



## Chapter 3: Providing a foundation for private saving



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### Summary

Chapters 1 and 2 outlined our proposals to tackle at source behavioural barriers to saving and to strengthen existing private pension provision. These include proposals for a new, low-cost pension saving scheme of personal accounts. But the current state pension system is highly complex, making it difficult for individuals to be confident about exactly what they can expect from the State, and many people – particularly women – will not get full pensions despite working or making other contributions to society for significant periods.

The state pension system seeks to achieve two objectives – to tackle pensioner poverty, and to provide a foundation for retirement incomes for all. The Government's reforms since 1997 have done both while maintaining long-term affordability. The objective of the reforms in this paper is to build long-term confidence in this approach.

As the number of pensioners increases, the generosity of the state pension system for those on average earnings is falling relative to the wealth of the rest of society. The reforms set out in this chapter will create a system that, over the long term and in the face of demographic change, provides a decent minimum for the poorest and a foundation for all upon which to plan for their retirement.

This chapter outlines proposals to:

- ensure that the basic State Pension can act as a foundation for further provision, by linking its value to rises in average earnings;
- raise the State Pension age from its level in 2024 of 65 for both men and women, in line with the growth in average life expectancy;
- reform the State Second Pension so that it becomes a simple, flat-rate weekly top-up to the basic State Pension; and
- ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, by taking steps from 2008 to target the Pension Credit on this group.

We can now also announce an intention to continue to uprate the Guarantee Credit in line with earnings over the long term.

The current system is based on outdated assumptions: its rules are rooted in an era in which most men were expected to work and pay contributions from 16 to State Pension age; and in which women were expected to rely on their husbands for support. Today's society is not like that. More and more people benefit from further and higher education while the trends of rising numbers of unmarried partnerships and growing female participation in the labour market are expected to continue.

### Summary *(continued)*

Many people's working lives are interrupted by caring and other activities. The introduction of Home Responsibilities Protection (HRP) in 1978 went a long way towards improving the situation for women. Women's pension entitlements are, on average, catching up with men's. But there remains a critical cohort of women over the age of about 45 now who did not fully benefit from HRP. They have significantly poorer contribution records – despite the fact that most of them will have made important and valuable contributions to society.

Many people are therefore left uncertain about whether they will get a full basic State Pension, and find it difficult to work out what additional State Pension they will get and whether their income will be means-tested. This chapter outlines how we will respond to these challenges. We will:

- reduce the number of qualifying years needed for a full basic State Pension from 44 for men and 39 for women to 30 for all those reaching State Pension age from 2010;
- convert HRP into a positive weekly credit, aligning the rules for when it is available between the basic State Pension and the State Second Pension;
- establish a new Carer's Credit for those undertaking care for the sick and severely disabled for 20 hours or more a week;
- abolish the minimum contribution conditions in the basic State Pension and the Labour Market Attachment Test in the State Second Pension, to ensure that every year of contributions or credits count; and
- further simplify and modernise the state pension system by abolishing outmoded elements such as adult dependency increases and National Insurance autocredits.

Taken together, the reforms outlined in this chapter contribute to meeting the key tests we have set for pension reform. They will promote **personal responsibility**, by ensuring that the state pension system operates effectively as a foundation on which people can build for their incomes in retirement. And they will aid **simplicity and fairness**, by ensuring that fewer people retire on less than a full basic State Pension.

The reforms are **sustainable**, as they deliver a pension that maintains its value relative to national wealth. And, through increases in the State Pension age and the withdrawal from direct provision by the government of earnings-related pensions, we will ensure that the system remains **affordable** for the long term.

## Context of reform

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### The demographic challenge

- 3.1 The overall balance within the current state pension system is under threat from the demographic challenges described in detail in Annex D. While the current system is affordable now, if unreformed it will remain so into the future only by becoming less generous for the average earner over time.
- 3.2 If spending on pensioner benefits were to remain constant per pensioner as a proportion of national income, spending would have to rise by around £80 billion per year (in 2006/07 prices), or over 2 per cent of GDP above its forecast level in 2050. If all current indexation policies were to be continued indefinitely, we would see a rise in spending on pensioner benefits of nearly 1 per cent of GDP (£30 billion in 2050) but this would mask a fall in the proportion of national income spent per pensioner of around a quarter.
- 3.3 The challenge, in the face of a growing number of pensioners, is to sustain the broad balance of the current system, including, crucially, its successes against pensioner poverty, while keeping it affordable and flexible into the future. Since 1997 we have focused money on the poorest pensioners, helping to lift 2 million pensioners out of absolute poverty and 1 million out of relative poverty. Pensioner incomes are higher on average than in any previous generation, while poverty among pensioners is historically low.
- 3.4 Our first task was to tackle poverty for today's pensioners. Our next priority is to provide a foundation for those who have contributed which will act as a building block for private saving for tomorrow's pensioners. Incentives to save in the current system remain strong. Recent research has shown that incentives for many on low incomes have improved as a direct result of the introduction of Pension Credit.<sup>1</sup> Problems with incentives could, however, develop if a pensions system evolved where a significant majority of pensioners were entitled to Pension Credit in the long term. That has never been the intention of this Government. But further unfounded speculation on this point could undermine the incentives of people who want to save today. Our reforms make it clear that this speculated further spread of entitlement to Pension Credit will not happen.

<sup>1</sup> Sefton J, van de Ven J and Weale M, 2005, *The effects of means testing pensions on savings and retirement*, NIESR (National Institute of Economic and Social Research).

### Providing a firm foundation for private saving

- 3.5 The state pension system must make clear the 'deal' between the State and the citizen. The state system must establish the right environment for people to take responsibility for their security in retirement, by allowing them to plan and make decisions today and in the future that they can understand and that they are confident will not be unravelled by future governments. The state system must provide a foundation on which people can be confident of building through the new pension saving scheme of low-cost, portable personal accounts. People should be clear about what the State will do, and what they must do for themselves.
- 3.6 The Government cannot, in the face of an ageing population, hope to provide both a foundation for private savings and a good-quality alternative to occupational provision.
- 3.7 We therefore propose to reform the structure of the state pension system in order to shift it to a simpler, flat-rate system that can provide a foundation for individual saving.

