Table 2.3. Components of the UK state pension system over time

	1948–1960	1961–1977	1978–2001	2002–2029	2030 onwards
Components:					
Flat-rate	BSP	BSP	BSP	BSP	BSP, S2P
Earnings-related	–	GRP	SERPS	S2P	–
Components entitled to for year of activity:					
Earning < LEL[a]	–	–	–	–	–
Earning ≥ LEL[a]	BSP	BSP, GRP	BSP, SERPS	BSP, S2P	BSP, S2P
Caring for a child aged < 6	–	–	BSP	BSP, S2P	BSP, S2P
Caring for a child aged 6–11	–	–	BSP	BSP, S2P	BSP, S2P
Caring for a child aged 12–16	–	–	BSP	BSP[b]	–
Self-employment	BSP	BSP	BSP	BSP	BSP
Unemployment	BSP	BSP	BSP	BSP	BSP
Incapacity for work	BSP	BSP	BSP	BSP, S2P	BSP, S2P

[a] NI contributions are assessed in each job that an individual has. Therefore, individuals must be earning above the LEL in at least one job that they hold in a given year in order to qualify for BSP. In future, those receiving universal credit who are in multiple part-time jobs will be able to earn credits towards the BSP on the basis of their total earnings.
[b] No longer the case from April 2010.
Note: Unemployment benefits credited for BSP entitlement include unemployment benefit 1975–1994, then contributory jobseeker's allowance since 1995. Incapacity for work covers those receiving sickness benefit 1975–1994, severe disability allowance since 1984, incapacity benefit since 1995 (only long-term claimants satisfying a labour market test earned credits for S2P) and employment & support allowance since 2008.
Source: Department for Work and Pensions, 2013c.

For individuals reaching the SPA over the next 69 years, exactly how much earnings-related pension they will get under the current system will depend on exactly how much they earned, in which years, whether or not they have contracted out, and whether or not they have done other creditable activities since 2002.

The different components of the state pension in existence over time, and the activities for which an individual could accrue entitlement to each component, are summarised in Table 2.3.

Contracting out

Since the introduction of SERPS in 1978, it has been possible to 'contract out' of the state second-tier pension. This means that individuals did not accrue any SERPS/S2P entitlement, but in exchange they (and their employer) paid lower NI contributions to the state.[19] However, these individuals were required to be members of a private pension scheme that would pay them a pension that was expected to be at least as great as the second-tier state pension income forgone. In other words, an individual who was contracted out should be expecting to receive essentially the same (or more) total pension income as an otherwise-equivalent individual who has been contracted in, but less of this income will come from the state and more will come from a private pension.

Until 1987 (and since April 2012), it was only possible to contract out into a defined benefit pension scheme.[20] Between 1987 and March 2012, it was also possible to contract out into a defined contribution scheme.

A significant fraction of workers have contracted out of the second-tier state pension for large parts of their working lives. These individuals will appear to receive a relatively low state pension income in retirement but they will also enjoy the benefits of the higher private pension income made possible by the lower NI that they have paid to the state.

Derived and inherited rights

Some individuals arrive at SPA with very low entitlements to state pension in their own right. The prevalence of this has diminished over time as more

[19] This statement is a simplification of the current system in two ways. First, individuals earning between the LEL and the LET actually do now accrue some residual S2P entitlement. We abstract from this issue in the text. Second, the exact arrangements for NI for those who are contracted out depend on whether an individual was contracted out into a defined benefit (DB) or a defined contribution (DC) pension scheme. DB pension members (and their employers) pay lower NI contributions to the government. DC pension members pay the same NI contributions as contracted-in individuals but some of these contributions are then transferred by the government into their private pension scheme. The overall effect – that the net contribution paid to the state is lower – is approximately the same for each group. We therefore abstract from this technicality in the text and simply talk about contracted-out individuals 'paying lower net contributions to the state'.

[20] Before 1987, it was also possible to contract out into an S226 scheme, which is a pension specifically for self-employed people.

extensive crediting has been made available for periods of unpaid activity. However, there are still some individuals who can expect to reach SPA with less than full entitlement to the BSP, particularly those who have spent long periods outside the UK. Under the current system, provisions are in place to allow such individuals to boost their state pension income on the basis of their spouse's (or former spouse's) contributions.

A married (or civilly partnered) individual will receive 60% of their spouse's (civil partner's) BSP entitlement, if this is greater than his or her own BSP entitlement. This rises to 100% of their spouse's (partner's) entitlement after the partner dies.[21] Individuals can also inherit up to 50% of their spouse's SERPS and S2P entitlements when their spouse dies.

Up to 1977, women could elect to pay the 'married woman's reduced rate'. Women who elected to do so paid lower NI contributions and in return built up no BSP or SERPS/S2P entitlement. After 1977, no one was able to start paying the reduced rate but, under certain conditions, those who had already opted in could continue paying it. Only approximately 3,000 women are still paying National Insurance contributions at the reduced rate,[22] but those who opted to pay it in the past will potentially have relatively poor NI contribution histories. For this

Box 2.2. Examples of state pension entitlements under current legislation

The following examples describe hypothetical individuals with specific career histories up to 2016. All the individuals described were born in 1957 and started their careers at age 21, in 1978. All monetary figures are expressed in 2013–14 earnings terms.

Zainab has been continuously self-employed since the age of 21. Under current legislation, by 2016 she will have accrued full entitlement to the BSP but will have no SERPS or S2P entitlement, as she has always been self-employed. She therefore expects to get £109 a week of state pension income from age 66.

Mohammed has always been employed on moderate earnings. He has never contracted out. By 2016, Mohammed will have accrued entitlement to a total of £184 a week of state pension income from age 66. This comprises £109 from the BSP plus £75 of additional pension.

Ava has the same career history as Mohammed but has always been a member of her employer's occupational pension scheme and contracted out of the state second-tier pension. By 2016, Ava will have accrued entitlement to £121 of weekly state pension income. This comprises £109 from the BSP plus £12 of S2P entitlement.

[21] Slightly different arrangements exist for divorced people who have not remarried; see, for example, Bozio, Crawford and Tetlow (2010) for details.

[22] See Department for Work and Pensions (2013d) for further details of derived and inherited rights.

group in particular, the ability to derive rights from one's partner's contributions remains especially important.

To help clarify some of the points mentioned in this section, Box 2.2 describes – for some illustrative individuals with particular career histories – what state pension income people will receive under the current pension rules.

2.3 Pension income received under the current system

In March 2012, the average weekly state pension paid to those aged 65–69 was – in 2013–14 earnings terms – £111.83 (the average was £129.50 for men and £95.57 for women).[23] These figures are well below the maximum possible amount that men and women of these ages could have accrued if they had a full record of contributions to the BSP and second-tier state pension. Our calculations imply that the maximum state pension entitlement someone from this group could have accrued is around £282. While these lower levels of pension in receipt arise largely because most individuals will not have been continuously employed throughout their working-age years, they also reflect the fact that large numbers of people have spent periods contracted out.

As female labour market participation has increased over the past few decades, the number of women qualifying for a full BSP has increased, and reliance on derived pensions is decreasing. Furthermore, a change to the BSP affecting those retiring after 2010 reduced the required number of years of NI credits to qualify for a full BSP from 39 to 30, so state pension entitlement should be higher particularly for later cohorts of women. DWP estimates that, by 2015, around 85% of women will qualify for a full BSP in their own right.[24]

[23] Source: http://tabulation-tool.dwp.gov.uk/5pc/sp/tabtool_sp.html.

[24] Department for Work and Pensions, 2006.

3. Proposed Reforms

The main proposal of the Pensions Bill 2013–14 is to combine the basic state pension (BSP) with the state second pension (S2P) to create a new single-tier pension. Alongside this, the Bill proposes abolishing the pension credit savings credit. We describe the single-tier pension in more detail in Sections 3.1 and 3.2, before discussing the transition issues in Section 3.4. Section 3.3 discusses the specific issue of contracting out. Section 3.5 describes pension credit and what the implications of abolishing the savings credit would be.

3.1 The proposed single-tier pension

Under the Pensions Bill proposals, from April 2016 anyone earning above the lower earnings limit (LEL) or engaged in a number of other types of 'creditable' activities would accrue entitlement to a flat-rate amount of future state pension income. The list of creditable activities is set out in Table 3.1 – the first two columns of this table repeat what was presented in Table 2.1 for the current system. Essentially the same set of creditable activities that currently earn an individual entitlement to the BSP would also earn an individual entitlement to the single-tier pension, but these are a slightly broader set of activities than those for which an individual currently earns entitlement to S2P.

The amount accrued in any given year would be equal to $^1/_{35}$ of the full single-tier pension amount, irrespective of which of these creditable activities an individual was doing or exactly how much they paid in National Insurance (NI) contributions. In other words, an individual would need 35 years of any type of 'contributions' in order to receive the full single-tier pension.

Once an individual had accrued 35 years of entitlement, they would earn no more entitlement for additional years of creditable activities or payment of NI contributions. The Pensions Bill also proposes that individuals who accrue less than some minimum number of years of contributions will receive no state pension at all; the White Paper suggested this minimum should be no more than 10 years of contributions (this was increased from the Green Paper, which originally proposed a minimum of 7 years).[25] Figures presented in this report assume that the threshold is set at 10 years.

The exact level of the proposed single-tier pension is yet to be finalised, but the White Paper suggested that it should be £146.30 per week (in 2013–14 earnings terms). This level would be sufficient to ensure that no individual with full entitlement would qualify for the means-tested pension credit standard

[25] Pensions Bill – http://www.publications.parliament.uk/pa/bills/cbill/2013-2014/0006/2014006.pdf. White Paper – Department for Work and Pensions, 2013a. Green Paper – Department for Work and Pensions, 2011.

minimum guarantee (which is £145.40 a week for a single person in 2013–14).[26] If the flat-rate pension were set at £146.30 per week, each year of accrual would be worth £4.18 of state pension income (= $^1/_{35}$×£146.30). In the remainder of this report, we assume that the single-tier pension will be set at this level. This is in line with the assumptions underlying the policy costings that were published by the Department for Work and Pensions (DWP).[27]

To illustrate how state pension accrual would work under the proposed system, Box 3.1 describes three example individuals – these are the same individuals described in Box 2.1.

Table 3.1. How different activities are treated by the current state pension system and the single-tier pension

Activity	Earns entitlement to BSP?	Earns entitlement to S2P?	Earns entitlement to single-tier pension?
Earning > LEL	✓	✓	✓
Caring for child aged ≤ 11	✓	✓	✓
Foster carer	✓	✓	✓
Caring for sick or disabled adult (20+ hours per week)	✓	✓	✓
Incapacity or limited capability for work[a]	✓	✓	✓
Maternity allowance	✓	×	✓
Statutory maternity/ paternity/adoption/sick pay	✓	×	✓
Working tax credit	✓	×	✓
Jobseeker's allowance	✓	×	✓
Self-employment	✓	×	✓
Universal credit[b]	✓	×	✓

[a] Entitlement to severe disablement allowance earns individuals entitlement to both BSP and S2P. Entitlement to incapacity benefit and employment & support allowance earns individuals entitlement to BSP and, with some extra conditions, to S2P.
[b] Once universal credit is rolled out, some of those who would not otherwise be credited under existing crediting arrangements, and who receive housing benefit or child tax credits, or whose partner receives working tax credit, will earn credits towards the BSP. All members of benefit units receiving universal credit will earn credits towards the BSP.
Note: In addition to those activities listed in the table, the following activities also earn entitlement towards the BSP and the single-tier pension, but not S2P: jury service, wrongful imprisonment, being the partner of a member of the armed forces posted overseas, being on an approved training course.
Source: Department for Work and Pensions, 2013c.

[26] Some individuals might still be entitled to more than the pension credit standard minimum guarantee level: for example, carers and the severely disabled may receive up to £110.60 extra a week of guarantee credit.

[27] Department for Work and Pensions, 2013b.

Box 3.1. Examples of future state pension accrual under the single-tier system

The following examples describe hypothetical individuals in the year 2016. All monetary figures are expressed in 2013–14 earnings terms.

Lucinda is 35 years old, is employed and earns £900 a week. She regularly saves money into a personal pension and also receives a pension contribution from her employer. Under the single-tier system, in return for paying National Insurance contributions on her earnings for a year, Lucinda will accrue extra state pension income worth £4.20 per week, which she will receive from the age of 68.

Jacob is 29 years old, is employed and earns £115 per week. He does not save in a private pension. In return for paying NI contributions on his earnings for a year, Jacob will accrue extra state pension income worth £4.20 per week, which he will receive from the age of 68.

Yousef is 58 years old and spends 35 hours a week caring for his mother. Between the ages of 20 and 55, he was self-employed and paid class 2 NI contributions; he will therefore already have accrued a full 35 years of entitlement to the single-tier pension. Yousef's caring responsibilities will therefore accrue him no extra state pension income.

The White Paper suggested that the level of the single-tier pension should be increased at least in line with growth in average earnings. The BSP is bound in legislation to increase each year at least in line with average earnings growth, though this government has committed to triple lock it (increase by the greatest of CPI inflation, average earnings growth and 2.5%) until the end of this parliament.

In its Impact Assessment of the reform,[28] DWP assumed that the single-tier pension would be increased indefinitely in line with the triple lock. Throughout this report, we have chosen to illustrate the impact of the single-tier pension policy assuming that both the BSP and the single-tier pension are uprated beyond the end of the current parliament by average earnings growth rather than a triple lock. This is both because it makes description of the policies clearer and because it does not seem plausible or desirable to keep in place a policy that, in the very long run, implies state pension entitlements becoming larger and larger relative to average earnings.[29]

[28] Department for Work and Pensions, 2013b.

[29] In producing long-term forecasts for the public finances, the Office for Budget Responsibility assumes that the triple lock implies an average 0.26 percentage point per year increase in the BSP above average earnings growth, an assumption that was adopted by DWP when producing its Impact Assessment of the recent White Paper reforms. This ratchet implies that state pension entitlements will become larger and larger each year relative to average earnings.

3.2 Ending derived and inherited pensions

The single-tier pension will provide more extensive crediting of unpaid activities than the current system, particularly for periods of unpaid activity that occurred before 2002. This should therefore reduce substantially the number of people who have very low state pension entitlements in their own right.

A further component of the proposed single-tier pension is, therefore, to end the current system of derived and inherited rights. For those reaching SPA after 2016, it will no longer be possible to accrue pension entitlement based on one's spouse's contributions.[30] This creates a potential group of losers who would have received a 'Category B' pension based on their spouse's contributions, but who now will receive either much less or nothing based on their own contributions.

The number of individuals who are affected by this who have always lived in the UK should be vanishingly small, as generous crediting arrangements and increasing labour-force attachment of women mean that more people are accruing pensions in their own right. However, for those outside the UK who do not earn qualifying years in their own right, this policy represents a significant long-term reduction in the potential pension entitlement they can accrue.

3.3 Ending contracting out

Under the current pension system, individuals with occupational defined benefit pensions can contract out of S2P. The Pensions Bill 2013–14 sets out legislation to abolish this ability to contract out, meaning that all employees with one job earning the same amount in a given year will pay the same NI contributions and accrue the same state pension entitlement.

The immediate implication of this is that individuals who would have contracted out of S2P will accrue greater state pension entitlement for each year of activity under the proposed system than they would under the current system but they and their employers would also pay higher NI contributions.

Incorporating historic contracted-out entitlements into the new single-tier pension was an important challenge for the government in designing the single-tier policy. In the next section, we describe how this will be dealt with and what the implications are for the different treatment of those who did and did not contract out in the past.

[30] There will be some protection for the group of women who were paying the married woman's reduced rate in 1981.

3.4 Transition issues

The government plans to introduce the single-tier pension in April 2016, in a way that transfers rights to the new system as quickly as possible. From April 2016, all that will be needed to calculate an individual's state pension income is their 'foundation amount' (defined below), their activities since 2016 and the level of the single-tier pension. In contrast to previous reforms to the state pension system, it will not be necessary to retain an understanding of the rules governing previous incarnations of the state pension system or to keep a record of the full history of an individual's working life. This would, therefore, make the new state pension system significantly simpler than the current system.

In this section, we start by discussing the mechanics of the proposed transition to the single-tier pension before highlighting some of the implications of the transition arrangements. A full discussion of the winners and losers in the short term is left to Chapter 4.

The mechanics of transition

In April 2016, every working-age individual's accrued pension entitlement (including entitlement to the BSP, GRP, SERPS and S2P) will be combined to form their 'current scheme valuation'. This will only include entitlement accruing from the individual's own contributions – that is, derived or inherited rights will not be taken into account. This 'current scheme valuation' will be compared with the individual's 'single-tier valuation', or the amount of single-tier pension entitlement that they would have accrued if they had spent their working life up to 2016 under the single-tier system instead.[31] Entitlement as of 2016 will be the higher of these two valuations, and will form the individual's 'foundation amount'.

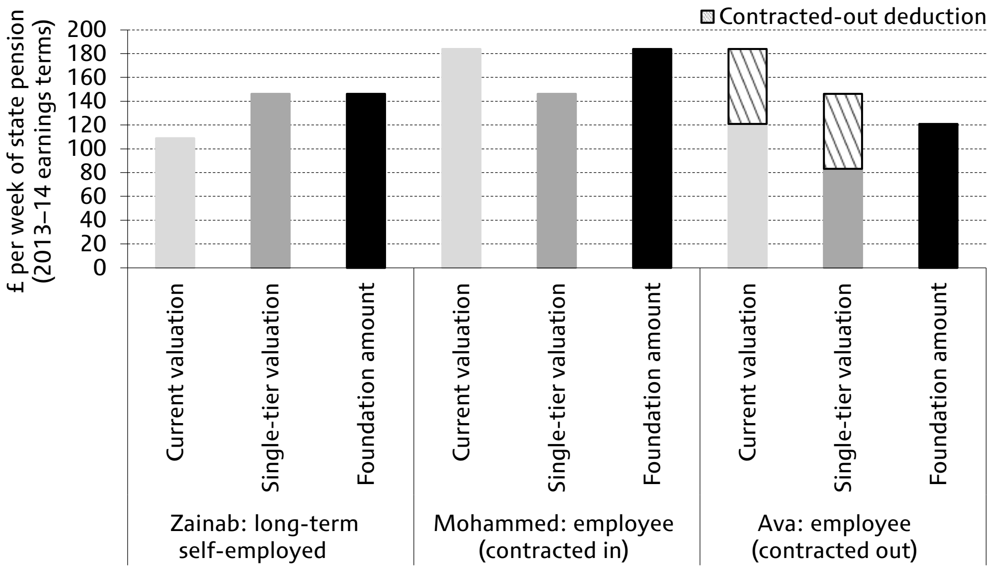
Those who have contracted out in the past will face a 'contracted-out deduction' to their valuations under the current and proposed systems, to account for the fact that they will have built up entitlement in a private pension scheme.

This process is illustrated in Figure 3.1, which shows the calculation for the same three individuals who were described in Box 2.2. Zainab will have been self-employed for 38 years by 2016, having started self-employment at the age of 21. She has 35 qualifying years for the BSP, but no entitlement to GRP/SERPS/S2P. Her single-tier valuation (£146.30) will be higher than her current valuation (a full BSP, worth approximately £109 in 2016–17).

Mohammed has been employed and contracted in since the age of 21. His single-tier valuation would be £146.30, as he has more than 35 qualifying years. This is lower than his current scheme valuation of £184.00. Therefore, his foundation amount will be set equal to his existing entitlement under the current system.

[31] Activities that were previously credited for the BSP will be treated as accruing credits to the single-tier pension.

Figure 3.1. Current and single-tier valuations and the foundation amount



Note: This example is for example people reaching SPA in the 2023 tax year who started work at age 21 in 1978. See Box 2.2.
Source: Department for Work and Pensions, 2013e.

Ava has had the same career history as Mohammed but she has always been a member of her employer's defined benefit pension scheme and has always been contracted out of the state second-tier pension. Under the current system, her entitlement would be the same as Mohammed's less her contracted-out deduction. This gives her a current scheme valuation of £121.00. Similarly, her single-tier valuation will be the same as Mohammed's less the same contracted-out deduction – giving her a single-tier valuation of £83.30, which is lower than her current scheme valuation. Her foundation amount would therefore be set equal to her current scheme valuation. Although Ava will have a lower foundation amount than Mohammed, she will also receive additional pension from her occupational pension scheme, which ought to compensate for this difference in state pension income.

Beyond the implementation year, there are changes both to future accruals and to how pension entitlement already accrued will be uprated.

Additional accruals after 2016

Under the current system, individuals can continue accruing additional BSP entitlement until they reach a maximum of 30 years of contributions and they can continue accruing additional S2P in every year until they reach SPA. For example, Mohammed – described above – would earn additional state pension worth £1.70 a week at SPA if he continued to work beyond 2016. Ava could also accrue the same extra entitlement if she chose to contract back in to the state second-tier pension. Zainab, however, would not accrue any more state pension income as she already has full BSP entitlement and – as a self-employed person – does not accrue entitlement to S2P.

In contrast, under the proposed system, anyone with a foundation amount of at least £146.30 will not be able to accrue any more state pension entitlement. For the individuals just described above, this means that neither Zainab nor Mohammed would be able to accrue any further state pension entitlement after 2016, whereas Ava would be able to do so. (Ava would accrue £4.18 of extra state pension income for each additional year of contributions.) This is despite the fact that Mohammed and Ava have essentially paid the same net NI contributions in the past and will continue to do so in the future, if they both continue to work and earn the same amount.

The apparent inequity between Mohammed and Ava in their ability to accrue further state pension entitlements after 2016 arises from how the government has chosen to deal with past contracting out in the Pensions Bill reforms. The option chosen means that the system will move more quickly towards a simple, easy-to-understand single-tier pension, in which most new pensioners will receive the full single-tier pension from the state. However, it has the disadvantage that it treats individuals who contracted out in the past differently from those (otherwise-identical) individuals who contracted in.

Indexation of pension rights after 2016

From April 2016, up to £146.30 of individuals' foundation amount entitlement will be earnings indexed, while any state pension entitlement in excess of £146.30 will be increased by CPI inflation (this applies both before and after someone reaches SPA).

Under current legislation, SERPS/S2P entitlements are uprated by inflation after the SPA but revalued in line with average earnings growth during working life.

For example, in 2016, Mohammed – described above – will get a foundation amount of £184.00 – equal to his current scheme valuation at that point. Under the current system, until he reaches the SPA, all of this £184.00 will be uprated each year in line with growth in average earnings. However, once he reaches SPA, his BSP entitlement (£109.00) will continue to be uprated with average earnings growth, while his additional pension entitlement (£75.00) will only be increased in line with CPI inflation. Under the single-tier system, from 2016 onwards £146.30 of his state pension entitlement would be uprated in line with average earnings, while the remaining £37.70 would be increased in line with CPI inflation. This would continue after he reaches SPA.

Whether specific individuals gain or lose from this change to uprating policy will depend on exactly how much their foundation amount exceeds £146.30 and how many years they have left before they reach the SPA.

The implications of transition

The proposed pension system will result in a significant windfall increase in the state pension rights of three particular groups:

- those who were employed on relatively low earnings (although still at or above the LEL) between 1978 and 2001 – these individuals will have accrued BSP but little or no SERPS entitlement;
- those who were carrying out activities prior to 2002 that earned entitlement to BSP but not SERPS – for example, caring for children, caring for sick or disabled adults, or receiving certain out-of-work benefits;
- those who have been self-employed.

For these types of individuals, the proposed system is likely to represent a windfall gain. As discussed in greater detail in Chapter 4, most of these 'winners' are in earlier cohorts.

In addition, those who have spent periods contracted out of SERPS/S2P will have the potential to accrue a larger total pension than otherwise-identical individuals who had been contracted in, as they will be able to 'work off' these contracted-out years in order to qualify for an increased state pension with no loss of private pension from their years spent contracted out.

Given the transition rules proposed in the White Paper, almost no one would see a significant reduction in their accrued entitlement as a result of the reform.[32] Those whose foundation amount exceeded the single-tier pension level in 2016 would have that entitlement 'protected'.[33] However, there are potentially a large number of individuals who have not yet reached the SPA who should anticipate accruing a state pension entitlement of more than £146.30 under the current system and who would, therefore, receive less under the proposed system than under the current one. As described in Chapter 5, these losers are most heavily concentrated in later cohorts – those who entered the labour market after (or not very long before) 2002.

3.5 Changes to means-tested benefits

The current system of means-tested benefits for pensioners includes the pension credit, which itself is comprised of two components – the pension credit guarantee credit (PCGC) and the pension credit savings credit (PCSC).

The PCGC tops up income to a minimum level (£145.40 for a single person and £222.05 for couples in 2013–14), whereas the PCSC was introduced to reward private saving and has a maximum award of £18.06 (£22.89 for couples). As of November 2012, 14% of 65- to 69-year-olds claimed the pension credit and

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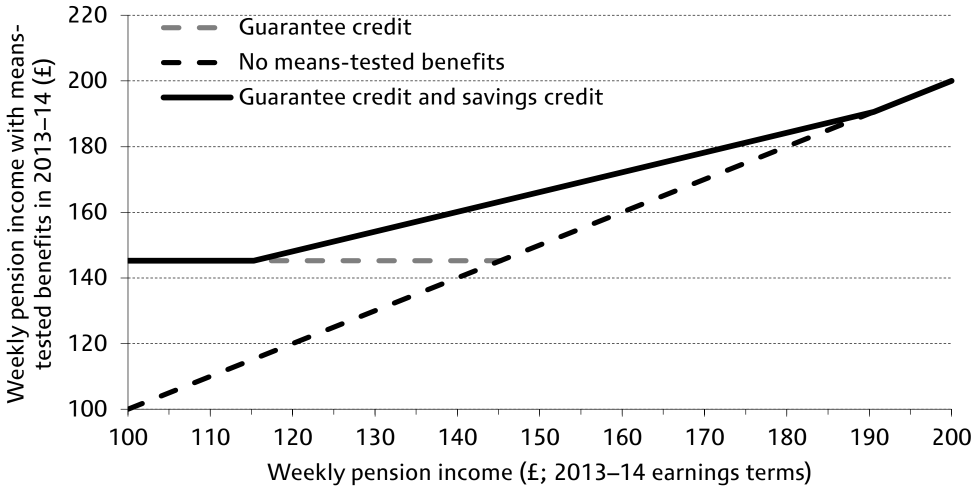
[32] Some groups who do – those with fewer than 10 years of contributions and those who would have received pensions based on their spouse's entitlement who will now only receive a pension based on their own contributions – are discussed in Chapter 4.

[33] The proposed 'protection' does actually constitute a small reduction in pension entitlements for this group. This is because state pension rights in excess of the single-tier level will only be uprated between 2016 and SPA in line with CPI inflation, rather than average earnings growth, as would happen under current legislation.

received an average award of £53.75 (2013–14 earnings terms).[34] However, DWP estimates of take-up rates in 2009–10 indicate that only 62–68% of those entitled to the pension credit actually claimed it (implying that as many as 20–22% of 65- to 69-year-olds may have been entitled to some element of the pension credit).[35]

Figure 3.2 illustrates the current pension credit (PC) system, showing for a single person what their income would be including PC, based on their income without PC. The solid black line shows the level to which PC tops up individuals' incomes. For example, this shows that anyone with an income below £115.30 a week is eligible to receive PCGC to top up their income to £145.40. Individuals with slightly higher income than this are also eligible to receive some PCSC, which tops up their income further. The slope of the black line shows how much extra total income someone would receive (after taking into account means-tested pension credit) if their non-means-tested income were to increase by £1.

Figure 3.2. How the pension credit tops up pensioner income



If a single individual has an income below £115.30 a week (that is along the horizontal portion of the black line), a £1 increase in non-means-tested pension income will result in no change in total income, as their PCGC award will simply be reduced by £1 as well. Individuals expecting to be in this situation would have no incentive to save for retirement, as extra pension income would simply be offset one-for-one by loss of PCGC.

If a single individual has non-means-tested income between £115.30 and £190.55, they will be eligible for some PCSC. For these people, a £1 increase in non-means-tested income would increase total income by 60p. Individuals

[34] Source: http://tabulation-tool.dwp.gov.uk/5pc/pc_prim/tabtool_pc_prim.html. Population estimates from 2010-based National Population Projections (ONS).

[35] Take-up rates for those eligible only for PCSC are estimated to be particularly low, at 43–48%. For these individuals, the pension credit represents at most £18.06/£22.89 (singles/couples) of extra weekly income. Department for Work and Pensions, 2013f.

expecting to be in this position would have a greater incentive to save for retirement than those expecting lower income, but still less incentive than people who expect to avoid the scope of means-tested PC altogether.

However, even under current legislation, in the long run, pension credit savings credit will be increasingly unimportant. This is for two reasons. First, the PCSC thresholds are changed each year such that the income band for PCSC entitlement will get smaller over time. Second, as more people are credited automatically for S2P alongside the BSP, it will become less important to reward levels of 'saving' just above the level of the basic state pension.[36]

The single-tier proposals include the abolition of PCSC: in other words, pensioner incomes would simply be topped up to the level of the dashed grey line in Figure 3.2, and then would increase with private income (shown by the dashed black line) once non-means-tested income exceeds the PCGC level. Under this policy, everyone with income below the PCGC level would face a one-for-one reduction of their means-tested income with every increase in their non-means-tested pension income, but those with incomes above the PCGC level would be out of the scope of this means testing and face no disincentives to save.[37]

There will be transitional protection for benefit units where one member reaches SPA before 6 April 2016, such that they will still be able to claim pension credit savings credit in the future once the oldest member of the couple reaches the male SPA.

[36] The lower income threshold for PCSC entitlement has historically been set roughly at the level of the full BSP.

[37] Some of these individuals might still, however, qualify for means-tested housing benefit and/or support for council tax.

4. Short-Run Effect of the Proposed Reforms on Pensioner Incomes

The proposed reforms have different implications in the short run from in the long run. This is because the state pension entitlements of people retiring in the next few decades are heavily affected by historic pensions legislation, which in particular treated unpaid activities less generously. The proposed reforms aim to 'protect' pension entitlements that have already been accrued. Therefore, the main effect in the very short term is to increase entitlements for some groups, while leaving other groups' entitlements largely unchanged. There are, however, some notable short-term losers, such as those who would have accrued fewer than 10 years of contributions by 2016; these people would receive no state pension income under the proposed rules unless they were able and chose to pay voluntary class 3 National Insurance contributions to improve their contribution records.

In this chapter, we describe who, in the short term, will see their state pension rights increased or decreased as a result of the proposed reforms. In particular, we focus on those who will be reaching SPA between 6 April 2016 and 5 April 2020 – this group includes women born between 6 April 1953 and 5 July 1954 and men born between 6 April 1951 and 5 July 1954. We make use of a unique data set that links individuals' NI contribution histories with detailed survey information on their socio-demographic characteristics, financial circumstances and health. We briefly describe the data in Section 4.1.

To make clear how the proposed reforms affect household incomes, we start by describing how they would affect individuals' weekly state pension income at SPA (Section 4.2) and the present discounted value of their pension income over the whole of their retirement (Section 4.3). Obviously, for those who expect to be entitled to some means-tested benefits after SPA, some of these gains in state pension income will be offset by a reduction in means-tested entitlement. Section 4.4 therefore discusses how total household income will be affected by these reforms after taking into account eligibility for means-tested pension credit and the planned abolition of the savings credit component. Section 4.5 summarises.

4.1 Data

In this chapter, we make use of a unique data set containing detailed household micro data linked to individual NI records to describe how the first few cohorts of individuals to retire under the new single-tier pension would be affected by the reforms. The English Longitudinal Study of Ageing (ELSA) interviews a representative sample of the English household population aged 50 and over every two years – following the same individuals over time. The survey asks a huge range of questions covering – among other things – demographic characteristics, socio-economic circumstances, wealth, physical and mental health, social participation and cognitive function. Survey respondents were also asked for permission to link their survey answers to various administrative data sources, including NI contribution records from HM Revenue and Customs.

This linked data set allows us to examine in detail the accrued state pension rights of survey respondents (calculated using both the current and proposed rules) and how eligibility varies across individuals and households with different characteristics. This allows us to provide a much richer picture of how the proposed reforms affect different types of individuals than is possible with only administrative data. It also allows us to calculate individuals' state pension entitlements precisely, which would not be possible with survey data alone. However, this advantage comes at the cost of being constrained to examine only those cohorts for whom information can be gleaned from ELSA. Consequently, this chapter focuses only on those reaching SPA between 6 April 2016 and 5 April 2020.

The first wave of ELSA (collected in 2002–03) covered a representative sample of the English household population born on or before 29 February 1952. To allow us to examine a slightly wider set of cohorts, we have used the ELSA sample to

Table 4.1. Characteristics of those reaching the SPA between 6 April 2016 and 5 April 2020

	Men	Women	All
SPA = 2016 (%)	31.6	27.5	30.3
SPA = 2017 (%)	31.6	20.7	28.2
SPA = 2018 (%)	25.1	21.9	24.1
SPA = 2019 (%)	11.7	29.9	17.4
Characteristics in 2002–03			
Age (mean)	49.9	48.9	49.6
Couple (%)	79.9	69.8	76.7
Single (incl. widowed/divorced) (%)	20.1	30.2	23.3
Has children (%)	84.8	87.1	85.5
No children (%)	15.2	12.9	14.5
Low education (%)	39.4	43.7	40.7
Mid education (%)	32.3	38.0	34.0
High education (%)	28.3	18.3	25.2
Working (%)	85.7	78.7	83.5
Not working (%)	14.3	21.3	16.5
Total family net income (mean)	£547.40 p.w.	£428.70 p.w.	£510.50 p.w.
Total family net income (median)	£464.50 p.w.	£388.00 p.w.	£438.50 p.w.
Total net wealth (mean)	£302,372	£289,528	£298,381
Total net wealth (median)	£255,948	£192,058	£226,823
Sample size	762	340	1,102

Note: Education is defined as 'low' if left full-time education at or before the compulsory school-leaving age (CSL), 'mid' if left full-time education between the CSL and age 18, and 'high' if left full-time education at age 19 or above. Total wealth is per-head household wealth, and includes private pension wealth but not state pension wealth.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

simulate data for cohorts born up to 5 July 1954. The way that we have done this is described in more detail in Appendix B, which also provides an assessment of the reliability of the ELSA–NI linked data and the simulated data.[38]

Together, the ELSA data and simulated data provide us with a sample of the cohorts who will reach SPA up to 5 April 2020 – that is, during the first four years from the proposed implementation date for the single-tier pension. Table 4.1 shows some summary statistics on the sample. One point to note is that, because of the way that the SPA for women is increasing between 2016 and 2020, far fewer women than men will reach SPA during this period. Therefore, 69% of our sample are men and only 31% are women.

In this chapter, we examine how our results vary across individuals with different levels of wealth. The measure of wealth we use is total household net wealth. This includes all financial, housing, private pension and physical assets held by an individual and their partner (where relevant), less any outstanding mortgages and other debts. Table 4.1 shows that among our sample, half of individuals live in a household with total net wealth of no more than £226,823. The men on average live in slightly wealthier households than the women in our sample. In the following subsections, some analysis is presented by 'quintile' of total net wealth. To construct these quintiles, we divide our sample up into five equally-sized groups based on the wealth per person held by their family unit.

4.2 Comparing state pension income at SPA under the proposed and current systems

This section describes – for individuals reaching SPA between 6 April 2016 and 5 April 2020 – how state pension income at SPA under the proposed system will compare with what they would get under the current system. For more detail on how pension income will be calculated in the new system and how rights already built up under the existing system will be 'protected', see Sections 3.1 and 3.4.