### Unequal entitlements in the state pension system

- 3.8 The state pension system recognises unpaid social contributions through HRP, Carer's Allowance and more recently through the introduction of the State Second Pension, which is more generous to carers and low earners. The introduction of the Minimum Income Guarantee in 1999, and its successor the Pension Credit in 2003, have helped lift nearly 1 million women out of relative poverty. Over 2.1 million, or two-thirds, of those who have benefited from Pension Credit are women.
- 3.9 But the Government is committed to reducing remaining inequality in outcomes, particularly for women and carers. The Department for Work and Pensions' publication *Women and pensions: The evidence* considers in detail the disadvantages women have faced in building pension provision.
- 3.10 The *Family Resources Survey* shows that there are around 3.6 million carers below State Pension age caring for adults in the UK. Most of these carers are building rights to the basic State Pension either because they are making sufficient National Insurance contributions or because they receive a benefit which attracts a credit towards their basic State Pension. However, around 390,000 carers are not accruing basic State Pension rights. 120,000 of them are caring for 20 hours or more a week, and this group of carers appears to face more difficulties in the labour market than those caring for fewer than 20 hours a week and than the overall population.

- 3.11 The average entitlements of women both to the basic State Pension and to additional State Pension (the State Earnings-Related Pension Scheme (SERPS) and State Second Pension) are still some way below those of men. Women's State Pension records are improving, largely as a result of HRP and increased labour market participation. However, only around 30 per cent of women reaching State Pension age recently are entitled to a full basic State Pension and by 2010 this will still be only around 50 per cent of newly retired women. This is compared with around 90 per cent of men in 2010. By 2025 around 80 per cent of women are projected to retire with a full basic State Pension, but the Government believes that action must be taken to improve state pension outcomes for women much earlier.
- 3.12 Reform must address these issues. But it must do so in a way that recognises the vital principle that with rights come responsibilities. The system must continue to offer 'something for something'. Everyone who contributes, whether through paid or social contributions, should expect to know what they will get from the State in retirement so that they can better plan their retirement and the savings they need to make. Through our reforms, those who contribute can have confidence that the state will provide a solid foundation.

## Summary of proposals

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- 3.13 In order to provide a simpler, flat-rate system that will be a foundation for individual saving, we will:
- link the basic State Pension to rises in average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012 but in any event at the latest by the end of the next Parliament. We will make a statement on the precise date at the beginning of the next Parliament;
  - raise the State Pension age in 2024 from 65 for both men and women in line with the growth in average life expectancy. The State Pension age will be increased by one year over a two-year period from 2024, and then again in 2034 and in 2044. This will signal the need for a behavioural change towards working longer as we live longer;
  - reform the State Second Pension so that it becomes a simple, flat-rate weekly top-up to the basic State Pension. Accruals will start gradually to become flat rate at the same time as we start to uprate the basic State Pension by earnings. We estimate that the State Second Pension will become completely flat rate around 2030 or shortly afterwards; and
  - ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, by taking steps from 2008 to target the Pension Credit on this group.

- 3.14 Taken together, these reforms will produce an affordable, sustainable and fair system, in which each generation will spend a similar proportion of their lives contributing to and receiving pensions.
- 3.15 Under the new system, anyone meeting the simpler entitlement conditions will receive a full basic State Pension worth about 20 per cent of median earnings. Years spent working or caring will boost this amount through the reformed State Second Pension, so that someone working or caring for 40 years can expect to retire on around 30 per cent of median earnings – or around £135 in today's earnings terms – before any private saving.
- 3.16 Everyone should have the opportunity to build a decent State Pension entitlement on the basis of their own actions and in their own right. We will modernise the contributory principle so that it reflects the social and economic realities of the 21st century. In order to achieve this, we will:
- reduce the number of qualifying years needed for a full basic State Pension to 30, from 44 for men and 39 for women;
  - convert HRP into a positive weekly credit for the basic State Pension, and align the rules for when the credit is available between the basic State Pension and the State Second Pension so that those caring for children aged under 12 are eligible;
  - align credits for foster carers across the basic State Pension and the State Second Pension;
  - move from a system of annual credits in the State Second Pension to weekly credits, enabling people to combine credited and paid contributions in order to accrue a year of entitlement to the State Second Pension;
  - establish a new Carer's Credit in the basic State Pension and the State Second Pension for those undertaking care for the sick and severely disabled for 20 hours or more a week; and
  - abolish the minimum contribution conditions in the basic State Pension and the Labour Market Attachment Test in the State Second Pension, to ensure that every year of contributions or credits counts.
- 3.17 These measures (which will apply to people reaching State Pension age on or after 6 April 2010) will help ensure that a far wider range of unpaid social contributions are recognised for the purpose of building entitlement to state pensions, resulting in a considerable and immediate increase in the number of women retiring on a full basic State Pension – around 70 per cent of those reaching State Pension age in 2010 instead of around 50 per cent without reform. In 2020, around 90 per cent of women and over 90 per cent of men reaching State Pension age are projected to be entitled to a full basic State Pension under our reforms.

- 3.18 As a result of the general improvement in entitlement, we will also be able to abolish a number of the complex and often outmoded provisions that currently exist in the state pension system. We will:
- abolish adult dependency increases which, as we recently announced in *A new deal for welfare: Empowering people to work*, we do not intend to carry forward into the Employment and Support Allowance; and
  - abolish National Insurance 'autocredits' awarded to those between 60 and 65, in line with equalisation of women's State Pension age.

## Earnings-linking the basic State Pension

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- 3.19 Since 1980, the level of the basic State Pension has been formally linked to inflation through the Retail Price Index (RPI).<sup>2</sup> Since 1999, the value of the basic State Pension has risen faster than this through a series of higher than inflation increases. But there has for years been a debate about whether the basic State Pension should be linked to earnings, as it was briefly in the 1970s.
- 3.20 There are a number of reasons to think that an earnings link represents an appropriate response to long-term demographic change. We have outlined how our reforms since 1997 have led to pensioner incomes being at their highest-ever level. Having significantly reduced pensioner poverty, we are now able to create a long-term foundation for saving by restoring the earnings link. We can make clear for the long term the deal between the State and the individual, to allow people to plan with confidence for their retirement.
- 3.21 People's expectations for their incomes in retirement are largely based on their earnings and standard of living during working age. If the state system is to serve as a foundation for their retirement planning, it must retain its level relative to these expectations. This will help to address the problem of undersaving by enabling people to predict with confidence what they are likely to receive from the State when they retire, and therefore what they will need to save in addition to meet their expectations.