The data we have only include information on individuals' activities up to 2010–11. In this section, we start by describing what individuals' state pension rights would be under the current and proposed systems if they then did no 'creditable' activities from 6 April 2016 onwards. We then discuss how this compares with the picture if individuals expect to continue working or doing other creditable unpaid activities between 2016 and when they reach the SPA. More detail on the assumptions made is provided in Appendix B.[39]

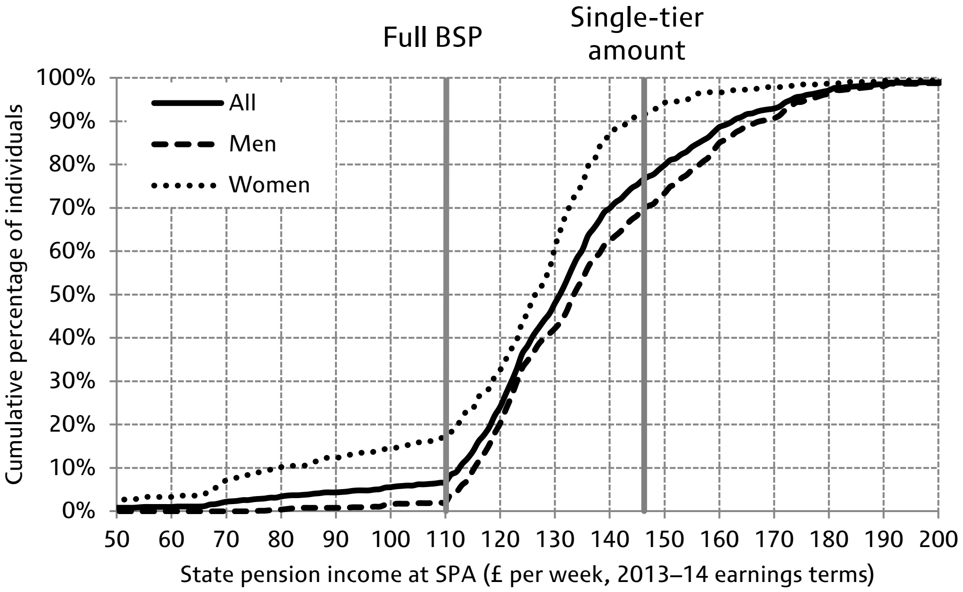
[38] Appendix B is available online at http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

[39] http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

Pension entitlements assuming individuals stop contributing in April 2016

Figure 4.1 shows the distribution of state pension income at the SPA under the current pension system for our sample. This shows that 25% of individuals (32% of men and 9% of women) will have accrued state pension entitlements worth at least the full single-tier amount of £146.30 per week by 2016 and that 93% of individuals (98% of men and 83% of women) will have accrued state pension income worth at least as much as the full BSP.

Figure 4.1. Distribution of accrued state pension income at SPA under current system



Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

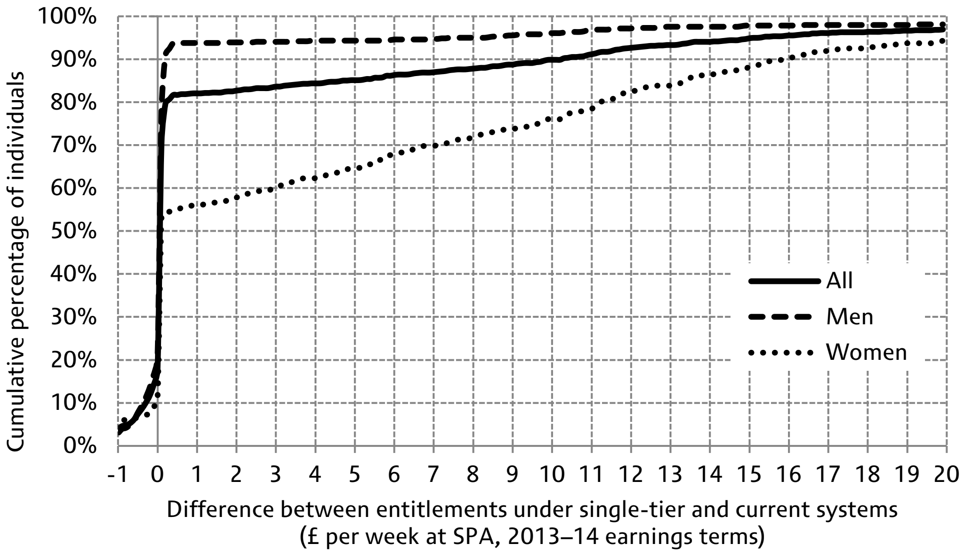
This baseline of pension entitlement under the current system in 2016 maps onto single-tier entitlement as follows: those individuals who have accrued at least the full single-tier amount before 2016 will experience no change, or a small loss, in state pension income at SPA. The 75% of individuals who will have accrued state pension entitlements worth less than £146.30 per week by 2016 could see their entitlement affected by the proposed system in one of three ways:

- First, their foundation amount could be higher than their entitlement under the current system. This would be the case if they are credited with accrual to the single-tier pension for activities that previously only gave them credit towards the BSP and not SERPS or S2P.
- Second, their foundation amount could be the same as their entitlement under the current system.
- Third, they could fall foul of the 10-year minimum contribution requirement for the new system, or lose out from the end of Category B pensions. In the

former case, they would not be entitled to any state pension. In the latter case, they would only be entitled to any state pension on the basis of their own contribution history, rather than that of their partner.

Figure 4.2 shows the difference between the state pension income that people will get under the single-tier system and the income they would get from the current system at SPA.[40] A positive number indicates that entitlement under the single-tier system will be greater than entitlement under the current system.

Figure 4.2. Distribution of change in state pension income at SPA under proposed system compared with current system – assuming no further 'contributions' after April 2016



Source: Authors' calculation using English Longitudinal Study of Ageing and National Insurance administrative data.

Among the sample as a whole, just 18% will see an immediate increase in their state pension income as a result of the single-tier reforms. Women are much more likely to face this immediate gain than men, with 44% of women facing an increase in their entitlement as of 2016 compared with just 6% of men. The percentage seeing an increase in their state pension income of more than £5 per week is 15% (6% of men and 35% of women); 10% will see an increase of more than £10 per week (4% of men and 24% of women).

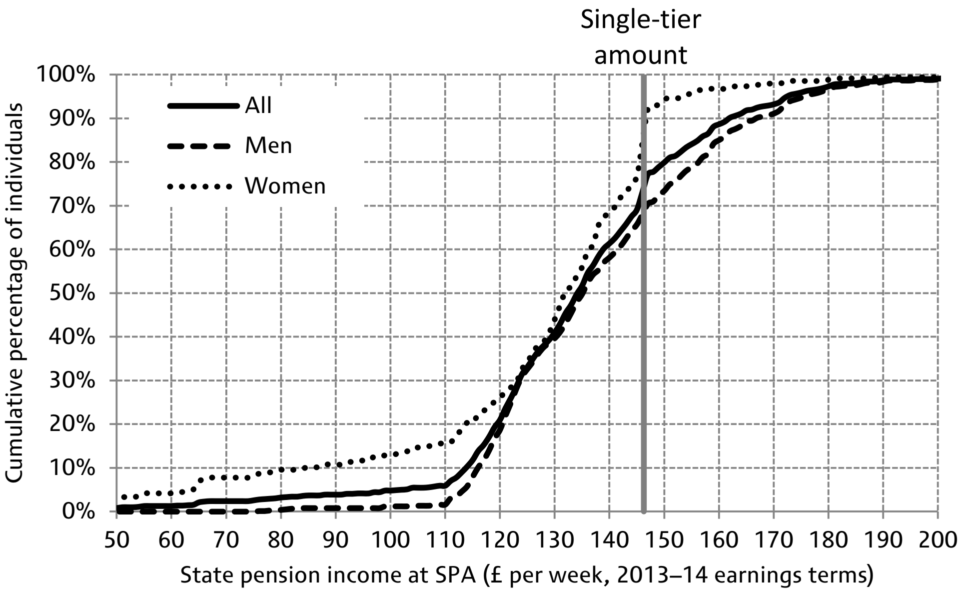
The vast majority (78%, including 91% of men and 50% of women) will see no immediate change in their state pension income. Of this group, a third (or 25% of the sample as a whole) will see essentially no change in their state pension income because they will already have accrued state pension income in excess of £146.30.

[40] Figure A.1 in Appendix A shows the equivalent figure for the subsample of individuals who would be entitled to less than £146.30 per week under the current system. (Appendix A is available online at http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.)

Only a very small fraction of our sample (4% of all individuals, including 3% of men and 6% of women) would see a reduction in their pension entitlement by £1 per week or more as a result of the proposed system. Around half of these women are those who fall below the 10-year minimum contribution condition and around half of the women are those who would qualify for a Category B pension under the current system but not under the single-tier system. That so few people in our sample are affected by the minimum contribution condition is not surprising since our sample is of the English household population and DWP asserts that most people who will be affected in this way currently live outside the UK. Those women who do fall foul of the minimum contribution condition may be able to boost their state pension entitlement by paying voluntary class 3 contributions to improve their record. This would be possible if they had any years from 2006 onwards for which they have not yet received a credit.[41]

The resulting distribution of state pension entitlements under the single-tier system is shown in Figure 4.3. Table 4.2 summarises the level of state pension income received under the current and proposed systems. This shows that 34% of men and 23% of women would have a pension income of at least £146.30 per week. In other words, 3% of men and 14% of women would see their state pension income at SPA boosted up to the full single-tier amount.

Figure 4.3. Distribution of state pension income at SPA under proposed rules



Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

[41] Source: http://www.hmrc.gov.uk/drafts/ss-conts-amedn-regs13.pdf.

Table 4.2. Percentage of individuals entitled to more and less than the full single-tier amount, under current and proposed systems

State pension entitlement	Men	Women	All
Current system			
£1 or more below £146.30 p.w.	68.4	91.0	75.4
Within £1 of £146.30 p.w.	2.3	1.5	2.1
£1 or more above £146.30 p.w.	29.3	7.5	22.5
Single-tier system			
£1 or more below £146.30 p.w.	65.7	77.3	69.3
Within £1 of £146.30 p.w.	5.0	15.3	8.2
£1 or more above £146.30 p.w.	29.3	7.5	22.5
Sample size	741	334	1,075

Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

It can also be noted from Table 4.2 that only 8% of individuals in our cohorts would actually receive pension income at the SPA equal to the proposed single-tier amount – 23% would enjoy a higher income due to pre-existing entitlements, while 69% would have a pension income lower than the full single-tier amount. This may make the simple, largely flat-rate nature of the policy more challenging to communicate, as few individuals will initially receive exactly the full single-tier pension level at SPA.

Implications of historic contracting out for entitlements under the single-tier system

One reason why a significant fraction of individuals in these cohorts will have a single-tier pension below £146.30 is that many individuals have been contracted out of the second-tier state pension (SERPS/S2P) in the past. While these individuals may appear to have relatively low state pension entitlements, they should have accrued rights in a private pension that (in expectation) are worth at least as much as the state pension forgone and they will have paid commensurately lower NI contributions. It is therefore interesting to illustrate what Figures 4.1 and 4.3 look like if we include these contracted-out pension entitlements as well – that is, if we pretend that these individuals had instead been contracted in throughout their working lives. This is shown in Figure 4.4, with the proportions above and below the single-tier amount summarised in Table 4.3.

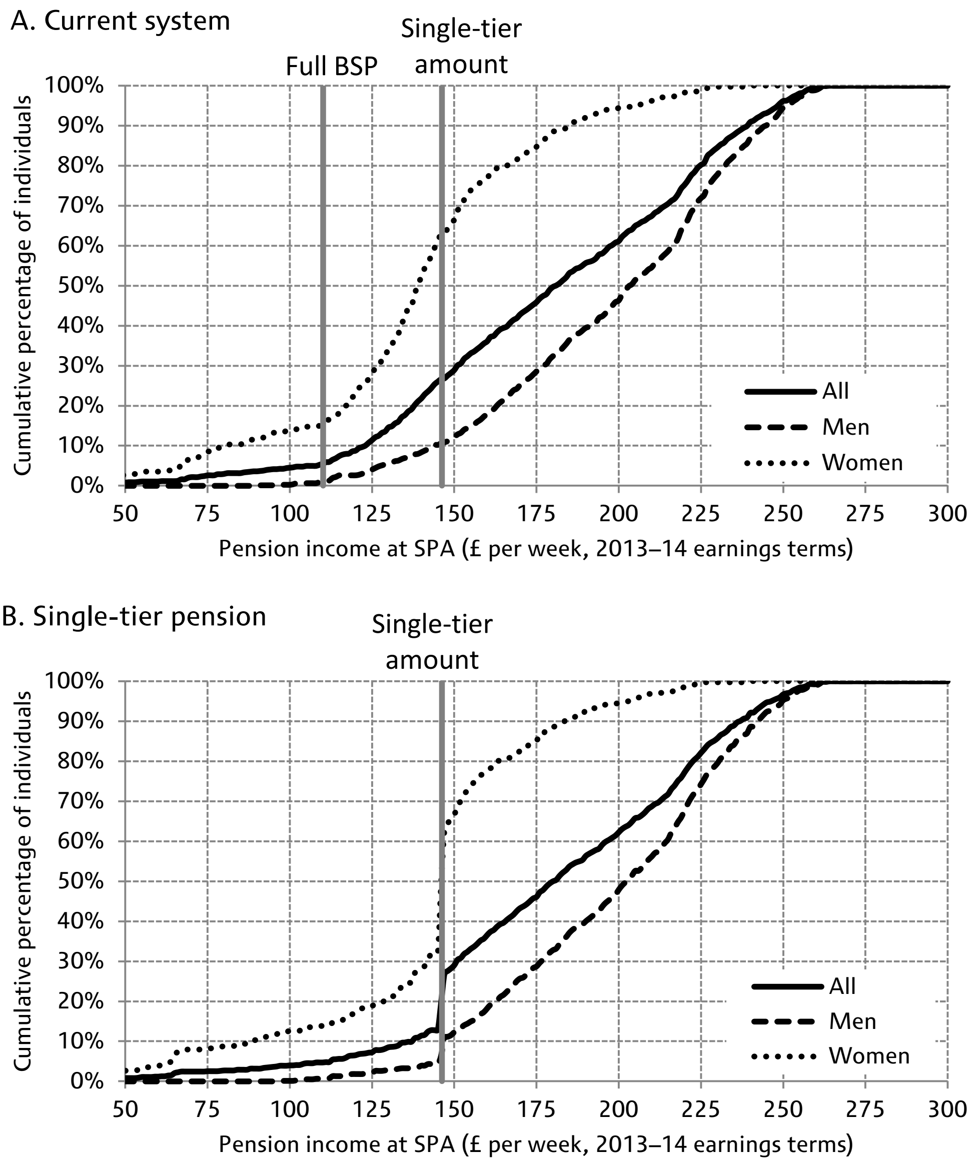
If no individual had ever contracted out, 95% of men and 67% of women would be entitled to a state pension income under the new system of at least the full single-tier amount based on their accrual up to 2016 (compared with 34% and 23% respectively shown in Table 4.2). Under the current system, assuming no past contracting out, 91% of men and 39% of women would have a state pension income of at least £146.30.

In the absence of contracting out, a larger proportion of individuals would see their pension entitlement boosted to the full £146.30 by the new system: 4% of men and 28% of women (compared with the 3% of men and 14% of women shown in Table 4.2).

Therefore, it is largely individuals' past contracting-out behaviour that means that they are below the full single-tier amount in 2016. Ignoring past contracting-out behaviour reduces the proportion of individuals entitled to less than the full single-tier amount from 69% to 14%.

Although the presence of contracting out does hamper the overall message of simplicity, in that fewer people than one might expect will receive exactly the full single-tier pension amount from the state, this is a necessary complexity of the transition process. It would have been very generous to a group of individuals

Figure 4.4. Distribution of accrued state pension income at SPA under current system and under proposed rules – assuming no contracting out



Note: Assumes individuals had never contracted out of SERPS or S2P.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

Table 4.3. Percentage of individuals entitled to more and less than the full single-tier amount, under current and proposed systems – assuming no contracting out

State pension entitlement	Men	Women	All
Current system (no contracting out)			
£1 or more below £146.30 p.w.	9.0	61.4	25.3
Within £1 of £146.30 p.w.	0.8	2.1	1.2
£1 or more above £146.30 p.w.	90.2	36.5	73.5
Single-tier system (no contracting out)			
£1 or more below £146.30 p.w.	4.9	32.9	13.6
Within £1 of £146.30 p.w.	5.0	30.5	12.9
£1 or more above £146.30 p.w.	90.2	36.5	73.5
Sample size	741	334	1,075

Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

who have private pension entitlements funded by rebates from (or lower contributions to) the state to apply no reduction to their single-tier amount in recognition of their years of contracting out. In fact, the transition arrangements chosen, which allow those who have been contracted out in the past to work this off, already treat this group more generously than otherwise-identical individuals who have been contracted in.

Characteristics of immediate winners and losers

Table 4.2 showed that 25% of individuals will already have entitlement under the current system of at least £146.30 by 2016. The protection of existing accruals means that these people will experience essentially no change in their state pension income at SPA under the new system. In addition, 59% of people would be entitled to less than £146.30 under the current system but would also experience no increase in their income as a result of the new system. Meanwhile, 18% of the sample would see their state pension entitlements increased (and 10% would experience an increase of £10 a week or more). Just 4% would see their rights reduced.

As alluded to in Chapter 3, different groups of people are affected by the reform in different ways. For example, those who have had periods of self-employment are likely to be relative winners, as they have previously only earned entitlement to the BSP. In order to understand the full impact of the reform, it is therefore interesting to examine the characteristics of those affected in different ways by the proposed single-tier pension.