<sup>2</sup> Regular uprating was introduced in 1973. Legislation allowed discretion to increase the basic State Pension in line with prices or earnings. From 1975 until 1980, legislation required the basic State Pension to be uprated by the better of earnings or prices inflation. Since 1980, the legislation has required the basic State Pension to be uprated in line with prices. However, in 2003 the Government undertook to uprate the basic State Pension by a minimum of 2.5 per cent.

- 3.22 It is also important to ensure that targeted benefits are just that – directed at those in society who need them most. At present, Pension Credit achieves this. The Government has successively raised the Guarantee Credit by earnings and has already committed to do so to 2008 in order to continue to tackle pensioner poverty. We intend to continue this uprating strategy over the long term. But if Pension Credit alone continues to rise with earnings and the level of contributory benefits drifts away from the means-tested safety net, it could mean that more and more people fall subject to means-testing in retirement. This could affect people's incentives to work and save, and dilute the sense of personal responsibility for saving that we want to instil.
- 3.23 The Government believes that people must have the opportunity to build a basic State Pension entitlement that can give them confidence in the value of making additional provision. This will also help to encourage people to save through automatic enrolment in the scheme of personal accounts. And we are clear that we cannot allow our progress against pensioner poverty to falter. Taken together, we believe that both the Guarantee Credit and the basic State Pension must retain their value relative to the average earnings of society.
- 3.24 During the next Parliament, therefore, we will re-link the uprating of the basic State Pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012 but in any event at the latest by the end of the next Parliament. We will make a statement on the precise date at the beginning of the next Parliament.
- 3.25 But this is a major undertaking. On its own, linking the basic State Pension to rises in earnings from 2012 would lead to an increase in spending on pensioners of £46 billion or 1.4 per cent of GDP by 2050, in addition to the costs of increasing coverage to state pensions. We have made clear that the Government's economic policies since 1997 have had specific benefits for pensioners and future pensioners. To risk the stability of the economy for the sake of linking the basic State Pension to earnings growth would be counter-productive. This element of the reform package is therefore inextricably linked to two others.
- 3.26 First, raising the State Pension age in line with increases in life expectancy will help to bring about a behavioural change so that people begin to work longer as they live longer. It will slow the growth in the number of pensioners, while ensuring that pensioners continue to be able to enjoy a roughly constant proportion of their adult lives in retirement. Maximising the impact of this increase, through the measures described in Chapter 4 to help people work for longer, will further help to stabilise the support ratio, ensuring that these reforms remain affordable.

3.27 Secondly, we intend to accelerate the withdrawal from direct provision of earnings-related pensions to provide a simple, flat-rate foundation that rewards working and caring, building on which will be the responsibility of individuals. Reforms to the State Second Pension will speed up the move to make it a flat-rate top-up to the basic State Pension and will reduce expected expenditure on the State Second Pension in the longer term, further helping to fund linking the basic State Pension to earnings. Reforms to the State Pension age and the State Second Pension are described later in this chapter.

## Raising the State Pension age

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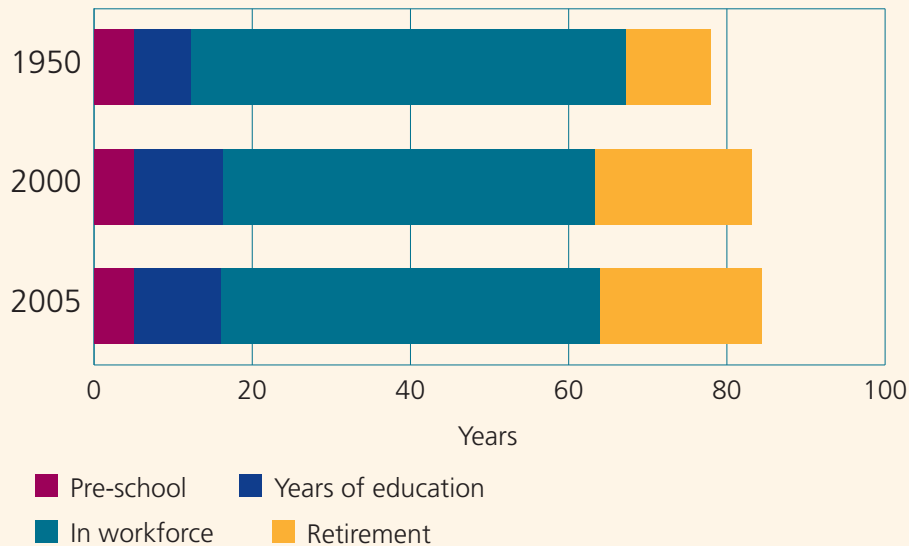
- 3.28 State Pension age in the UK has varied in the past. The first support for pensioners, introduced from 1909, was available only at 70. From 1926 to 1940 State Pension age was 65 for all. And only since 1940 has it been on the current basis. Not long after the current state pension scheme was introduced in 1948, the question of State Pension age was investigated in 1953–54<sup>3</sup> by the Phillips' Committee which concluded that State Pension age did "not represent the limit of working life".
- 3.29 Life expectancy has improved considerably since State retirement pensions were first introduced, and these improvements are projected to continue. Over the last two decades, the healthy life expectancy of men and women aged 65 has risen by more than two years. Despite this, men retire on average three years earlier than they did when the present State Pension ages were set and women two years earlier.

## Consequences of changing demographic and retirement patterns

- 3.30 Rising life expectancy is to be welcomed. However, there are other consequences we must face up to. If people are spending more years in retirement, they must work longer, increase savings or the State must find resources to pay the State Pension to more people for longer. The changes in the length of time an average man spends in different periods of his life are illustrated in Figure 3.i.

<sup>3</sup> *Report of the Committee on the Economic and Financial Problems of the Provision for Old Age*, December 1954, paragraph 308.