Of those who gain at least £10 per week of state pension income at SPA, 73% are women, 53% of them are in the lowest education group and 39% have been self-employed at some point in the past. On average, this group has spent 11 years in employment since 1975. In contrast, among those whose entitlement under the current system will already exceed £146.30 in 2016 and who therefore experience no increase in their state pension income at SPA, 89% are men, 43% are in the lowest education group and 27% have been self-employed. This group

Table 4.4. Average gains to state pension income at SPA among individuals with different characteristics

	% gain	% lose	Mean change from move to single-tier (£ p.w. at SPA)	*N*
All	**18%**	**4%**	**1.94**	***1,075***
Male	6%	4%	0.86	*741*
Female	44%	6%	4.34	*334*
SPA = 2016	18%	1%	2.21	*326*
SPA = 2017	14%	2%	1.33	*303*
SPA = 2018	13%	7%	1.23	*259*
SPA = 2019	32%	11%	3.44	*187*
Single	27%	1%	3.08	*250*
Couple	15%	6%	1.59	*825*
Any children	18%	5%	1.98	*919*
No children	16%	2%	1.71	*156*
Low education	23%	5%	2.46	*438*
Mid education	18%	4%	2.06	*366*
High education	10%	4%	0.93	*271*
Quintiles of total household net wealth				
Lowest quintile	36%	4%	3.99	*214*
2	20%	6%	2.15	*212*
3	22%	3%	2.49	*214*
4	4%	5%	0.58	*219*
Highest quintile	9%	5%	0.53	*216*
Ever paid reduced-rate NI	36%	7%	5.22	*59*
Self-employment years				
None	16%	4%	1.45	*814*
1 to 5	11%	8%	0.58	*85*
6 to 10	25%	8%	2.56	*77*
More than 10	36%	1%	6.66	*99*
Contracted-out years				
None	53%	11%	5.70	*196*
1 to 5	47%	8%	5.35	*88*
6 to 10	19%	5%	1.62	*78*
More than 10	5%	2%	0.52	*713*

Note: Gain (lose) is defined as pension income at SPA under the proposed single-tier pension system being £1 or more per week higher (lower) than pension income at SPA under the current system. Education is defined as 'low' if left full-time education at or before the compulsory school-leaving age (CSL), 'mid' if left full-time education between the CSL and age 18, and 'high' if left full-time education at age 19 or above. Total wealth is per-head household wealth, and includes private pension wealth but not state pension wealth.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

has spent on average 32 years in employment. These and other characteristics are described in Table A.1 in Appendix A.[42]

As shown in Table 4.4, the average increase in state pension income for men at SPA under the proposed system is 86p per week; this compares with £4.34 per week for women. Table 4.4 also provides some indication about which types of individuals gain the most. Women who have ever paid reduced-rate NI contributions are set to gain on average £5.22 per week, while people who have been self-employed for more than 10 years stand to gain £6.66 per week. A large proportion of individuals who have been in self-employment would gain, but notably not all. Among those who have been self-employed for more than 10 years, 36% would gain, compared with 25% of those who have been self-employed for between 6 and 10 years. (Those reaching SPA in 2019 are much more likely to gain than those reaching SPA between 2016 and 2018 because of the composition of individuals – 53% of those reaching SPA in 2019 are women, compared with 28% in 2016, 23% in 2017 and 28% in 2018.[43])

Those with lower levels of household total wealth per head are also more likely to benefit: 36% of the least wealthy fifth of individuals would benefit, compared with 9% among the wealthiest fifth. The mean change in pension income at SPA among the least wealthy fifth of individuals is an increase of £3.99 per week, compared with £0.53 among the wealthiest fifth of individuals. However, since the least wealthy individuals are more likely to be eligible for means-tested benefits, the interaction with means-tested benefits and the proposed abolition of pension credit savings credit will have important implications for this conclusion – this is discussed in more detail in Section 4.4.

Tables A.1 and A.2 in Appendix A present additional analysis of the characteristics of those who stand to gain and lose state pension income at SPA from the proposed reforms.[44]

How gains and losses change if individuals plan to contribute after April 2016

The preceding analysis described how the state pension income that individuals could get at SPA under the new system would compare with entitlements under current rules, assuming that individuals made no further contributions to the system beyond April 2016. For the very first cohort to be affected by the proposed reforms, this will be the final picture. However, for later cohorts, the ultimate pattern of gains and losses (relative to what could be achieved under the

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[42] Appendix A is available online at http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

[43] This is simply because of the way that the female state pension age is being increased between 2016 and 2018, while the state pension age for men will not start increasing until 2018.

[44] Appendix A is available online at http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

current rules) will also depend on what activities they plan to carry out from April 2016 onwards.

Figure 4.5 reproduces similar analysis to that shown in Figures 4.1–4.3 but under the assumption that people continue doing any contributory activity that they are doing in 2016 until they reach SPA. Panel A shows entitlement under the current system under this assumption about contributions. This shows that 27% of all individuals (34% of men and 11% of women) would expect to accrue a state pension under the current system worth at least the full single-tier amount. This is slightly higher than the 25% of individuals (32% of men and 9% of women) shown in Figure 4.1.

Figure 4.5. Distribution of accrued state pension income at SPA under current system and under proposed rules and difference between the two

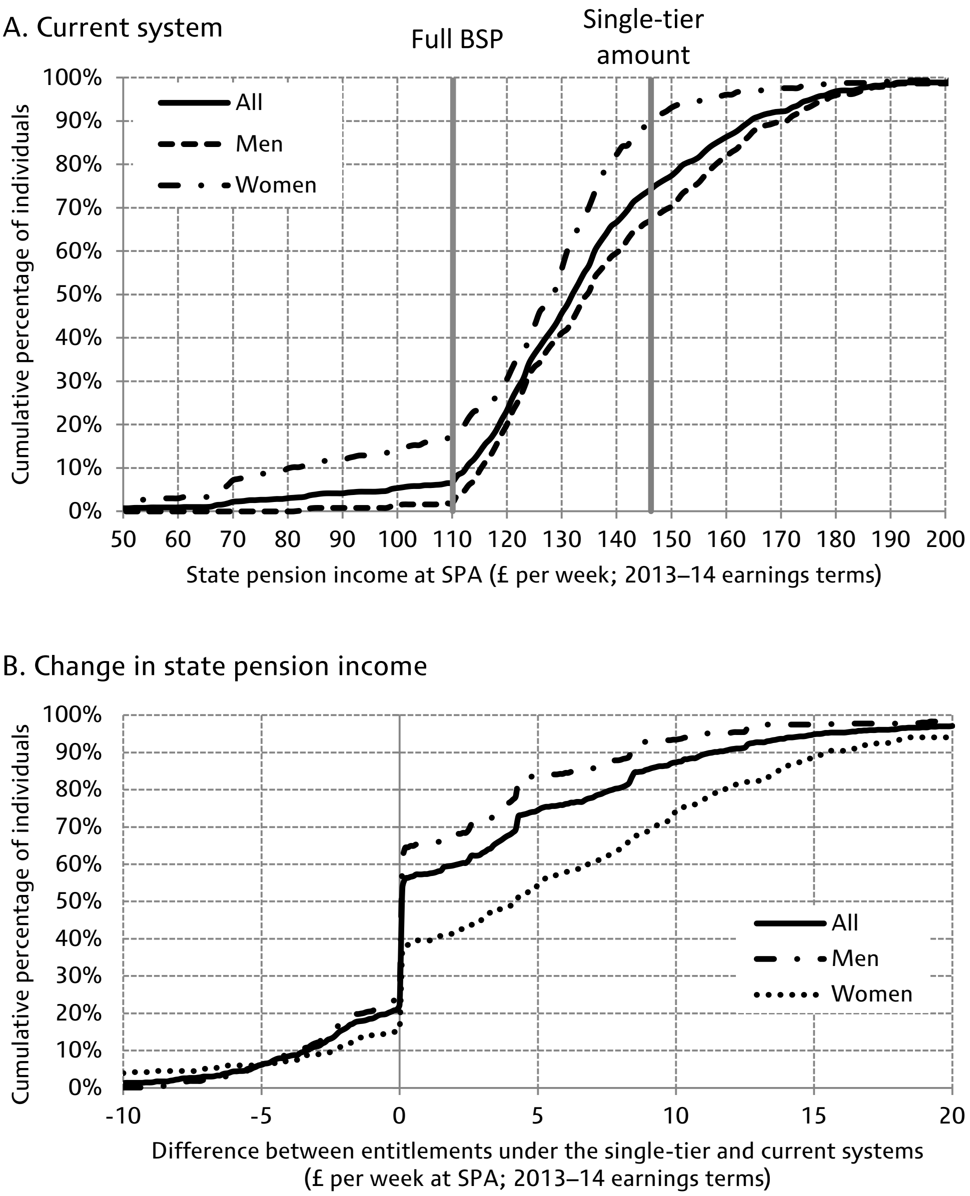
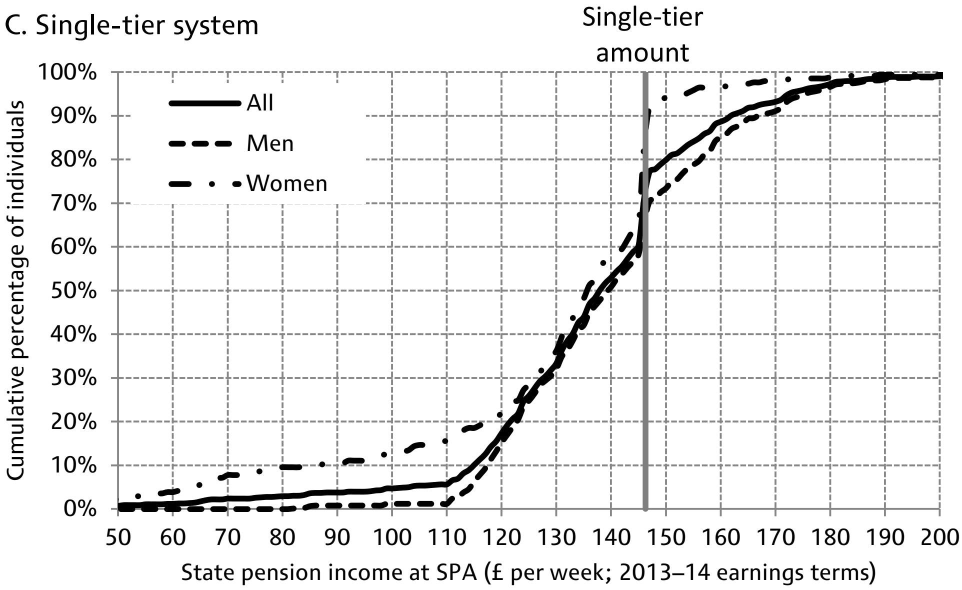


Figure 4.5 continued



Note: Assumes individuals continue contributing until SPA under both systems.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

Panel C shows the income these same people would have under the single-tier pension. This shows that 39% of individuals (42% of men and 35% of women) would accrue a state pension under the proposed system worth at least the full single-tier amount. This is higher than the 31% of individuals (34% of men and 23% of women) shown in Figure 4.3 for the case when we assume all remaining contributory activity stops in 2016. Table A.3 in Appendix A summarises these figures in a similar way to Table 4.2.[45]

Panel B of Figure 4.5 shows the change between the two systems. When compared with Figure 4.2, it illustrates that more people stand to lose from the proposed reforms once we take into account the possibility of additional contributions after 2016, although the proportion of people gaining also increases. Across the sample as a whole, 19% (21% of men and 14% of women) stand to receive a lower state pension income at SPA under the proposed system than under the current system, allowing for continued contributions up to SPA. This compares with our estimate that just 4% would lose if individuals expect to cease contributions in 2016 (see Table 4.4). There are two important factors underlying this pattern.

First, those who will already have accrued £146.30 under the current system by 2016 will find that – unlike under the current system – under the single-tier system they will be unable to accrue any further pension rights after April 2016. For example, for a high earner, this could mean forgoing S2P income worth up to

[45] http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

£7.70 per week at SPA.[46] As shown in Table A.4 in Appendix A,[47] on average those who will have already accrued £146.30 under the current system by 2016 are estimated to lose £2.58 per week of state pension income when we allow for contributions up to SPA; this compares with an average loss of just 39p per week under the assumption of contributions ceasing in March 2016.

Second, those who have had periods of contracting out in the past will find they are able to work this off after April 2016. This accrual that they can potentially achieve under the proposed system is considerably greater than the additional pension rights they may be able to earn under the current system. Under the current system, most of these individuals have already accrued full BSP and so additional years of contributions will provide them only with additional S2P entitlement (worth between £1.70 and £2.60 per week in state pension income for each additional year of contributions).[48] In contrast, under the proposed system, these individuals would be able to accrue £4.18 of weekly state pension income for each year's contribution. Comparing Table 4.4 with Table 4.5 later, we can see that only 5% of those with more than 10 years of contracting out stand to gain immediately from the single-tier pension (with the average gain being 52p per week of state pension income); however, once we allow for these individuals to continue contributing up to SPA, the proportion gaining rises to 39% and the average gain increases to £2.07 per week.

Across the sample as a whole, 43% of individuals would gain in terms of income at SPA, allowing for continued contributions up to SPA. This compares with just 18% who are estimated to gain under the assumption that contributions cease in 2016 (see Table 4.4). With contributions continuing up to SPA, 26% of individuals (17% of men and 47% of women) would see an increase in state pension income of at least £5 a week; 13% (7% of men and 26% of women) would see an increase of at least £10 per week.

Table 4.5 shows the proportion of individuals with certain characteristics who gain and lose from the proposed reforms under the assumption that individuals continue contributing until they reach the SPA; this is similar to the analysis presented in Table 4.4. Ignoring the possibility of future accrual (as we did at the start of this section) understates both the proportion of individuals who lose from the reform *and* the proportion who win. We found above that 3% of men and 6% of women are estimated to lose more than £1 per week in pension income at the SPA from the proposed reform if they make no further contributions after 2016. These figures increase to 21% and 14% respectively if we assume individuals continue contributing until the SPA. If we assume contributions cease in 2016, 6% of men and 44% of women are estimated to gain

[46] This calculation is based on someone earning at or above the upper accrual point (UAP) for three years from April 2016 to March 2019 and accruing additional S2P entitlement for this activity.

[47] http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

[48] This figure decreases over time as S2P accrual gradually becomes flat-rate and the maximum S2P accrual converges to £1.70.

more than £1 per week, but these figures are 35% and 61% if we assume individuals continue contributing until the SPA. One of the main reasons for gaining as a result of additional contributions after 2016 is the ability to 'work off' past periods of contracting out.

On average across individuals with almost any given characteristic, the mean gain in pension income at SPA is greater when we allow for contributory activity up to

Table 4.5. Change in pension income at SPA – assuming cease remaining contributory activity at SPA

	Pension income at SPA		
	% gain	% lose	Mean change
All	**43%**	**19%**	**2.74**
Male	35%	21%	1.62
Female	61%	14%	5.23
SPA = 2016	18%	1%	2.21
SPA = 2017	52%	26%	2.07
SPA = 2018	51%	28%	2.62
SPA = 2019	59%	27%	4.93
Single	50%	16%	3.79
Couple	40%	20%	2.42
Any children	44%	20%	2.80
No children	37%	15%	2.41
Low education	42%	23%	2.81
Mid education	44%	18%	2.94
High education	41%	15%	2.35
Quintiles of total household net wealth			
Lowest quintile	51%	22%	3.97
2	34%	34%	1.82
3	50%	19%	3.55
4	39%	11%	2.19
Highest quintile	39%	10%	2.18
Ever paid reduced-rate NI	51%	17%	5.51
Self-employment years			
None	41%	20%	2.19
1 to 5	39%	20%	1.79
6 to 10	48%	21%	3.41
More than 10	55%	10%	7.51
Contracted-out years			
None	54%	30%	4.63
1 to 5	52%	27%	4.72
6 to 10	35%	31%	1.89
More than 10	39%	14%	2.07

Note: See note to Table 4.4.

SPA than when we assume all contributions end in 2016. This suggests that, on average, the additional gains outweigh the additional losses. The exceptions to this are among individuals in the lowest two wealth quintiles, and among individuals with fewer than five years contracted out of SERPS/S2P. This is because few of the individuals with these characteristics would benefit from being able to 'work off' past periods of contracting out.

In the remainder of this section we present figures that assume individuals continue contributing until SPA.

Auto-credits under the single-tier pension

Currently, men aged between the female SPA and the male SPA receive automatic credits towards the BSP – that is, regardless of whether or not they are doing any creditable activity, they automatically receive a BSP (but not S2P) credit if they are aged above the female SPA but below their own SPA. As the female SPA rises to meet that for men, these 'auto-credits' are gradually being phased out. The government has not yet decided whether auto-credits will continue to exist under the proposed single-tier system; this is still under consideration. The analysis presented in this section assumes that auto-credits are discontinued.

Among the sample we consider here, men born between 6 April 1952 and 5 September 1953 (35% of men in our sample) could get at least one year of auto-credits between 2016 and SPA under the current system, if they have not already got 30 qualifying years for BSP. In our sample, 97% of the men born between these dates are expected already to have accrued 30 BSP qualifying years before they would potentially become eligible for auto-credits. Therefore, for the vast majority, the auto-credits would have no effect on state pension entitlement under the current system.

However, under the proposed single-tier pension, these auto-credits could have a much larger impact. For those eligible for auto-credits, following the evaluation of individuals' foundation amounts in 2016, a year of auto-credits would boost single-tier entitlement by £4.18 for all men with foundation amounts of less than £146.30. Of the men who could be eligible for auto-credits, 66% are estimated to have a foundation amount below £146.30. As described above, a large proportion of men who will have a foundation amount below this level are those who have had prolonged periods of contracting out. In our sample, 94% of men who could be eligible for auto-credits, who have a foundation amount of less than £146.30 but who have a full BSP have contracted out at some point in the past. Maintaining auto-credits could, therefore, potentially be very generous to a group of relatively well-off individuals. It would add to the group of gainers that we have identified in this section and by much more than our 'continue to SPA' assumption reveals, as the auto-credits would accrue to *all* men who would not otherwise accrue a qualifying year.

To avoid the benefit of auto-credits accruing to individuals who have been contracted out for prolonged periods in the past – which was not intended under the current system – it might make sense at least to restrict these auto-credits only to individuals with less than 30 (or perhaps 35) qualifying years for BSP, who would be the only ones to have benefited from them under the current system.

4.3 Gains and losses over the whole of retirement

The previous section discussed how many and what type of individuals would gain from the proposed single-tier pension in terms of pension income at the SPA. However, as described in Chapter 3, the single-tier pension and the state pension under current legislation are uprated slightly differently through retirement. Under the current system, the BSP element is uprated by growth in average earnings through retirement, while the SERPS/S2P element is uprated by price inflation. Under the proposed system, pension income up to the single-tier amount would be uprated by average earnings growth, while any additional pension income above that level would be uprated by CPI inflation. This means that total (cash) state pension income will grow more quickly under the proposed system than under the current system. Therefore, any losses in pension income at SPA will be at least partially offset by higher indexation later on, and those who do not appear to benefit from the single-tier pension at SPA may benefit from higher income later in retirement.

In this section, we consider whether individuals lose or gain from the proposed single-tier system as a whole over the whole of their life beyond SPA. To do this, we calculate the 'present discounted value' (PDV) of state pension entitlements under the proposed and current pension systems. The PDV is calculated by summing the stream of pension payments expected from the state from SPA until death assuming that all individuals die at their age- and sex-specific life expectancy[49] and discounting future payments using an appropriate discount rate.[50]

Table 4.6 shows what proportion of people with different characteristics would have a PDV of entitlements under the single-tier system that is greater or less than under the current system, and the mean change in the PDV from introducing the single-tier pension; a positive value indicates that the PDV of entitlements is greater under the single-tier system than under the current system. This is under the assumption that individuals continue contributing until they reach SPA.

Across all individuals reaching SPA between 6 April 2016 and 5 April 2020, the average change in the PDV (i.e. increase in wealth) is £4,013. Only 2% of people would lose over the whole of their retirement – this is the group who would have

[49] Life expectancies are taken from Office for National Statistics, 2009–2011 based cohort life tables.

[50] Table 4.6 assumes a 3% real discount rate. Using a higher discount rate will tend to increase the value of the current system relative to the proposed system, since under the current system a greater proportion of the total benefits are received early in retirement. Conversely, using a lower discount rate will tend to increase the value of the proposed system relative to the current system.

fewer than 10 years of entitlement to the single-tier pension and therefore would receive nothing (unless they make additional voluntary class 3 NI contributions).

The patterns of gains across different groups are – unsurprisingly – similar to those for gains in state pension income shown in Table 4.6 (reproduced from

Table 4.6. Change in present discounted value of pension income from proposed system and change in pension income at SPA – assuming cease remaining contributory activity at SPA

	Pension income at SPA			PDV of pension income over years post-SPA		
	% gain	% lose	Mean change	% gain	% lose	Mean change
All	**43%**	**19%**	**2.74**	**98%**	**2%**	**4,013**
Male	35%	21%	1.62	100%	0%	3,396
Female	61%	14%	5.23	94%	6%	5,381
SPA = 2016	18%	1%	2.21	99%	1%	4,135
SPA = 2017	52%	26%	2.07	99%	1%	3,670
SPA = 2018	51%	28%	2.62	99%	1%	3,864
SPA = 2019	59%	27%	4.93	96%	4%	4,561
Single	50%	16%	3.79	100%	0%	5,268
Couple	40%	20%	2.42	98%	2%	3,632
Any children	44%	20%	2.80	99%	1%	3,967
No children	37%	15%	2.41	98%	2%	4,021
Low education	42%	23%	2.81	98%	2%	4,662
Mid education	44%	18%	2.94	99%	1%	4,128
High education	41%	15%	2.35	98%	2%	2,809
Quintiles of total household net wealth						
Lowest quintile	51%	22%	3.97	97%	3%	5,607
2	34%	34%	1.82	99%	1%	4,968
3	50%	19%	3.55	99%	1%	4,556
4	39%	11%	2.19	99%	1%	2,621
Highest quintile	39%	10%	2.18	97%	3%	2,368
Ever paid reduced-rate NI	51%	17%	5.51	90%	10%	4,934
Self-employment years						
None	41%	20%	2.19	98%	2%	3,708
1 to 5	39%	20%	1.79	98%	2%	3,058
6 to 10	48%	21%	3.41	95%	5%	4,086
More than 10	55%	10%	7.51	100%	0%	7,279
Contracted-out years						
None	54%	30%	4.63	92%	8%	6,310
1 to 5	52%	27%	4.72	97%	3%	7,017
6 to 10	35%	31%	1.89	100%	0%	4,655
More than 10	39%	14%	2.07	100%	0%	2,940

Note: This table assumes a 3% discount rate. Also see note to Table 4.4.

Table 4.5). The gains are greater on average among women than men – £5,381 compared with £3,396. This is not only because women gain more state pension income on average but also because they are expected to live for longer post-SPA on average. Low-wealth individuals gain more on average than high-wealth individuals: those in the poorest wealth quintile gain £5,607 on average compared with £2,368 among the highest wealth quintile.

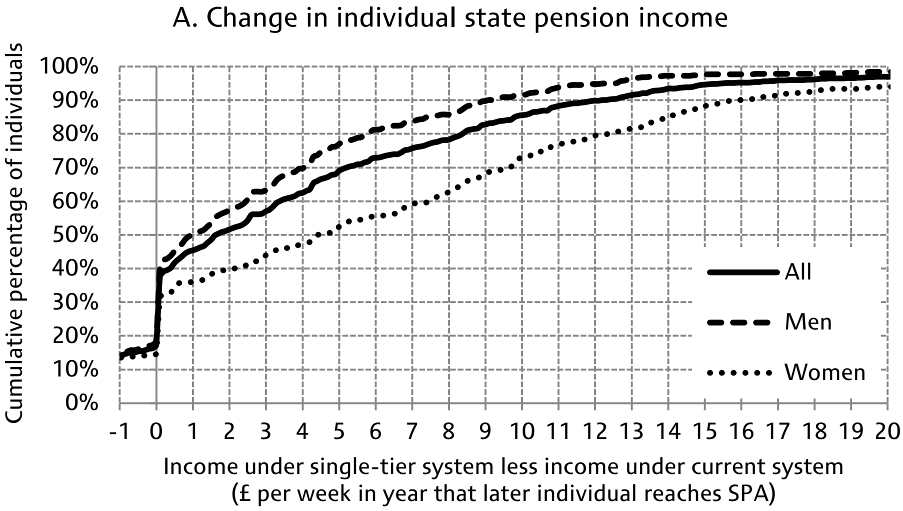
4.4 Interaction with means-tested benefits

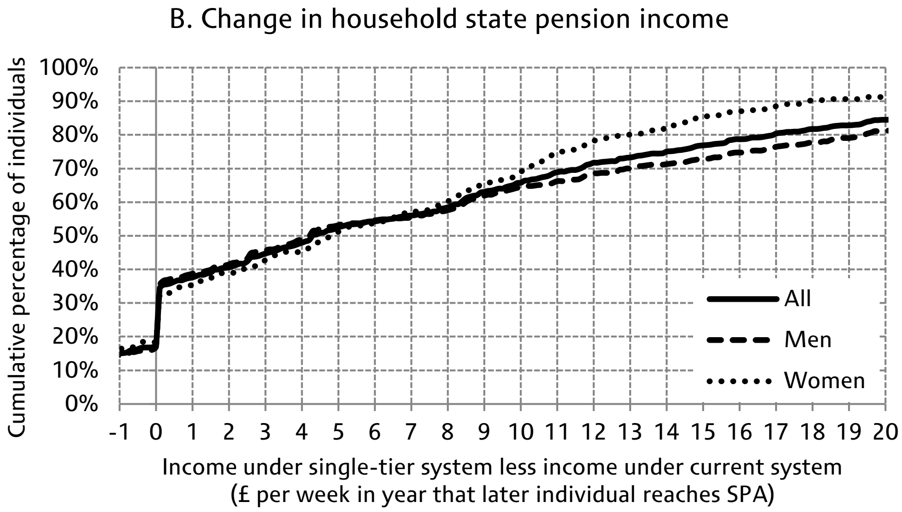
So far, this chapter has examined how state pension income will change as a result of the proposed single-tier reforms. As Table 4.5 showed, the largest gains in state pension income are concentrated among lower-wealth households; however, these households are more likely to be eligible for means-tested benefits, and so some of the changes in state pension income will be offset by changed entitlement to means-tested benefits. Ignoring this interaction overstates the cash gains and losses from the reforms for those who receive means-tested benefits. While individuals might of course prefer to have non-means-tested income rather than means-tested income, even if the amounts are the same, it is important to examine whether households' net income in retirement will actually be increased as a result of the state pension changes described above. Furthermore, although the removal of the PCSC is a coherent part of the single-tier proposals, its proposed abolition also has the potential to reduce income for these cohorts.

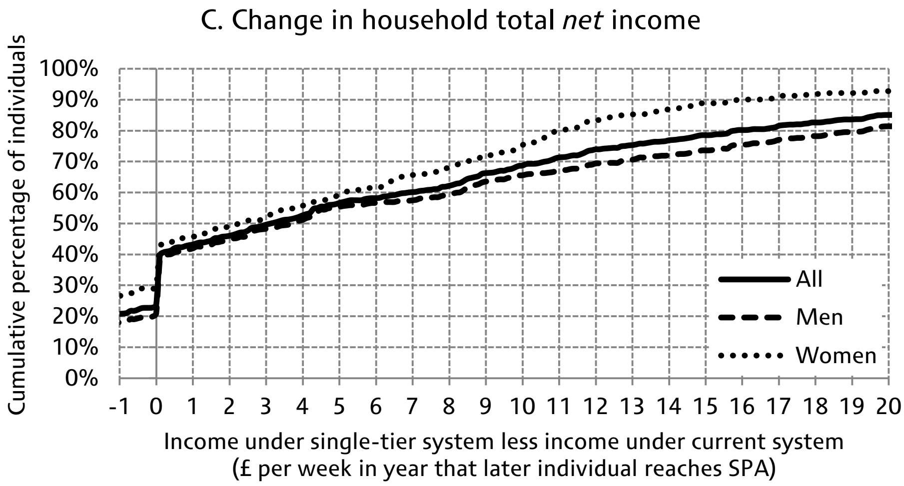
To assess the potential impact of the reforms on net household incomes, we have estimated means-tested benefit entitlement under the current and proposed systems, using information on state pension entitlements of the individual and their partner (where relevant) from the NI data and information on the individual's and their partner's private pension rights and household wealth holdings from ELSA. In these calculations, we take into account entitlement to means-tested pension credit but we ignore potential entitlement to other means-tested benefits, in particular housing benefit and support for council tax. We also assume full take-up of pension credit. Since, in reality, take-up is not complete, we will be overstating the extent to which the gains from the single-tier pension are offset by reduced means-tested benefit income.

Means-tested benefit entitlement depends not only on the income of the individuals described above but also on the circumstances of their partners. Therefore, in the analysis presented below, rather than focusing on income in the year in which the individual reaches SPA (as we have done above), we instead examine the family's income in the year in which the last individual in the couple reaches SPA. We have dropped from our sample a small number of individuals (49 people, less than 5% of our sample) who reach SPA between 6 April 2016 and 5 April 2020 but who have significantly younger spouses (who reach SPA later than 2026), since for these people this exercise would require examining income a long time in the future.

Figure 4.6. Distribution of change in income under proposed system compared with current system – assuming 'contributions' until SPA







Note: Excludes individuals whose partner's SPA is more than 10 years before or after their SPA.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

Figure 4.6 starts by describing the change in individual state pension income for the more limited sample just described in the year that the second partner in the couple (where relevant) reaches SPA, showing the distribution of changes in weekly pension income that would result from the introduction of the single-tier pension. These figures and all the analysis in this section assume that individuals continue to contribute until they reach SPA.

When we consider the year in which the last household member reaches SPA rather than the year in which each individual reaches SPA, more people are counted as gaining from the single-tier pension (55% in Panel A compared with 43% – shown in Table 4.5 – across all individuals, 50% of men compared with 35%, and 64% of women compared with 61%). This is because of the more generous indexation of pension income post-SPA under the single-tier pension system than under the current pension system.

In Panel B of Figure 4.6, we take total state pension income in the household and look at how that would differ between the single-tier system and the current system. The resulting distribution of gains is much more similar across the two sexes than the distribution of individual-level gains. Overall, 63% of individuals would see an increase in their total household state pension income of £1 or more, 34% would see an increase of £10 per week or more, and 15% of individuals would see a decline in their household state pension income of £1 or more.

Finally, Panel C describes the distribution of the estimated change in total household income, taking into account any change in pension credit entitlement and the abolition of PCSC under the single-tier system. Once these changes to means-tested benefits are taken into account, the gains from the proposed reform are smaller; this is because the additional state pension income for some households is offset by lower means-tested benefits. For example, 43% of individuals would see no change or a reduction to their total household income as a result of the reforms, compared with 37% who would see no change or a decrease in their household state pension income. When we consider total household income instead of individual state pension income, 21% rather than 14% of individuals in households would lose more than £1 per week in income post-SPA; this arises from the abolition of savings credit.

Overall, looking solely at changes in individual-level state pension income and ignoring means-tested benefit entitlement overstates the effect of the proposed reforms on household income. The extent to which this is important varies across groups with different characteristics. Table 4.7 shows the comparison for individuals with different characteristics. Looking at the average change in individual state pension income for individuals in each quintile of total net household wealth, we can see that the gains are largest on average for the lowest wealth groups, as described in Section 4.2. The poorest 20% of individuals gain £4.68 per week on average, compared with £2.53 for the richest quintile.

Taking into account the change in state pension entitlement experienced by partners (central panel of Table 4.7) actually reverses this picture, with higher-wealth households gaining on average £9.77 per week compared with £7.63 for the lowest-wealth households. This at least in part reflects the fact that higher-wealth households are more likely than low-wealth ones to contain couples, rather than single people.

Table 4.7. Percentage of gainers and losers from move to single-tier pension: by income definition and individual characteristics

	Individual state pension income			**Household state pension income**			**Total household net income**		
	Mean change	% gain	% lose	Mean change	% gain	% lose	Mean change	% gain	% lose
All	3.62	56%	15%	8.50	62%	15%	7.28	57%	21%
Male	2.65	52%	15%	9.57	61%	14%	8.86	58%	18%
Female	5.63	64%	14%	6.24	65%	16%	3.98	54%	27%
SPA = 2016	2.95	37%	1%	7.66	46%	6%	6.08	40%	13%
SPA = 2017	3.02	66%	19%	8.51	68%	18%	7.67	63%	23%
SPA = 2018	3.67	63%	21%	8.41	71%	19%	7.48	66%	24%
SPA = 2019	5.64	63%	24%	10.05	70%	21%	8.46	64%	27%
Single	3.79	50%	16%	3.79	50%	16%	-0.89	29%	40%
Couple	3.56	58%	14%	10.02	66%	15%	9.91	66%	15%
Any children	2.88	50%	14%	4.87	51%	13%	2.27	41%	25%
No children	3.74	57%	15%	9.11	64%	15%	8.12	60%	20%
Low education	3.59	53%	19%	8.01	60%	17%	6.20	52%	25%
Mid education	3.91	59%	12%	7.80	64%	11%	6.77	60%	16%
High education	3.26	57%	12%	10.26	63%	17%	9.81	61%	19%
Quintiles of total household net wealth									
Lowest	4.68	58%	17%	7.63	64%	14%	2.37	40%	38%
2	2.99	49%	25%	5.66	52%	27%	5.27	49%	29%
3	4.62	63%	14%	9.68	68%	15%	9.31	66%	17%
4	3.23	62%	9%	9.75	68%	10%	9.75	68%	10%
Highest	2.53	48%	9%	9.77	62%	10%	9.77	62%	10%
Ever paid reduced-rate NI	5.64	54%	17%	5.75	58%	19%	4.37	54%	25%
Self-employment years									
None	3.07	55%	16%	7.02	60%	17%	5.59	53%	24%
1 to 5	2.74	48%	16%	11.36	64%	15%	11.05	63%	16%
6 to 10	4.23	58%	12%	10.39	70%	8%	9.19	69%	9%
More than 10	8.20	70%	9%	16.57	74%	7%	16.39	74%	7%
Contracted-out years									
None	5.40	62%	25%	7.97	66%	23%	4.81	52%	36%
1 to 5	5.12	58%	24%	9.42	70%	18%	6.09	51%	32%
6 to 10	2.75	42%	28%	7.13	43%	24%	4.46	34%	38%
More than 10	3.01	56%	9%	8.68	63%	11%	8.45	62%	13%

Note: As for Table 4.4.
Source: Authors' calculations using English Longitudinal Study of Ageing and National Insurance administrative data.

Most interesting is the comparison between the middle and right-hand panels of Table 4.7 – the latter showing the change in household income between the current and proposed systems after taking account of means-tested benefit entitlements. The highest-wealth households are not entitled to any means-tested benefits and so the average gains are unaffected by taking pension credit into account. However, for low-wealth households, including pension credit makes a large difference: the average gain among low-wealth households is reduced from £7.63 per week to £2.37, and the proportion of these households that lose income as a result of the combined effect of the reforms to state pensions and pension credit is increased from 14% to 38% (for the highest-wealth households, the proportion remains constant at 10%).

4.5 Summary

A significant number of those reaching SPA between 6 April 2016 and 5 April 2020 will see their state pension income at SPA increased as a result of the proposed single-tier pension reforms. This is true of 61% of women and 35% of men. However, 19% of individuals (21% of men and 14% of women) will find that their income at SPA is lower than they could have achieved under the current system. On average, these cohorts' state pension income at SPA will be boosted by £2.74 per week as a result of the reforms.

Gains are largest among those who have spent periods out of the labour market caring for children and those who have had long periods of self-employment. We estimate that the average gain among women is £5.23 per week. The average gain among those who have had more than 10 years in self-employment is estimated to be £7.51 per week. The ability to 'work off' past periods of contracting out also means that those who have previously contracted out will also gain more than otherwise-identical individuals who remained contracted in.

Since state pension income will be indexed more generously during retirement under the proposed system than under the current system, virtually all of the losses that these cohorts will experience in state pension income at SPA will be recouped through higher state pension income later in retirement. We estimate that, over the whole of retirement, just 2% of individuals will actually have lower state pension income under the single-tier system than they would have under the current rules.

However, some of these gains in state pension income will be offset by reductions in means-tested benefit entitlements, including those arising from the proposed abolition of the pension credit savings credit. This is particularly the case for low-wealth groups. We find that, while 64% of individuals in the lowest wealth quintile in these cohorts live in households that will receive higher state pension income as a result of the reforms, only 40% of them will find that their household's net income is higher – after taking account of reductions in entitlement to means-tested pension credit.

5. Long-Run Effect of the Proposed Reforms on Pensioner Incomes

In this chapter, we attempt to clarify the long-run impact of the proposed reforms. The important distinction we draw between the 'long-run' effect of the policy (in this chapter) and the 'short-run' effect (discussed in Chapter 4) is between the effects on those who have spent most of their working lives under the S2P system ('long-run') and those who had a significant period under the SERPS system ('short-run'). Individuals who started their working lives in 2002 or later (born in 1986 or later) will have spent their entire working lives under the S2P system, as this was introduced in 2002. This group can, therefore, certainly be considered as falling within our long-run analysis. In addition, our conclusions on the long run will also apply to those earlier cohorts who will have spent a large proportion of their working life under the current system, including those expecting to accrue at least 31 years of creditable activities between 2002 and their SPA. This latter group could include individuals born as early as 1966, depending on their work histories.

For many of our illustrations, we focus on individuals who were aged 16 in 2002; these people were born in 1986 and will reach SPA in 2054. We examine this group because they are the first group to have spent their entire working lives under the S2P system. This group would also spend the vast majority of their working lives under the proposed system, if it is implemented, as currently planned, in April 2016.

This chapter describes how incomes in retirement (from both state pensions and means-tested benefits) would differ under the current and proposed systems in the long run. Sections 5.1–5.3 focus solely on state pension income, while Section 5.4 considers what impact the proposed reforms will have on income from means-tested benefits. Section 5.5 provides a summary.