**Figure 3.i Average years spent in each life stage for men retiring in 1950, 2000 and 2005**



Sources: Pre-school years are based on the age that compulsory education starts; average years of education for the 1950 retiree are based on the minimum school-leaving age at the time; average years of education for 2005 retirees are based on Banks and Smith (2006); Retirement in the UK using Family Expenditure Survey data; average age at retirement and life expectancy are based on Pensions Commission analysis

- 3.31 Some of these issues could be addressed by increasing the levels of employment among older workers. While the average retirement age for women, 62, is above their current State Pension age, men on average retire at 64, one year before they become eligible for their State Pension. By contrast, five decades ago when life expectancy was lower, men on average retired at 67 and women at 64. This means that those who retired in 1950, who constituted about 40 per cent of their generation, survived to a retirement which then accounted for 17 per cent of their adult life. If the retirement age remains at the current level, those who will retire in 2050 would constitute about 90 per cent of their generation and could look forward to spending on average 35 per cent of their adult life in retirement.
- 3.32 However, rising life expectancy is a long-term trend and we need to raise the State Pension age in order to address the fact that although we are living longer, on average we are not working proportionately longer. The rise in State Pension age will need to go hand in hand with cultural and behavioural change around retirement, and a corresponding rise in average retirement age. Measures already brought forward by the Government, together with those proposed in *A new deal for welfare: Empowering people to work* published earlier this year, will help us to meet our aspiration of 1 million more older workers. This is a part of the wider goal of an

employment rate equivalent to 80 per cent of the working-age population. Chapter 4 of this paper contains a range of further policy proposals designed to deliver still more progress towards this objective, and outlines the positive overall impact on pensions if we were to meet this aspiration by 2030.

- 3.33 In order to maintain stability in retirement incomes, people need to take greater personal responsibility for their working and saving decisions. To help them do this, the Government will provide a foundation by linking the basic State Pension with earnings. But in doing this it is imperative that we don't pay for progressively longer retirements.
- 3.34 We therefore support the Pensions Commission's recommendation that the State Pension age should rise to 68 by the middle of the century. We propose to introduce legislation to raise the State Pension age in stages:
- the first increase, from 65 to 66, to be phased in over two years, starting in April 2024;
  - the second increase, from 66 to 67, again phased in over two years, from April 2034; and
  - the third increase, from 67 to 68, also to be phased in over two years, from April 2044.
- 3.35 By 2050, these reforms to State Pension age alone will reduce the costs of our proposed reforms to the state pension system by around £30 billion. By doing this we will continue to tackle pensioner poverty, be able to sustain the generosity per pensioner of the State Pension, and sustain the balance between work and retirement.

### **Findings from the National Pensions Debate: rise in State Pension age**

Participants at the National Pensions Day were asked to consider a gradual increase in State Pension age as part of a package of measures for reforming state pensions. Following their deliberations, the majority (56 per cent) agreed with a gradual rise in State Pension age, though just under a third (32 per cent) disagreed. More people over State Pension age agreed with the proposed gradual rise in State Pension age than any other age group. 46 per cent of young people (aged between 16 and 24 years) disagreed with a gradual rise in State Pension age, while 42 per cent agreed.

## What will raising State Pension age mean in practice?

- 3.36 On current projections, the increase in State Pension age will mean that men reaching State Pension age in the future will, on average, spend about the same number of years of their adult life in receipt of the State Pension as now, as shown in Figure 3.ii. For women, there is a slight reduction compared with the position as it is projected to be in 2020 (when the increase in female State Pension age to 65 will be fully phased in). However, there is no significant reduction in the actual number of years, which remains greater than for men.

**Figure 3.ii Number of years spent post-State Pension age following transition to new State Pension ages**

Years	2006 Current State Pension age	2020 State Pension age at 65	2026 State Pension age at 66	2036 State Pension age at 67	2046 State Pension age at 68	2055 State Pension age at 68
Men	20.1	21.6	21.1	21.1	21.0	21.8
Women	28.3	24.5	24.0	23.8	23.6	24.4

Source: Government Actuary's Department's 2004-based principal projection; median cohort figures for the UK

Note: State Pension age for women is currently 60.

- 3.37 Figure 3.iii shows that the proportion of adult life spent in receipt of the State Pension will remain about the same. By 2055, assuming life expectancy continues to increase in line with projections, for both men and women the number of years after State Pension age will be broadly the same as that of those reaching 65 in 2020 – indeed for men, it would have grown slightly.

**Figure 3.iii Percentage of adult life spent post-State Pension age following transition to new State Pension ages**

Percentage	2006 Current State Pension age	2020 State Pension age at 65	2026 State Pension age at 66	2036 State Pension age at 67	2046 State Pension age at 68	2055 State Pension age at 68
Men	30.0	31.4	30.6	30.1	29.6	30.4
Women	40.3	34.3	33.3	32.7	32.1	32.8

Source: Government Actuary's Department's 2004-based principal projection; median cohort figures for the UK

Note: State Pension age for women is currently 60.

- 3.38 Figure 3.iv shows that raising State Pension age to 68 would not, on average, reduce the numbers of people who survive to the new State Pension ages.

**Figure 3.iv Percentage of people projected to survive to State Pension age following transition to new State Pension ages, compared with earlier generations**

Percentage	Generation born in 1941 (1946 for women) reaching State Pension age in 2006	Generation born in 1955 reaching State Pension age of 65 in 2020	Generation born in 1960 reaching State Pension age of 66 in 2026	Generation born in 1969 reaching State Pension age of 67 in 2036	Generation born in 1978 reaching State Pension age of 68 in 2046	Generation born in 1987 reaching State Pension age of 68 in 2055
Men	76	82	82	83	84	86
Women	89	88	88	89	89	91

Sources: Figures for the generation born in 1941 are based on the Government Actuary's Department's England and Wales life tables; the subsequent figures are based on the Government Actuary's Department's UK life tables

Note: State Pension age for women is currently 60.