5.1 How would the level of state pension income received at state pension age compare?

Table 3.1 indicated that the vast majority of people who would accrue entitlement to the proposed single-tier pension would also accrue entitlement to both the BSP and the S2P under the current system.[51] In this section, we focus on how accrual of both BSP and S2P compares with accrual of single-tier pension.

[51] Of those getting a qualifying year in 2011, 72% got them via class 1 contributions, which would also earn S2P entitlement; 18% accrued a qualifying year via credits, and many of these people would also have earned a qualifying year to S2P; and 4% accrued a qualifying year through a combination of credits and class 1 contributions. Source: DWP 1% sample of the National Insurance Recording System (NIRS2).

There are some groups who, under current legislation, would accrue only BSP and not S2P. These include those who are in self-employment, those receiving jobseeker's allowance and those who will be newly credited under universal credit (for example, those with multiple jobs earning below the LEL who may now be credited on the basis of their household income). We abstract from these groups in the following analysis; however, in Section 5.3, we examine the impact of the proposed reforms on the self-employed, and our conclusions there also apply to any others who would spend long periods of their life under the current system accruing entitlement to the BSP and not the S2P.

One year's accrual of BSP and S2P under the current system would be worth more (in terms of income at SPA) than one year's accrual of single-tier pension entitlement; but the latter would be worth more than a year of BSP accrual on its own. For example, under current legislation, an individual engaged in a creditable activity or working and earning at the LEL in 2016–17 would accrue entitlement to around £3.63 of BSP and £1.70 of S2P income at SPA, giving a combined accrual of £5.33.[52] This compares with £4.18 under the proposed system.[53]

Exactly how much more income someone would get at SPA under the current system than under the proposed system depends on how many years of contributions an individual has during their working life. In addition, for anyone making contributions between 2016 and 2030 (when accruals of S2P will still be earnings-related under current legislation), it will also depend on the exact level of their earnings.

Figure 5.1 shows the level of weekly state pension income that an individual born in 1986 would get at SPA, depending on the number of years of contributions they make during their working life. Panel A illustrates this for a 'low earner' – that is, someone who earns between the LEL and the LET in every year they are contributing (or, equivalently, is engaged in some form of S2P-creditable activity) – while Panel B illustrates this for a 'high earner' – that is, someone who earns at (or above) the UEL in each year that they are in work. There are three important points to note:

- Regardless of how many years of contributions an individual expects to have, the current system always delivers a higher income at SPA than the proposed system would. The difference is larger for high earners than for low earners in this cohort because the current legislation still provides for some earnings-related accrual to S2P up to around 2030.

[52] This holds for anyone who had not already accrued 30 years of contributions to the BSP. For someone who had accrued 30 years of BSP entitlement already, an additional year's accrual under the current system would only amount to £1.70 of extra weekly state pension income. These numbers are slightly different from those that apply to accruals in 2013–14 (£1.75 for S2P) because of how thresholds are uprated over time with lagged earnings growth / inflation and then deflated by contemporaneous earnings growth.

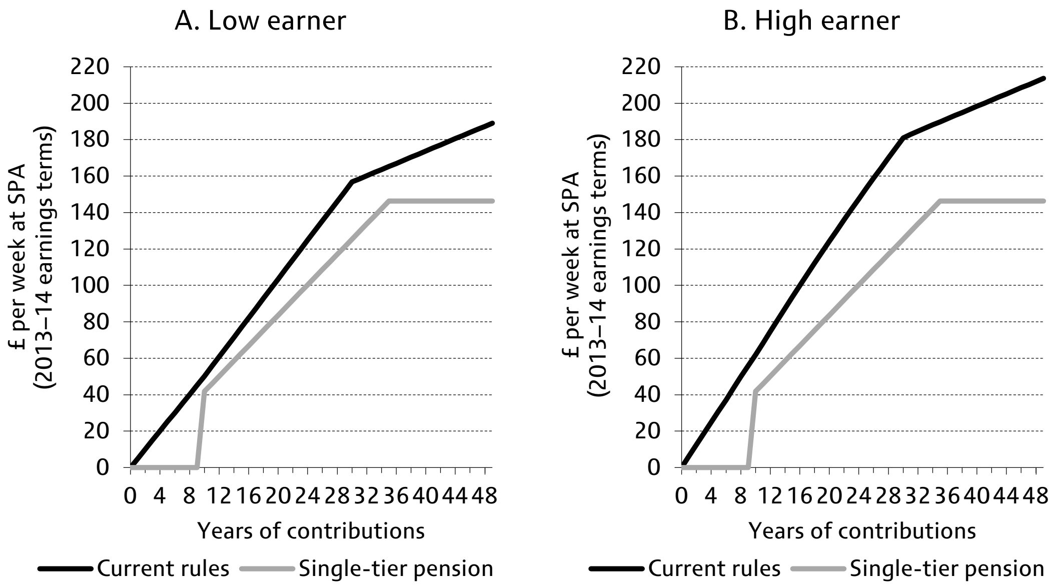
[53] However, if an individual had already accrued 35 years of contributions to the single-tier pension, the extra year of contributions would result in no increase in state pension income.

- For those expecting to have fewer than 10 years of contributions, the current system will provide considerably more income than the proposed system. Under the proposed system, those with fewer than 10 years of contributions will receive nothing, whereas they would receive up to £45.20 per week as a low earner (£55.92 as a high earner) under the current system.

- The relative advantage of the current system is also greater for those expecting to contribute for more than 35 years. The maximum amount of state pension income that someone in this cohort could receive under the proposed system is £146.30 per week. This compares with a maximum of £213.60 per week under the current rules for a high earner and £189.04 per week for a low earner (both with 49 years of contributions).

A similar picture would hold for slightly earlier and later cohorts than the one shown in Figure 5.1. For later cohorts, the picture for both high and low earners would look like Panel A – this is because the earnings-related element of the current system is diminishing and therefore both low and high earners will accrue increasingly similar amounts of pension income. For somewhat earlier cohorts, there would be a greater divergence between the two lines for higher earners. (For the effect of the single-tier pension on much earlier cohorts, see Chapter 4, which describes the short-run implications of the policy.)

Figure 5.1. Weekly state pension income at SPA under current and proposed systems: individuals aged 16 in 2002–03



Note: Figures are shown for someone who is contracted in, who starts working/contributing at age 16 and accrues their years of contributions continuously thereafter. The level of the BSP is assumed to increase with the triple lock until April 2015 and then with average earnings growth thereafter, whereas the value of the single-tier pension is assumed to be £146.30 in 2013–14 earnings terms and uprated with average earnings growth after 2016. A 'low earner' is defined as someone who earns between the LEL and the LET in every year they are in work (or, equivalently, is engaged in some form of S2P-creditable activity). A 'high earner' is defined as someone who earns at (or above) the UEL in each year that they are in work.
Source: Authors' calculations.

Box 5.1 provides further illustration by describing the state pension accrual that three example individuals would receive under the current and proposed systems.

Box 5.1. Examples of state pension accrual under the current and single-tier systems

The following examples describe hypothetical individuals born in 1986. All monetary figures are expressed in 2013–14 earnings terms.

Randall is employed and earns at the UEL every year between the ages of 20 and 54 (inclusive); he is not a member of a private pension scheme. Under current legislation, he will accrue state pension rights worth £186.30 per week at the SPA, which he will receive from the age of 68. This comprises £109.00 per week of BSP entitlement and £77.30 of S2P entitlement. Under the proposed single-tier pension system, he would accrue a state pension worth £146.30 per week.

Jeff is employed for 10 years and earns at the LEL between the ages of 20 and 29 but then suffers an accident at work and is unable to work again due to ill health. He then receives the limited capacity for work component of universal credit until he is 55. Under current legislation, he will accrue state pension rights worth £166.50 per week at the SPA, which he will receive from the age of 68. This comprises £109.00 of BSP entitlement and £57.50 of S2P entitlement. Under the proposed single-tier pension system, he would accrue a state pension worth £146.30 per week.

James is self-employed for 45 years between the ages of 20 and 64 (inclusive). Under current legislation, he will accrue state pension rights worth £109.00 per week at the SPA, which he will receive from the age of 68. This comprises simply a full BSP, as he does not accrue any entitlement to S2P. Under the proposed single-tier pension system, he would accrue a state pension worth £146.30 per week.

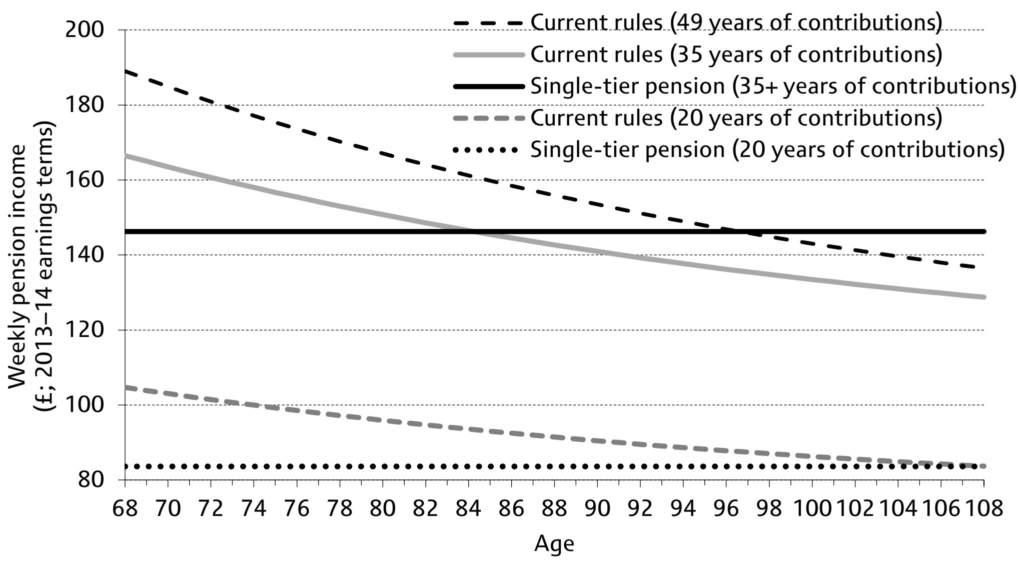
Zach has 30 years of moderate earnings. Under the current system, he will accrue a state pension of £156.80 per week at SPA, made up of a full BSP (£109.00) and £47.80 of S2P. Under the proposed single-tier pension system, he would accrue a state pension worth £125.40 per week.

5.2 How would state pension income evolve through retirement under the two systems?

As shown in the previous section, the amount of state pension income received at SPA would unambiguously be lower under the proposed system than under the current rules for the majority of individuals in later cohorts, based on the indicative figures provided in the White Paper for the level of the single-tier pension. (The main exception to this is the self-employed, and any others who do activities that only earn BSP entitlement; these groups are discussed in Section 5.3.) However, the single-tier pension is set to be indexed more generously through retirement than combined BSP and S2P income is. Therefore, when comparing the two systems, it is important to consider the entire stream of pension income that an individual would receive throughout their retirement, rather than just the income at SPA.

Figure 5.2 shows how weekly pension income would evolve during retirement, for someone born in 1986 with 20, 35 or 49 years of contributions to the state pension system; this is the same example 'low earner' shown in Panel A of Figure 5.1. The 35-year contribution history corresponds to the example of Jeff described in Box 5.1.

Figure 5.2. How state pension income evolves during retirement under the current and proposed systems: low earners aged 16 in 2002–03



Note: This graph is for someone contracted in, aged 16 in 2002–03, who works continuously from 2002–03 and earns between the LEL and the LET in every year they are in work (or, equivalently, is engaged in some form of S2P-creditable activity). Someone with 35 years of contributions is assumed to make contributions between the ages of 20 and 54 inclusive, and someone with 20 years of contributions is assumed to make them between the ages of 20 and 39 inclusive. The level of the BSP is assumed to increase with the triple lock until April 2015 and then with average earnings growth thereafter, whereas the value of the single-tier pension is assumed to be £146.30 in 2013–14 earnings terms and uprated with average earnings growth after 2016.
Source: Authors' calculations.

Under the proposed system, any individual born in 1986 who accrues at least 35 years of contributions towards the single-tier pension will receive £146.30 per week from SPA (age 68) onwards. This figure remains constant in earnings terms, reflecting the fact that the level of the single-tier pension will be increased each year in line with growth in average earnings.

By contrast, pension income under the current system would decline through retirement. This is because, though the BSP is indexed to average earnings, the S2P element is only indexed to prices. Therefore, Jeff – with 35 years of credits to BSP and S2P – would receive more income at SPA under the current system than under the proposed system (£166.52 per week, rather than £146.30 per week). However, this income will decline over time relative to average earnings, and so the weekly income he would expect to receive from age 85 onwards would be higher under the proposed single-tier system than under the current system.

If Jeff instead had 49 years of contributions, his state pension income under the proposed system would not exceed that under the current system until he was aged 97. (For a high earner, these cross-over points would happen even later – at ages 96 and 107, respectively – as shown in Figure A.2 in Appendix A.[54])

Taking the sum of pension income across Jeff's whole retirement under the two systems, and discounting future pension income at an appropriate rate, we find that he would have to live to beyond age 105 to be financially better off under the proposed system than under the current rules. If he had 49 years of contributions instead, he would have to live to an implausibly old age in order to be financially better off under the proposed system than under the current one.[55,56,57]

Although we have focused here on presenting figures for some example individuals from one specific cohort, the same inferences apply to everyone who expects to have at least 31 years from 2002–03 onwards in which they will engage in activities that are creditable towards both BSP and S2P under the current system.[58] As described in Table 2.1, these activities include earning above the LEL, caring for a child aged under 12, caring for a sick or disabled adult for at least 20 hours a week and, under some conditions, receiving certain incapacity-related benefits.

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[54] http://www.ifs.org.uk/docs/report_single-tier_pension_appendices.pdf.

[55] All these figures are calculated applying a 3% per year discount rate to real future pension income (deflated by CPI inflation). Using a higher discount rate would increase the age to which one would have to live in order to be financially better off under the proposed system; using a lower discount rate would reduce the age.

[56] The factor driving this difference is the amount of someone's current pension entitlement that is uprated with prices (their S2P entitlement) compared with the corresponding value of the single-tier pension (i.e. STP entitlement minus BSP entitlement) that is uprated with average earnings. The higher this proportion is, the longer it takes for entitlement under the current system to sink below that of the single-tier pension. Both younger cohorts and individuals with fewer than 35 years of entitlement face a higher proportion of S2P entitlement to the excess of STP entitlement over BSP entitlement, and so they have to live to beyond 105 years for the proposed system to be more value to them than the current system.

[57] Under our assumptions, with 49 years of contributions, Jeff would have to live to 139 years old in order to be financially better off under the proposed policy.

[58] This definition of the long run excludes those who have contracted out in the past. In some sense, individuals who contracted out prior to implementation will always be affected by the current pension system, as they will retain pension rights in their private pension that will not necessarily compare with the accrued rights of an (otherwise-identical) contracted-in individual. One should not compare 'long-run' outcomes for those who contracted out under the current system but who will reach SPA under the single-tier system with the 'long-run' outcomes for contracted-in individuals; for those who have contracted out, the true long-run comparison to make is with those who reach 16 in 2016 and beyond.

5.3 The self-employed

The self-employed are one of the few groups that, in the long run, will be able to accrue entitlement to a greater state pension under the proposed pension system than under the current one. As described in Table 2.1, under the current system self-employed individuals accrue entitlement to only the BSP, and not the S2P, for each year in which they make class 2 NI contributions. This means that a self-employed individual in 2016–17, for example, would accrue £3.63 of BSP under the current system, compared with £4.18 under the proposed system. Therefore, all other things being equal, (long-term) self-employed individuals would gain significantly from the proposed reforms. This is demonstrated by the example of James in Box 5.1.

However, there are two caveats to this statement to bear in mind. First, self-employed individuals currently pay lower NI contributions to reflect the fact that they receive lower benefits from the state.[59] If the government decides to increase NI contributions for self-employed people alongside the changes to the state pension system, then the self-employed may not gain to the same extent as just suggested (or, indeed, at all). As the government brings benefits for the self-employed in line with those for the employed – addressing an inequality between the two groups that has existed for decades – it would seem to make sense also to equalise their contributions.

Second, individuals rarely spend their entire working lives in self-employment – they are likely instead to have some periods of employment and/or other activities (such as caring for children) that earn entitlement to S2P.[60] Therefore, currently self-employed individuals could lose out from the proposed reform. For example, an individual born in 1986 (starting working life in 2002) might only need to spend 31 years engaged in other creditable activities or earning at the LEL (out of 52 potential years of working life) to have a lower total stream of pension income in retirement under the proposed pension than under the current system.[61] They could, therefore, spend at least 40% of their working life in self-employment and still not gain from the proposed reform.

[59] HM Revenue and Customs estimates the net cost to the government of reduced NI contributions for the self-employed was £1.6 billion in 2012–13. See http://www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf.

[60] Of our core (representative) ELSA sample born 1945–1952, 21% have spent any years between 1975 and 2003 in self-employment (32% of men and 12% of women). This group of individuals with any self-employment has spent an average of 16 years in self-employment (out of a maximum of 29) and an average of 15 years with positive employment earnings.

[61] This is based on comparing the present discounted value of the state pension income stream under the current and proposed systems, assuming that the individual lives to age 90 (which is the ONS's latest, period-based, estimate of life expectancy for individuals born in 1986). Our calculation assumes that the BSP and proposed single-tier pension are uprated in line with earnings.

5.4 How does the proposed system affect who would qualify for means-tested benefits and what they would receive?

In the preceding sections we focused on the impact of the proposed reforms on individuals' state pension incomes. However, the proposals set out in the Pensions Bill also affect entitlements to means-tested benefits in two distinct ways. First, the proposals affect the level of individuals' state pension income in retirement, which may move people above or below the means-testing thresholds for various benefits. Second, the Pensions Bill proposes abolishing one existing means-tested benefit – the savings credit component of pension credit (PCSC). Since these effects arise from independent aspects of the reform (in other words, PCSC could be abolished with or without the move to the single-tier pension and the single-tier pension could be introduced with or without abolishing PCSC), we consider each in turn.

The effect of the single-tier pension on entitlement to means-tested benefits

As described in Sections 5.1 and 5.2, in the long run almost all individuals will accrue lower state pension entitlement under the proposed system than under the current system. Such a reduction in the generosity of the state pension would – other things being equal – increase the dependence of individuals on means-tested benefits. The pension credit guarantee credit (PCGC) is available to single pensioners with incomes below £145.40 per week (2013–14 terms).[62] Figure 5.1 indicates that, under the current state pension system, a low-earning individual born in 1986 would require 28 years of contributions towards the BSP and S2P in order to accrue a state pension income at the SPA in excess of £145.40, while under the proposed system such an individual would require 35 years of contributions. Therefore individuals with between 28 and 35 years of contributions may be entitled to PCGC at the SPA under the proposed pension system (provided they did not have other income sources or wealth that pushed them above the threshold), while these individuals would not be entitled to any PCGC at the SPA under the current system.

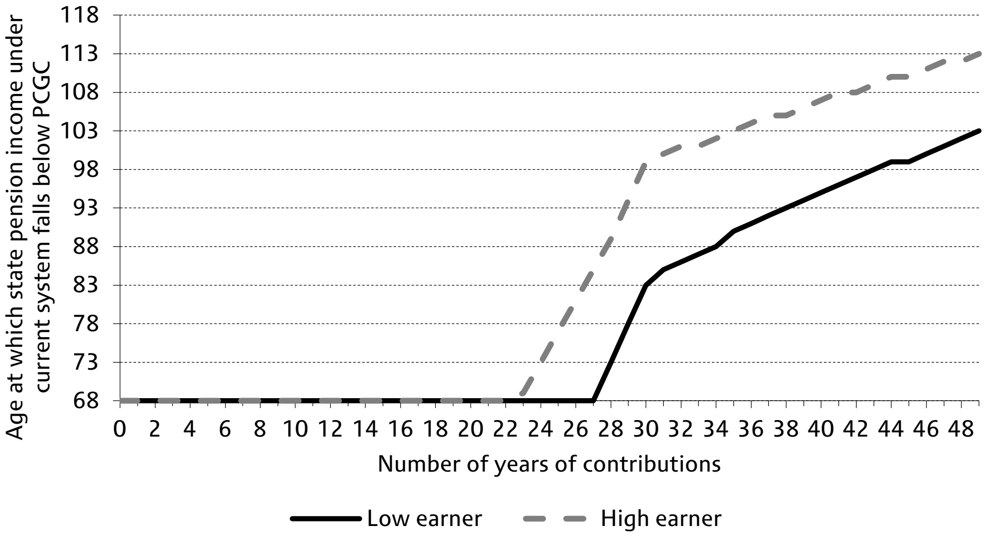
While more people are likely to qualify for means-tested PCGC at SPA under the proposed system than under the current system, it is possible that some individuals who would not be eligible for means-tested benefits at SPA under the current system would fall onto them as they get older, given the way that state pension income and means-testing thresholds are indexed under current

[62] Income for the purposes of assessing PCGC entitlement includes the following: state pension income, occupational or private pension income, annuity income, earnings, most social security benefits (excluding housing benefit, support for council tax, attendance allowance, disability living allowance, and any Social Fund payments), and capital income over £10,000. See http://www.dwp.gov.uk/publications/specialist-guides/technical-guidance/pc10s-guide-to-pension-credit/income-rules/#counts for an exhaustive list.

legislation. This is described briefly in the next paragraph for completeness. However, given the range of activities that earn entitlement to both BSP and S2P under the current system – and therefore the likelihood that many people will have relatively high state pension entitlements in the future under current legislation – most people in the long run should not expect to be in this position.[63]

The PCGC level is increased each year in line with average earnings. State pension income under the current system is increased less quickly than this. Therefore, under the current system, there could be some individuals whose state pension income is sufficient to remove them from PCGC eligibility at SPA but who will fall back onto means-tested benefits at older ages. As an example, a single low earner born in 1986 who accrued 28 years of contributions to BSP and S2P would find that their state pension income from the current system would fall below the PCGC level by age 73; this would rise to age 90 if they had accrued 35 years of contributions, as shown in Figure 5.3.

Figure 5.3. Falling onto means-tested benefits?



Note: This graph is for someone contracted in, aged 16 in 2002–03, and who is an employee continuously from 2002–03, so someone with 10 years of contributions here is assumed to start work in the 2002–03 tax year and stop in 2012–13. The low earner is assumed to earn between the LEL and the LET in every year they are in work (or, equivalently, is engaged in some form of S2P-creditable activity), whereas the high earner is assumed to earn at or above the UEL in each year. The level of the BSP is assumed to increase with the triple lock until April 2015 and then with average earnings growth thereafter, whereas the value of the single-tier pension is assumed to be £146.30 in 2013–14 earnings terms and uprated with average earnings growth after 2016. The pension credit guarantee credit level is uprated with average earnings growth.
Source: Authors' calculations.

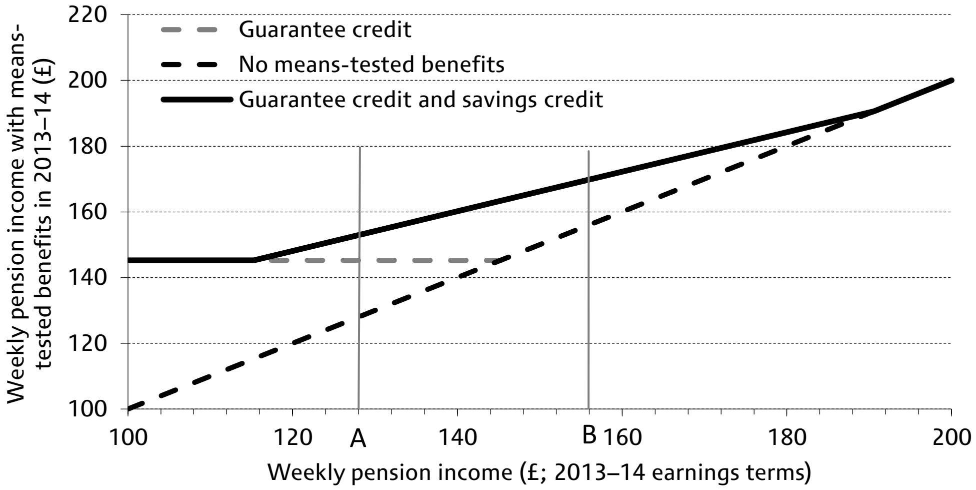
[63] DWP estimates that, even by 2020, approximately 85% of people reaching SPA will have 35 or more qualifying years, though these qualifying years will include years of self-employment and other activities that accrue BSP but not S2P entitlement.

The effect of abolishing pension credit savings credit on entitlement to means-tested benefits

The removal of the PCSC will reduce the maximum income at which someone would be entitled to pensioner-specific means-tested benefits, and therefore reduce the number of people entitled to such benefits. However, pensioners are entitled to other means-tested benefits such as housing benefit and support for council tax. The reduction in the number of individuals entitled to any means-tested benefits driven by the abolition of PCSC therefore depends on how many individuals are currently entitled only to the PCSC and not to any other means-tested benefits.

While means-tested benefits can be an effective way of targeting limited public resources to those on lower incomes, they may also reduce incentives to save; for those who expect to be eligible for PC, each £1 of private income received in retirement will reduce the amount of PC received. Indeed, it was this very concern that motivated the introduction of PCSC, as well as the idea that those who had saved for retirement should be rewarded for doing so.

Figure 5.4. Pension credit



How the pension credit system operates is described in more detail in Section 3.5. Figure 5.4 repeats Figure 3.2 and shows how PCGC and PCSC top up non-means-tested income for single individuals. Abolishing PCSC will increase the expected marginal withdrawal rate of means-tested pensioner benefits for some individuals, while reducing it for others. In particular, we can think of two groups who are affected in different ways:

1. Those who expect to have income below the PCGC level but above the minimum threshold for PCSC eligibility will face a higher marginal withdrawal rate if PCSC is abolished. Instead of losing 40p of PC income for each £1 increase in private income (i.e. a 40% withdrawal rate), these people would face a 100% withdrawal rate of PCGC. Those with income at point A

would go from facing the slope of the solid black line to facing the 100% withdrawal rate corresponding to the dashed grey line.

2. Those who expect to have income above the PCGC level but below the maximum threshold for PCSC eligibility (for example, those with income at B) will face a lower marginal withdrawal rate if PCSC is abolished. Instead of facing a 40% withdrawal rate, these people would not be entitled to any PCSC income at all and so would not face any withdrawal of PCSC.[64]

Those above the PCSC upper threshold will still face withdrawal rates of 0%, and those below the PCSC lower threshold will still face 100% withdrawal rates.

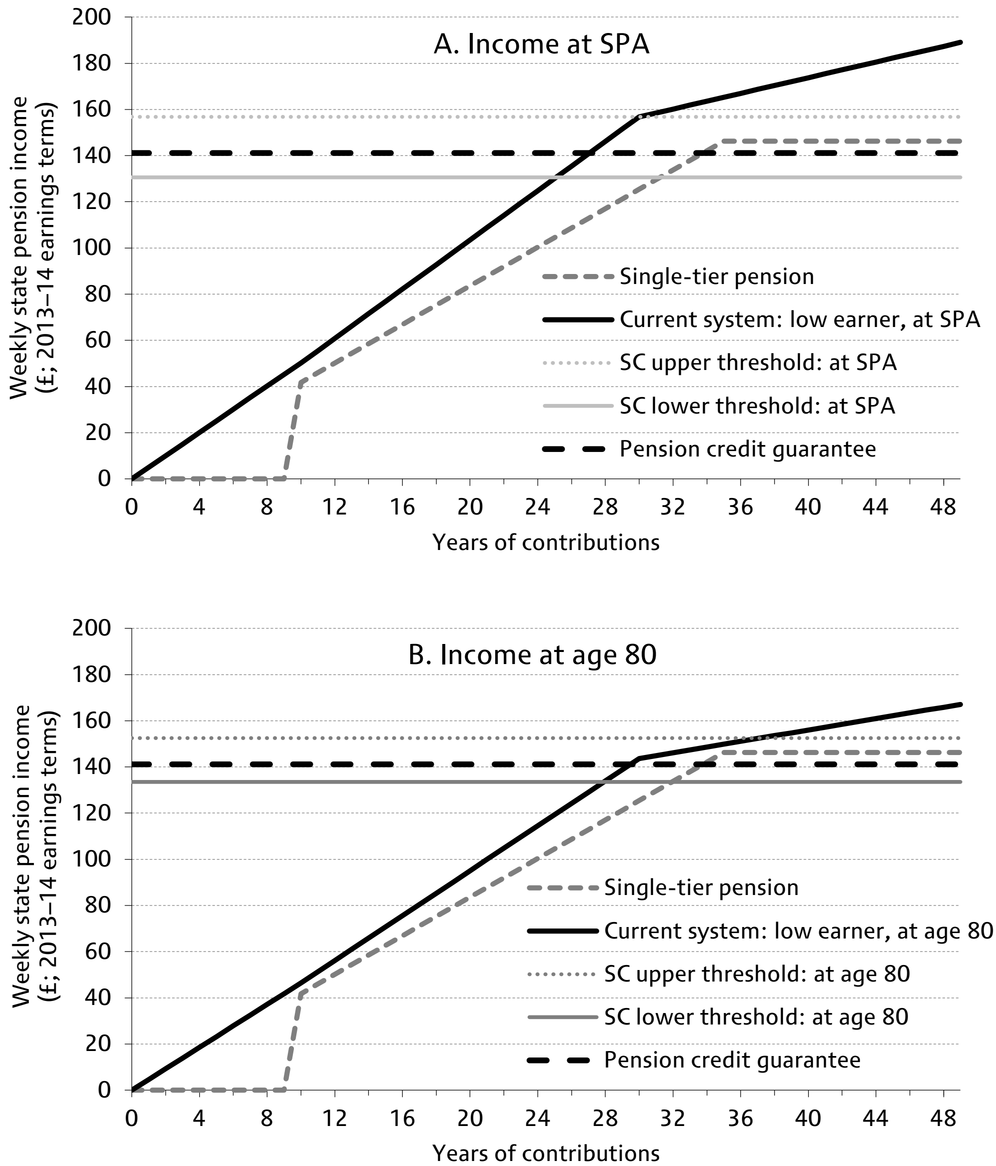
Marginal incentives to save privately for retirement would be decreased for group 1 and increased for group 2. Whether or not an individual expects to be in one of these groups will depend not only on their state pension income but also on any other private resources they have. However, for illustrative purposes, Figure 5.5 shows – for individuals who only have state pension income – how many years of contributions they would need to have under the current and proposed state pension systems in order to fall into one or other (or neither) of these groups. It takes the example of a single low earner born in 1986. Since, as mentioned above, under the current system state pension income declines relative to the PC thresholds over time, it is important to think not only about individuals' circumstances at SPA but also their circumstances later in retirement. Figure 5.5 therefore shows not only which group an individual would fall into at SPA but also which group they would be in at age 80.

Panel A of Figure 5.5 shows that, at SPA, single individuals with 26 or 27 years of contributions would fall into group 1. Those with 28 or 29 years of contributions would fall into group 2. Panel B shows that this person would need 38 years of contributions to ensure they remained outside PCSC eligibility at the age of 80. Those with fewer than 27 years of contributions would be unaffected by the abolition of PCSC – facing a 100% withdrawal rate both with and without the PCSC. As the SPA rises, labour force attachment increases and growing numbers are credited with state pension entitlement for unpaid activities, the size of the groups affected by PCSC will fall to zero.

Eligibility for pension credit therefore looks rather similar under the current and proposed systems. Under current legislation, eligibility for PC extends further up the income distribution (because of PCSC) but state pension incomes would be higher for a given number of years of contributions. Meanwhile, under the proposed system, state pension income would be lower but eligibility for PC would cease at a lower level of income.

[64] Note that this withdrawal rate may not affect their overall marginal effective tax rate, as they may be facing withdrawal of their housing benefit income or support for council tax.

Figure 5.5. State pension income and pension credit eligibility



Note: These graphs are for someone contracted in, aged 16 in 2002–03, and who is an employee continuously from 2002–03, so someone with 10 years of contributions here is assumed to start work in the 2002–03 tax year and stop in 2012–13. The low earner is assumed to earn between the LEL and the LET in every year they are in work (or, equivalently, is engaged in some form of S2P-creditable activity). The level of the BSP is assumed to increase with the triple lock until April 2015 and then with average earnings growth thereafter, whereas the value of the single-tier pension is assumed to be £146.30 in 2013–14 earnings terms and uprated with average earnings growth after 2016. The pension credit guarantee credit level is uprated with average earnings growth and the maximum pension credit savings credit award is frozen in nominal terms, meaning that the lower and upper thresholds converge with one another.
Source: Authors' calculations.

To illustrate the impact of the abolition of PCSC and how it interacts with the introduction of the single-tier pension more clearly, Box 5.2 returns to the example of James and Box 5.3 returns to the example of Zach, both from Box 5.1.

Box 5.2. Effect of the single-tier pension and abolition of pension credit savings credit on James's income in retirement

The following example describes a hypothetical individual, James, born in 1986. As described in Box 5.1, he accrues 45 years of credits to the BSP (or the single-tier pension) through self-employment.

Under the **current pension system**, James's state pension income at SPA will be £109 per week. James has saved into a private pension and he expects to receive £25 a week of income from these savings. James receives £7 of PCGC and £2 of PCSC. For every additional £1 of private saving, he has £1 of PCGC withdrawn, but he gets an extra 60p of PCSC, giving him some incentive to save privately.

Under the **single-tier pension system**, James's state pension income at SPA would instead be £146.30, and his private pension income would take him well above the PCGC level. He would receive no top-up to his income from the PCGC (the PCSC would no longer exist). His marginal incentive to save into a private pension would therefore be improved: instead of 60p of extra income from each extra £1 of saved income, James would expect to keep all of the additional income. (However, the higher level of state pension income he expects to get under the single-tier system may decrease his incentive to save privately.)

Box 5.3. Effect of the single-tier pension on Zach's income in retirement

The following example describes a hypothetical individual, Zach, born in 1986. As described in Box 5.1, he accrues 30 years of credits to the BSP and S2P (or the single-tier pension) through earnings.

Under the **current pension system**, Zach's state pension income at SPA will be £156.80 per week, taking him just over the maximum income threshold for PCSC eligibility. He will therefore expect to keep any income he receives from his private pension saving – none of it will be withdrawn through means-tested benefits.

Under the **single-tier pension system**, as Zach has only 30 years of entitlement, his single-tier pension entitlement of £125.40 will fall below the level of the PCGC. He will have his income topped up by the government to the PCGC level of £141.10. However, for each £1 of income that he receives from his private savings, he will face the withdrawal of £1 of his PCGC entitlement. He therefore will have no incentive to save privately for retirement.

The above discussion implicitly assumes that all those who would be eligible for PC would take it up. In reality, take-up is not 100%; DWP estimates that, although in 2009–10 between 73% and 80% of those eligible for pension credit guarantee credit actually claimed it, only 43–48% of those eligible for the savings credit claimed it.[65] For individuals who might qualify for PCSC but do not intend to take

[65] Department for Work and Pensions, 2013f.

it up, abolishing PCSC will not have any effect on the marginal withdrawal rate they expect to face in retirement.

5.5 Summary

The proposed single-tier pension represents a less generous state pension for almost everyone in the long run. Income at the SPA would be lower under the proposed system, and particularly so for those who contribute for longer, whether through paid employment, caring or receiving disability-related benefits. Although the more generous indexation arrangements under the proposed system would narrow this gap through retirement, most people would have to live to beyond age 100 to be better off overall.

The only real exception to this is those who expect to spend the majority of their working lives in self-employment or who will newly receive credits to the basic state pension when universal credit is introduced; these individuals could get a significantly greater state pension income in retirement under the proposed system than under the current system. However, it remains to be seen whether the self-employed will be asked to pay higher NI contributions, which could offset this gain.

The direct effect of the single-tier pension proposals in the long run, therefore, is to reduce state pension income for most people. This will increase the need for most individuals from later cohorts to save privately for retirement. In addition, the abolition of the pension credit savings credit will reduce incomes further for some groups. It will also change the marginal financial incentive to save privately for retirement for some people – increasing it for some and decreasing it for others.

6. Wider implications of the proposed reforms

The proposed single-tier pension reform marks the latest, possibly final, step on a long – and ultimately somewhat circular – journey for state pensions in the UK. The single-tier pension would bring back a state pension that looks rather like the system in place before the 1975 Social Security Act, although with more extensive crediting for those doing unpaid activities.

The proposed changes have significant implications for both the UK's public finances and for individuals and their finances. In this chapter, we describe how the latest proposed reforms fit into the extensive history of state pension reforms over the last 40 years, and discuss the wider implications of and lessons to be drawn from the new system for the government and individuals.