- 3.39 As discussed in Chapter 2, we propose that the Government will periodically commission reviews, drawing on a range of independent expert advice.
- 3.40 These reviews could, for example:
- provide advice to the Government on whether the timetable for increasing State Pension age – as set out in legislation – remains appropriate;
  - gather evidence on future life expectancy and the consequences for public expenditure;
  - provide detailed analysis of disparities in life expectancy between different social classes and the relative effects on different social groups of increases to the State Pension age; and
  - monitor participation rates and levels of contributions to the personal savings scheme as well as the labour market for older workers (including average retirement ages).
- 3.41 While there is growing public acceptance of the evidence that life expectancy overall is increasing, there is nonetheless concern that the additional years will not necessarily be healthy years. To date, the evidence would suggest that increased life expectancy is also resulting in people staying healthier for longer. As the Pensions Commission has noted, this is an area where evidence is incomplete. Another task of these reviews could be to keep this evidence under review.

- 3.42 We note the Pensions Commission's suggestion that the age at which people become entitled to the Guarantee Credit in Pension Credit could remain at 65, in order to protect those with the lowest life expectancies. We think this is an issue that must be considered nearer the relevant time in the light of the available evidence about inequalities in life expectancy and trends in working among older people. More detail about demographic trends in relation to different social groups is contained in Annex D.

## Reforms to the State Second Pension

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- 3.43 On top of the basic State Pension, many people are accruing a second tier of state pension, through the State Second Pension, which replaced SERPS in 2002.
- 3.44 The State Second Pension has given many people, particularly women and carers, access to an additional pension for the first time. Currently those bringing up children under the age of six, certain carers and people with a long-term disability are all credited into the State Second Pension at a flat rate of around £1.20 a week at retirement for every year worked or credited, with those earning above the Lower Earnings Threshold (£12,500 a year) accruing some earnings-related provision on top.
- 3.45 The State Second Pension has also helped those on low incomes by treating anyone earning over the Lower Earnings Limit (£4,368 a year) but earning below £12,500 as if they earned at this higher level. In addition, the rate at which the pension accrues at £12,500 has been doubled under the State Second Pension, making the scheme far more redistributive than SERPS (1978–2002).
- 3.46 But while the Government will this year spend £19 billion on the State Second Pension, or its contracted-out equivalents through the rebates, this aspect of the system is poorly understood. Few people are aware of it at all, and even fewer of how their entitlement to it builds. Many people are building entitlement to the State Second Pension without even being aware that they are doing so.
- 3.47 The beginning of this chapter made clear that, in the face of an ageing population and the need for the state system to provide a foundation for people's savings, the State should move away from the direct provision of pensions related to individuals' earnings and concentrate on flat-rate provision in the future. The introduction of the new personal accounts scheme will mean that for the first time everyone will have access to a genuinely low-cost private savings vehicle. We do not want the State Second Pension to duplicate this, which is why we are able to reinforce and speed up its change in focus to a flat-rate top-up benefit for years spent working, caring or parenting.

- 3.48 Accruals will start to become flat rate more quickly at the same time as we start to uprate the basic State Pension by earnings. We estimate that the State Second Pension will become completely flat rate in around 2030, or shortly afterwards.
- 3.49 Some people have argued that providing a flat-rate State Pension should entail a move to a single-tier State Pension, perhaps at the level of the Guarantee Credit – often referred to as the Citizens' Pension. However, we believe that we can achieve a better outcome through our reforms. We will create a simple, flat-rate system which gets most people over the level of the Guarantee Credit, but we will be able to do this more quickly and at less cost.

### Box 3a: Why not a Citizens' Pension?

The Pensions Commission considered the case for an Enhanced State Pension, similar in design to the Citizens' Pension proposed by the National Association of Pension Funds.

Although models for a Citizens' Pension vary in detail, the underlying proposition is a flat-rate pension set at the rate of the Guarantee Credit and uprated in line with earnings. It would be paid to new and existing pensioners. Both the Savings Credit and the State Second Pension (and contracting out) would be withdrawn as soon as the Citizens' Pension was in place.

The Government recognises the attractive simplicity that could in theory be achieved through a Citizens' Pension. We have thoroughly examined the Pensions Commission's response to the proposition and tested alternative approaches to achieving a single flat-rate pension.

Like the Commission, we have concluded that the complexity and expense of gradual transitional approaches to a Citizens' Pension are too great – the prize of simplicity would be lost.

The alternative, 'big bang', implementation where the new system immediately replaces the old is more plausible than gradual transition methods. However, the Government again agrees with the Pensions Commission's findings that a modified two-tier system provides the most practical and safe approach.

The costs of introducing a Citizens' Pension overnight are immediate and substantial. If an Enhanced State Pension were introduced in 2010, the Pensions Commission estimates that it would cost an additional £14 billion in the first year. This would increase to £25 billion by 2015 and would peak at £60 billion (2.2 per cent of GDP) around 2040, before falling back to £39 billion (1.2 per cent of GDP) by 2050. This is clearly unaffordable and would put the stability of public finances and the viability of pension reform at risk. It is implicit in these costs that the preserved rights that workers have built to SERPS and the State Second Pension (and contracting out equivalents) are paid on top of the Citizens' Pension.

**Box 3a: Why not a Citizens' Pension?** *(continued)*

Moreover, many poorer pensioners would see little change in their circumstances and, unless transitional protection was applied, could lose income because of the withdrawal of the Savings Credit.

The Pensions Commission therefore examined a more complicated but less expensive model which reduced costs, and tackled the regressive distributional effects of the model above.

Their revised model introduced an 'offset' arrangement whereby pensioners would be paid the better of what they had built up under the previous system or the new pension. In practice this means that any accrued State Second Pension rights would be offset against the Citizens' Pension – so that people would get either what they had built up under the old arrangements or the new pension set at the level of the Guarantee Credit, whichever was greater.

The Pensions Commission considered that this would be too difficult to implement because of the complexity of applying the offset to the many different types of rights people have built up under the current system. People would not have a clear idea of what the State would provide.

Furthermore this offset method would still result in a considerable immediate increase in expenditure. Costs using the offset arrangements would be an additional £10 billion in 2010, and £8 billion in 2015. Costs would peak at 0.9 per cent of GDP around 2040, falling back to 0.3 per cent GDP by 2050.

Whatever the precise design, there are concerns about the fairness of any kind of Citizens' Pension: some people would get the same pension despite having paid in very different amounts over the last 50 years, based on an understanding that their contributions would affect their retirement incomes. For example, the self-employed – who have not contributed to the State Second Pension – would get the same outcomes as employees who have.

The Pensions Commission concluded, as does the Government, that – starting from where we are now – a two-tier system is preferable to a single-tier pension. A two-tier system has greater flexibility, there is public attachment to the basic State Pension and a two-tier system avoids the transitional complexity of one tier and the risks associated with an immediate cessation of contracting out.

- 3.50 We therefore plan to accelerate the way in which accruals in the State Second Pension are becoming flat rate. This benefit will be protected against rises in average earnings during accrual, and then against inflation once in payment. Combined with a basic State Pension linked to earnings, this will produce a total State Pension that is uprated partly by earnings and partly by prices in payment, as recommended by the Pensions Commission. Under the new benefit, each year of work, parenting or caring will effectively top up the State Pension by at least £1.20 a week at retirement in average earnings terms.
- 3.51 This proposal is in line with the recommendation of the Pensions Commission to move to a flat-rate State Second Pension by 2030 – though we extend coverage of the State Second Pension from 2010 to bring in more people with lower earnings and more carers through our coverage reforms outlined later in the chapter.
- 3.52 Together with our measures to increase coverage in the basic State Pension, outlined later in this chapter, this will mean that, after 40 years of work or credits, a low earner can expect to build up an additional top-up of around £60 a week. Coupled with their basic State Pension entitlement, this will give a total State Pension at retirement of around £135 a week in today's earnings terms.

### Entitlement for the self-employed

- 3.53 The Pensions Commission recommended that the Government investigate the possibility of extending coverage of State Second Pension to the self-employed on a voluntary basis. The Commission's suggested mechanism for achieving this was through the introduction of age-related National Insurance contributions.
- 3.54 The Government accepts that any consideration of the self-employed becoming entitled to the State Second Pension would need to include age-related contributions. Setting a standard rate in a voluntary system could mean that the young are overcharged (they are more likely to get a better return in a private pension) and older workers undercharged.<sup>4</sup> Given that the young would be unlikely to join the scheme because it would not be worthwhile, other National Insurance payers would have to subsidise older workers entering at what would effectively be a cheap rate. (Because State Second Pension is compulsory for employees throughout a working life a standard rate can be charged without the need for age-related contributions.) However, age-related contributions are probably too expensive for most older low paid workers to consider.

<sup>4</sup> The State Second Pension is a defined benefit – each year of contributions buys a set amount of weekly pension (though a younger person will have to wait longer to receive the money). But in private pensions, a younger worker's investment has the benefit of many years of investment growth and interest.

3.55 We share the Pensions Commission's own concerns that

"... the complexity of age-specific contribution rates and the higher level required later in life, might make voluntary membership of State Second Pension unattractive for many self-employed."

3.56 The Government is unable to reconcile these issues and is reluctant to commit taxpayers' money to setting up a speculative scheme where enrolment may be low. Nor does the Government wish to introduce a scheme exclusively for self-employed people with only low profits. Profits from self-employment can fluctuate year on year, which would result in people being included and then excluded. Such a scheme would have arbitrary cut-off points and would have to have numerous exclusions and exceptions (for instance, someone in part-time self-employment who had other earnings or a large occupational pension).

3.57 A further factor when considering scheme development is that the average duration of self-employment is around eight years. For many earners, who move from employment to self-employment and back again, it is unlikely that a period out of the State Second Pension would have a significant impact on their retirement income.

3.58 The introduction of personal accounts, described in Chapter 1, will bring in new arrangements to enable the self-employed to build a second pension. On balance, the Government believes that the State Second Pension should not be extended to the self-employed.

## Pension Credit

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### Guarantee Credit

- 3.59 Pension Credit is made up of two elements. The first, the Guarantee Credit, ensures that no one aged 60 or over need live on an income below £114.05 a week (£174.05 for couples). Pension Credit is the successor benefit to the Minimum Income Guarantee (MIG), both of which have risen in line with average earnings growth since 1999. The Guarantee Credit is payable to people aged 60 or over, rising to 65 or over with the equalisation of State Pension age for men and women between 2010 and 2020.
- 3.60 The Government has committed to uprating the Guarantee Credit in line with earnings until 2008. We can now announce an intention to continue this uprating strategy over the long term. This will ensure that the gains we have made against pensioner poverty are secure into the future. As now, the Guarantee Credit will provide a guaranteed minimum level of income in retirement for those who have been unable to provide adequately for their own retirement. It will also provide a higher income for people with severe disabilities and other specific groups.

### Savings Credit

- 3.61 The second element to Pension Credit is the Savings Credit, available to people aged 65 and over. This ensures that those low and moderate earners who have modest savings for retirement over the level of the basic State Pension benefit from their savings. The operation of the Savings Credit is described in more detail in Box 3b.

#### Box 3b: The Savings Credit

The Savings Credit rewards people aged 65 and over (or who have a partner of that age) who have made some additional provision for their retirement, for example through a second pension or capital assets. It applies to all those with modest incomes over and above the value of the full basic State Pension which for 2006/07 is £84.25 for a single person and £134.75 for a couple.

The Savings Credit accrues at the rate of 60p for every pound of qualifying income above the threshold, up to a maximum of £17.88 for a single person and £23.58 for a couple. People with income above their guarantee level (which is the standard Guarantee Credit of £114.05 a week for single people or £174.05 a week for couples plus any additional amounts payable for severe disability, caring responsibilities, and/or housing costs) will have their Savings Credit reduced by 40p for every pound of income above that level. This means that pensioners with income up to £159 a week (£233 a week for couples) can qualify. Some, including severely disabled people and carers, will be able to qualify if their incomes are higher than this.