6.1 A long and circular road

In 1974, the UK state pension system contained a basic state pension (BSP), which was uprated each year in line with growth in average earnings. People accrued entitlement to this pension if they worked and paid flat-rate NI contributions; men needed 44 years and women 39 years of contributions to receive the full BSP.[66]

In 1975, the Labour government legislated for a new earnings-related pension, which dramatically increased the pension that higher earners, in particular, could get from the state. From the very start, commentators pointed out that this system looked unsustainable and that the government did not appear to have given adequate consideration to the long-run costs (Hemming and Kay, 1982). The last 30 years have been spent – by parties of all political persuasions – unpicking this policy and reducing the future costs to the taxpayer. At the same time, the system has been made more generous to those who spend periods in unpaid activities. The single-tier pension reform marks perhaps the final logical step on this journey.

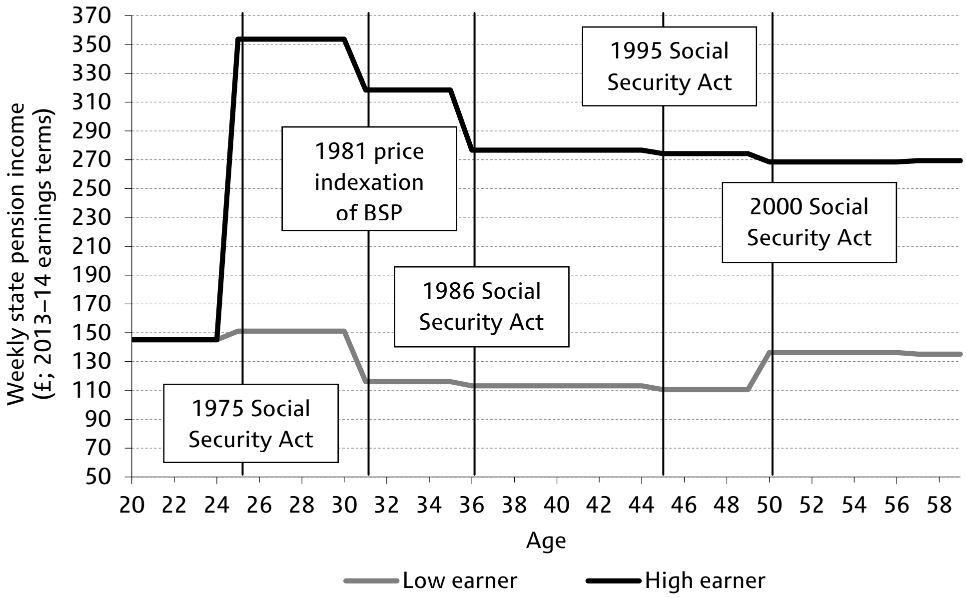
A number of different policy reforms have been attempted over the years to reduce the overall cost of the UK state pension system and to divert more of the spending towards those with lower lifetime earnings. Figure 6.1 gives an indication of the effects of the various policies by showing the pension income at SPA that low- and high-earning men born in 1950 would have expected to get at certain ages, given the legislation that was in place when they were that age – assuming that they expected it to remain in place. The low earner shown is assumed to have earned fractionally above the lower earnings limit (LEL) for 49

[66] As mentioned in Chapter 2, there was also graduated retirement pension, which had been introduced in 1961. Entitlements to this are very low – largely because they have not been fully uprated to account for price inflation over time.

years – between ages 16 and 64. The high earner is assumed to have earned at the upper earnings limit (UEL) for the same 49 years.

At the age of 20 (in 1970), assuming these people knew their future earnings trajectories and believed that contemporaneous state pension legislation would continue, both these individuals would have expected to get a state pension income at the age of 65 of £145 per week (in 2013–14 earnings terms) – that is, a full BSP indexed to growth in average earnings. In 1975, when these people were 25, a new Social Security Act was passed, which legislated for the original incarnation of SERPS. This hugely increased the income that the high earner would have expected to receive from the state pension, although it had essentially no effect on the low earner.

Figure 6.1. Expected state pension income at SPA based on legislation in place when individuals were at different ages: men born in 1950



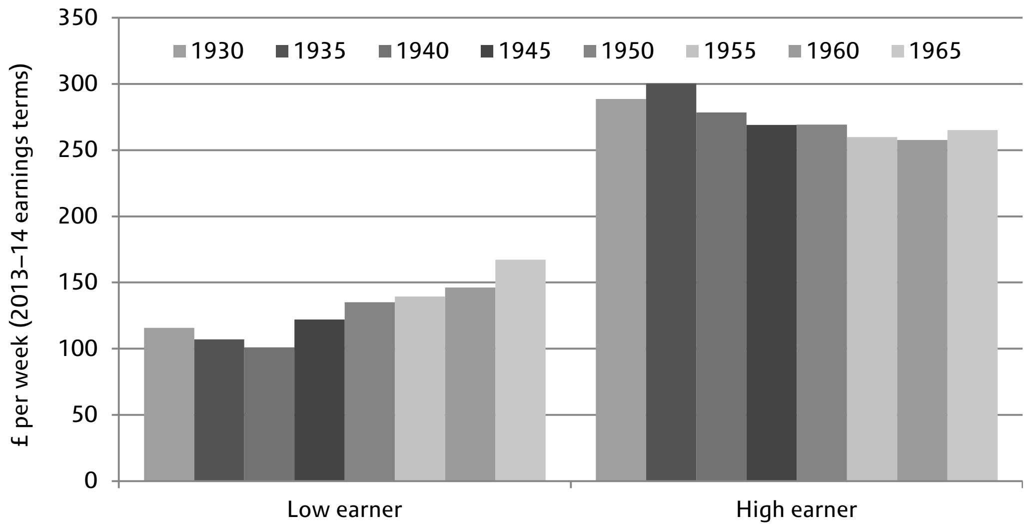
Note: This graph is for men born in 1950, who are assumed to be employed and to be contracted in to the state second-tier pension for all years (where relevant) between ages 16 and 64. The low earner is assumed to earn at fractionally above the LEL, while the high earner is assumed to earn at the UEL. The figure includes all major state pension reforms but excludes minor changes that have happened to uprating in the past. The figure also excludes entitlement to the graduated retirement pension.
Source: Authors' calculations.

It quickly became apparent that the costs of the state pension system implied by the 1975 Act were unsustainable. Against this backdrop, the Conservative government in 1981 decided to break the link between the BSP and average earnings and instead uprate using the retail price index. This decision affected both the high and low earners and reduced the amount that each of them would have expected to get from the BSP by £35 a week.

Subsequent reforms of SERPS (in 1986 and 1995) reduced the value of SERPS for the high earner by £44 a week in total. Finally, at the age of 50, the introduction of S2P in the 2000 Social Security Act increased the state pension that the low earner would expect to get by £26 per week. For the low earner, this last reform returned their expected pension to about £10 a week below the level that was implied by the pre-1981 earnings-indexed BSP.

State pension reforms since 1974 first dramatically increased the amount of state pension that higher earners could receive from the state, then gradually reduced the additional pension available to higher earners. The biggest effect on many, particularly low earners, was the decision to index the basic state pension in line with prices after 1981. This significantly reduced future entitlements. Reforms to the earnings-related element and crediting of unpaid activities from 2000 onwards have benefited lower earners. The combined effect of these reforms means that high earners in earlier cohorts will have received relatively higher state pension entitlements than high earners in later cohorts, while low (or non-) earners in later cohorts have tended to fare better than low (or non-) earners in earlier cohorts.

Figure 6.2. State pension income at SPA for example low- and high-earning men, by cohort



Note: This graph is for men born in different years, who are assumed to be employed and to be contracted in to the state second-tier pension for all years (where relevant) between ages 16 and 64. The low earner is assumed to earn at fractionally above the LEL, while the high earner is assumed to earn at the UEL. The figure excludes entitlement to the graduated retirement pension.
Source: Authors' calculations.

This is illustrated in Figure 6.2, which shows state pension income at SPA for example low- and high-earning men from a number of different cohorts. (These example low and high earners have the same type of career history as the individuals depicted in Figure 6.1.) For low earners, later cohorts will receive more state pension income than earlier cohorts did – with the 1965 cohort expecting to receive £167 a week at SPA under current legislation (in 2013–14 earnings terms), compared with just £101 a week for the 1940 cohort, who reached SPA in 2005. Conversely, higher earners fared better in earlier cohorts, with state pension entitlements peaking (at £300 a week) among the 1935 cohort, who reached SPA in 2000, compared with £265 a week for the 1965 cohort. These trends also mean that the potential entitlements of high and low earners have been converging over time.

The single-tier pension proposals are, therefore, potentially the final step in a tortuous journey back towards a state pension system that will look remarkably similar to the one that was in place in 1974. As suggested by Figure 6.1, had the link between the BSP and average earnings not been broken in 1981, the BSP would now be worth around £145 a week – essentially the same level as suggested for the single-tier pension. Arguably the main reason for breaking the link with earnings in 1981, and the subsequent reforms in 1986 and 1995 that reduced the generosity of SERPS, was to reduce the future costs of state pensions, which had been dramatically increased by the introduction of SERPS in 1975. The single-tier proposals serve to sweep away the remnants of the earnings-related state pension system and restore an earnings-indexed basic level of state pension income. The one big difference between the single-tier pension and the 1974 system is that the single-tier pension will be essentially universal, with extensive crediting of unpaid activities, which was not available in 1974.

6.2 Reducing the long-run costs of state pensions

The latest long-run public finance forecasts from the Office for Budget Responsibility (OBR) suggest that age-related spending will increase significantly over the next 50 years. One driver of this is the growth in spending on state pensions implied by current policy. The Office for Budget Responsibility (2012) suggests that spending on state pensions will increase from 5.7% of national income in 2011–12 to 8.3% by 2061–62.[67]

As we described in Chapter 5, in the longer run, the proposed single-tier pension reforms imply a reduction in state pension income for most people in later cohorts compared with what they could expect to get under current legislation. It is therefore not surprising that DWP estimates that these proposals will reduce future state pension spending by 0.4% of national income.[68]

The OBR's long-run forecasts suggest that – at some point – additional measures to reduce public spending or increase tax revenues will be required to prevent the upward trends in age-related spending implied by current policy leading to rising levels of public debt.[69] The single-tier proposals could be considered as going some way to delivering such an adjustment. Therefore, to the extent that the single-tier proposals provide greater clarity about how this required adjustment in public policy will be achieved, they might be welcomed by current younger cohorts even though they lose directly (in terms of their future state pension income) from the changes. The proposals will also, no doubt, be

[67] These figures assume that the BSP will be triple-locked indefinitely.

[68] Department for Work and Pensions, 2013b.

[69] See chart 3.8 of Office for Budget Responsibility (2012).

welcomed by future governments, who will be saved from having to grasp this thorny problem themselves.

6.3 Future political risk

There are some reasons to believe that the proposed single-tier reform may be more long-lasting than the multitude of other reforms over the past 40 years. In particular, the reforms of the past 30 years have predominantly been about gradually unpicking the system of earnings-related pensions that came into effect from 1978. The single-tier pension can be seen as the final point in that journey. Being more straightforward and easier to understand, it may also prove more robust.

However, there are always parameters that could be changed by future governments. Probably the most obvious in the single-tier system is the indexation arrangement. The proposed legislation provides for earnings indexation of the level of the single-tier pension. Changing this could have a profound effect on future pension entitlements. The move to price indexation of the BSP in the early 1980s demonstrates the potential for this: had the indexation arrangements for the BSP not been changed at that point, the BSP would now be worth around £145 a week, rather than £110.

Future governments will need to understand how tweaking this parameter affects people. Perhaps more importantly, future voters will also need to understand this. A change to the indexation of pensioner benefits may sound superficially as if it affects only older people at that point. However, because under the single-tier system (just as with the BSP) such a change compounds in each future year, it is the youngest who stand to lose (or gain) the most if indexation is made less (or more) generous.

The current government has stated that it intends to use the SPA to control future spending on state pensions – that is, to increase the SPA further if increases in longevity lead to higher projected pension spending. However, changing the SPA takes a long time to generate reductions in pension spending and future governments may be tempted to look for quicker savings by changing indexation. Equally, future governments might be tempted to woo older voters by making indexation arrangements more generous. If they do, they will need to be mindful of the long-run costs.

6.4 Greater need for private saving

For most individuals in later cohorts, the proposed reforms represent a reduction in the income that they can expect to receive from the state in retirement relative to currently legislated policy. This increases the need for them to save privately for retirement. As Figure 5.5 showed, a low (or non-) earner born in 1986 who accrues 35 years of credits towards the BSP and S2P would see their potential state pension income at SPA reduced from £8,618 per year to £7,629 per year by the proposed single-tier reforms. To make up this deficit, they would need to save more privately for retirement. These figures would be greater for a higher earner.

Previous research suggests that individuals in the UK do change their private retirement saving behaviour in response to changes in state pension entitlements.[70] However, if the only effect of the policy were to reduce future state pension income, it is extremely unlikely that private saving would respond sufficiently to avoid future pensioner incomes being lower than they would have been. Saving more for retirement means giving up some expenditure today, and it would be surprising if individuals chose to reduce spending today to a great enough extent to avoid any reduction in expected expenditure during retirement. Instead, they are more likely to opt for a smaller cut in spending today and accept that this will result in a small cut in their future retirement resources.

Reducing future pension income is not, however, the only effect of the proposed reforms. They should also increase clarity about how much individuals can expect to get from the state in retirement. Furthermore, by going some way to reducing future pressure on public spending, the latest reforms may also increase individuals' certainty that there will not be further radical reforms to state pension entitlements before they reach SPA.

Greater clarity could increase private retirement saving if either (i) it enables individuals to engage with decisions about pension saving who would otherwise have done nothing through inertia or (ii) it makes individuals more aware of how little income they can expect to get from the state in retirement. Repeated reforms to state pensions make it hard for individuals to make appropriate, well-informed decisions about how much to save privately for retirement. Greater certainty should ensure that individuals' private saving decisions – whatever they may be – are ultimately more optimal, although this does not necessarily mean they will save more.

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[70] Attanasio and Rohwedder, 2003.

7. Conclusions

Pensions Bill 2013–14 proposed a significant reform of state pension rules in the UK – bringing about a system under which the same state pension income will be accrued for a wide range of activities during working life. This reform marks perhaps the final step on a journey to unpick the effects of the 1975 introduction of SERPS. Indeed, the proposed system will look rather similar to the state pension system that was in place in 1974, although with more extensive crediting for periods of unpaid activity. The short- and long-run effects of the proposed reforms are very different.

The short-run effect of this policy is to equalise pension incomes for those close to retirement more quickly than would be achieved under current legislation. Few people living in the UK will see any significant reduction in their already accrued rights but some will see significant increases. In particular, this applies to those who had significant periods out of paid work caring for children prior to 2002 and to the long-term self-employed. Using a unique new data set that links individuals' National Insurance contribution histories to detailed survey data on their socio-demographic, financial and health circumstances, we have been able to analyse in detail how the proposed reforms will affect the state pension entitlements and means-tested benefit entitlements of those reaching state pension age (SPA) between April 2016 and March 2020.

Our analysis suggests that 27% of those reaching SPA between April 2016 and March 2020 (34% of men and 11% of women) would anyway accrue state pension rights worth more than the level of the single-tier pension. This group will be largely unaffected by the proposed reforms.

In these short-run cohorts, 19% of individuals (21% of men and 14% of women) stand to receive a lower state pension at SPA under the proposed system than under the current system. At the same time, 43% of individuals (35% of men and 61% of women) will see an increase in state pension income; 26% of individuals would see an increase of at least £5 per week in their state pension income and 13% would see an increase of at least £10 per week.

Those who are likely to see the largest increases in their state pension income are women, people with relatively low wealth and those who have been self-employed. On average, individuals in these cohorts living in England are set to gain £2.74 per week in state pension income at SPA. This figure is £5.23 for women, compared with £1.62 for men. We estimate that those who have had at least 10 years in self-employment will gain on average £7.51, compared with £2.19 among those who have never been self-employed. Those in the richest wealth quintile will gain £2.18 per week on average, compared with £3.97 per week among the lowest wealth quintile.

Some of these increases in state pension income will be offset by the loss of means-tested benefits and, for some groups, the abolition of savings credit alongside the introduction of the single-tier pension will actually lead to an overall reduction in their household income. Our analysis suggests that the redistributive effect of the changes to state pension income will be somewhat offset by changes in means-tested pension credit entitlement. For example, while 64% of sample members in the lowest wealth quintile live in households that would experience a net increase in state pension income, this figure falls to 40% when we take into account the loss of means-tested pension credit. Conversely, we find that 62% of those in the richest wealth quintile live in households that gain in terms of their state pension income and this figure is unchanged when we take into account means-tested pension credit.

In the long run, the effect of the proposed reforms will be to reduce state pension income for most people. The reductions will be largest for higher earners. However, the system will become less expensive to the exchequer, easier to understand and more transparent.

With lower pension income coming from the state, later cohorts will need to save more privately for their retirement. Our calculations suggest that someone born in 1986 who earns at the lower earnings limit (LEL) for 35 years would see their potential state pension income at SPA reduced from £8,618 per year to £7,629 per year by the proposed single-tier reforms. To make up this deficit, they would need to save more privately for retirement.

Exactly how current younger people will respond to this policy remains to be seen. The lower state pension income increases the need to save privately, and the reduced complexity may also make it easier for people to engage with decisions about their retirement saving and may help them to make more appropriate decisions. The government will, however, need to communicate clearly and honestly with currently younger individuals to ensure they understand how this policy reform affects them and that they will need to save privately if they want to achieve more than the level of retirement income provided by the new single-tier pension.

The lower exchequer cost in the long run suggests that this reform may be longer-lasting than the many others that have come before. The Office for Budget Responsibility's long-run fiscal projections last year suggested that further reforms would be needed at some point to reduce upward pressure on public spending (or increase additional tax revenues) in future. To the extent that the single-tier reforms help to deliver this, they perhaps avoid some other policy that might also have been costly to these same cohorts.

The single-tier pension system will be easier to understand and more transparent than the existing system. There will be far fewer parameters for future governments to tweak if they are searching for short-term savings or giveaways. However, this is a risk as well as a virtue. Apparently small changes to the indexation of the single-tier amount could compound over time to imply a large change in state pension income for later cohorts – just as the decision to move the basic state pension from earnings to price indexation in 1981 did. Future governments and voters will need to be cognisant of this fact.

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