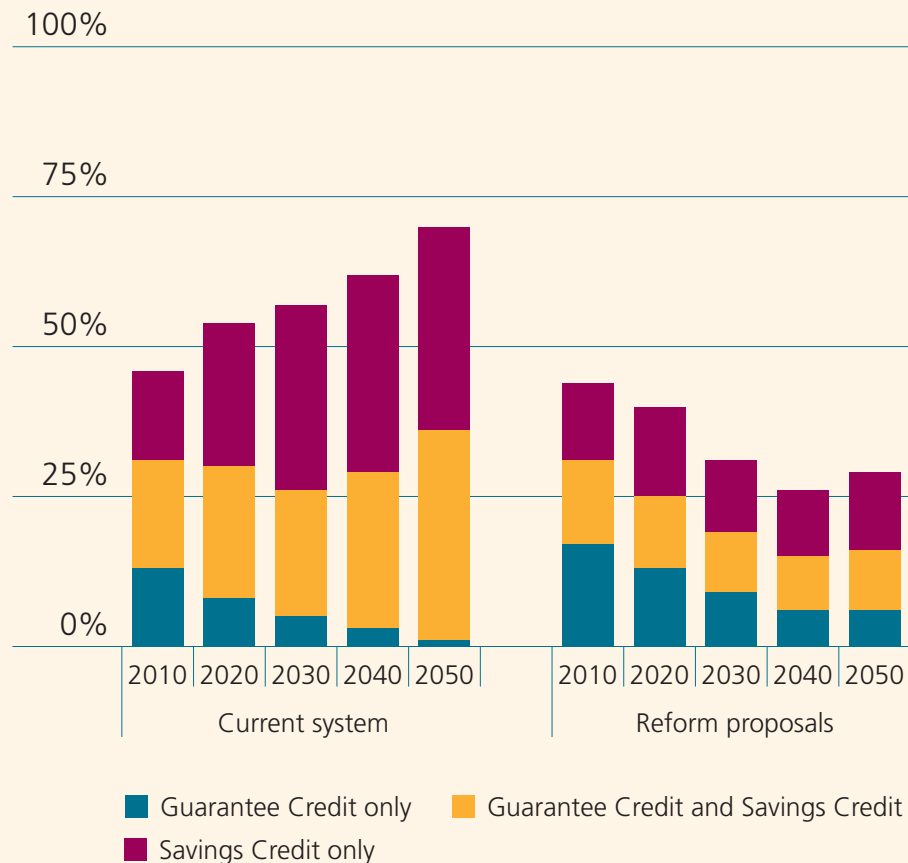
### Box 3b: The Savings Credit *(continued)*

The maximum Savings Credit award is set at 60 per cent of the difference between the basic State Pension and the Guarantee Credit. The gap between these two has been widening as one increases with average earnings and the other increases by less. Because it draws momentum from both, the maximum Savings Credit grows faster than either of these uprating factors in isolation, which means it grows faster even than the Guarantee Credit, and therefore faster than earnings.

If current uprating policies were pursued indefinitely, an increasing proportion of the pensioner population would be entitled to the Savings Credit. It has never been the Government's intention that a significant majority of the pensioner population would, in the long term, be eligible for Pension Credit. Our reforms confirm this.

- 3.62 To ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, we will take steps from 2008 to target the Pension Credit on this group.
- 3.63 We think this is reasonable because the State Second Pension has, since 2002, provided generous provision for low-paid employees. Those who earn between the National Insurance contribution Lower Earnings Limit and £12,500 a year (and those credited in) accrue a pension at a flat rate as though they were earning £12,500 a year and at twice the old SERPS accrual rate. This means low-paid employees get a more than fair return on their contributions. This must, over time, influence the design of the Savings Credit.
- 3.64 The Savings Credit will continue to reward people who make provision for their retirement. However, as State Second Pension matures, more and more people will have built up State Second Pension entitlement. We agree with the Pensions Commission's assessment that the starting point for calculation of the Savings Credit should be raised as this happens. From 2008 we will uprate the lower threshold of the Savings Credit by earnings. From 2015 the maximum Savings Credit will be frozen in real terms.
- 3.65 The impact of this, alongside our reforms to the structure and coverage of the other aspects of the State Pension and the introduction of a low-cost scheme of personal accounts, will be a considerable reduction in the numbers of people whose entitlements will be means-tested in the future. Under current uprating policies projected forward, around 70 per cent of pensioner households will be entitled to some Pension Credit by 2050. Under our reforms, that figure will be reduced to around a third. This will further help to clarify people's savings decisions and retirement planning. Figure 3.v shows how entitlement to Pension Credit is projected to develop into the future under current policy and after the reforms to the state pension system.

**Figure 3.v Proportion of pensioners eligible for Pension Credit over time**



Source: DWP projections, using micro-simulation modelling

Notes: The estimates indicate that over time the reform proposals will reduce the proportion of pensioners eligible for Pension Credit, although the size of the reduction is sensitive to the modelling assumptions and projected changes in the distribution of pensioner incomes.

The estimates shown here are the mid-points of projections taken from two separate micro-simulation models. Modelling of reform proposals does not include any increase in private saving from the introduction of personal accounts, which would further reduce the numbers eligible for Pension Credit.

Projections under current policies are consistent with the long-term expenditure projections for Pension Credit.

Projections under reform will depend on the policy detail. This chart illustrated outcomes based on a 2012 start date for earnings uprating of the basic State Pension and setting the saving credit in earnings terms from 2008 and then real terms from 2015. As paragraph 37 of the summary sets out, our objective, subject to affordability and the fiscal position is to uprate basic State Pension by earnings from 2012 but in any event at the latest by the end of the Parliament. We will make a statement on the precise date at the beginning of the next Parliament.

## Tax-benefit integration

- 3.66 Since 1997 the Government has reformed Britain's tax and benefit systems to achieve three overarching objectives: to ensure adequate financial incentives to work and save; to reduce child poverty and increase financial support for all families; and to tackle poverty among the current generation of pensioners and support people in providing for their retirement.
- 3.67 In the past the tax and benefit systems failed to address the challenges of poverty and incentives to work and save for retirement. The Government has brought forward a series of reforms designed to bring the tax and benefit systems closer together. Taken together, the Government's policies to modernise the tax and benefit systems constitute the most fundamental reform of those systems since the 1940s. For pensioners this has meant, alongside the introduction of the Pension Credit, additional resources to raise the age-related personal allowances in Income Tax, designed to lift more pensioners out of Income Tax and ensure that most taxpaying pensioners benefit. In 1999, and again in 2003, additional resources were used to give step increases in the level of these allowances, and exceptionally between 2001 and 2005 the age-related Income Tax allowances were indexed in line with the rise in average earnings.
- 3.68 In the light of the proposed reforms to the state pension system set out in this paper, the Government will continue to consider the potential gains from greater tax and benefit integration in terms of improving financial incentives to work and save and providing greater simplicity for pensioners.

## A new contributory principle – the proposals in detail

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- 3.69 The pension system of the 1950s and 1960s sought to provide some protection of pension entitlements for women by allowing wives to draw on the contribution records of their husbands.
- 3.70 Reforms since the 1970s have had a dramatic and very positive impact on the pension entitlements of women and carers. The introduction of HRP in 1978 meant that the vital contribution made to society by those caring for children was recognised for the purposes of building entitlement to a pension. Since that time, years spent caring for children under 16 have counted for the purposes of building entitlement to the basic State Pension, but usually only for complete years.

- 3.71 The introduction in 2002 of the State Second Pension as a successor to SERPS meant, for the first time, that some caring responsibilities were reflected not only in basic State Pension entitlement but also in access to a second pension. Each year 1.9 million carers, mostly women,<sup>5</sup> are now credited in to the State Second Pension as if they were earning £12,500 per year. Those earning above £12,500 will continue to accrue some earnings-related provision until around 2030.
- 3.72 There remains, however, a generation of women aged over 45 who can expect to reach State Pension age with significantly lower amounts of basic State Pension than men. The immediate issue is tackling the inequality for this generation of women who may have missed out on the full impact of HRP but also may have not returned to or kept in touch with the labour market in the way younger women have.
- 3.73 There is a widespread consensus about the need to act to counter the inequalities that currently exist between men and women in state pension entitlement. In a recent survey almost four out of five people thought that carers of sick or disabled relatives should get the same amount of state pension as someone who had worked all their life.<sup>6</sup> Many approaches to achieving better state pensions for women have been suggested. The Pensions Commission proposed a residence test.
- 3.74 We agree with the Pensions Commission that a two-tier system is still the best way forward but that the basic State Pension as a near universal underpin is the right foundation on which to build and on which to encourage private saving.
- 3.75 We do not agree that the solution to inequality lies in moving all or part of the entitlement rules onto a residency basis. The reasons for this view are outlined in more detail in Box 3c. But the key reason is a belief that the contributory principle promotes personal responsibility and positively rewards people's contributions to society.

<sup>5</sup> Source: Lifetime Labour Market Database (a 1 per cent sample of NIRS 2 data). Data relate to 2003/04 and include all those in the UK, and those accruing the contracted-out equivalent.

<sup>6</sup> *BMRB Omnibus survey*, February 2006.

### Box 3c: Why not a residence test?

Our core objection to a residence test is one of principle. *A new deal for welfare: Empowering people to work* reaffirmed our view that our system of welfare should be based on the recognition that with rights come responsibilities.

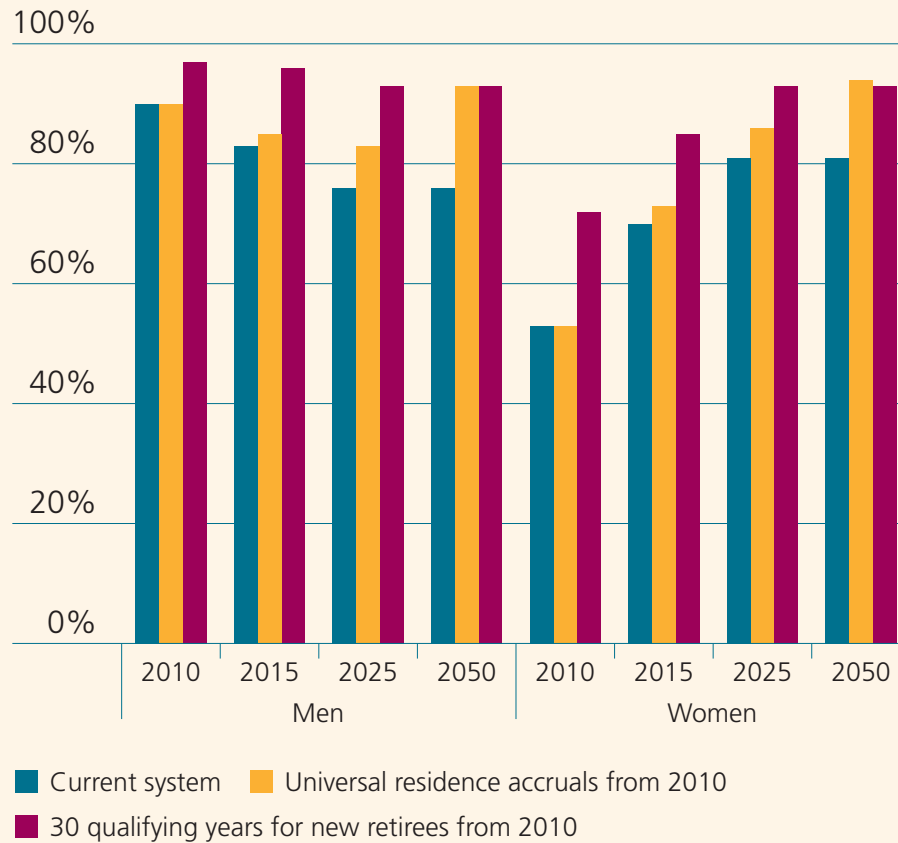
The Government believes it is right for people to receive state pensions in return for making economic or social contributions during their working lives. We do not think it is fair to recognise people for State Pension purposes purely on the basis of residence while others are contributing to society through working and caring.

But there are also more practical and operational concerns with a residence test. These are set out below.

- There is **no established system for recording residence retrospectively outside those under the existing tax and benefit systems**, and these systems do not cover all members of the population. A residence test could only be introduced for new accruals. As part of the EU, the UK also has significant movement of people in and out of the country, for example to work abroad, and is subject to reciprocal social security agreements both with other European Economic Area countries and through bilateral agreements.
- Under the sort of residence test proposed by the Pensions Commission, the impact of the changes takes many years to make a difference. We believe our reforms to the contributory system have **more radical and immediate effects** than a move to a residence test for future accruals, as shown in Figure 3.vi.
- A long residency test would have the best chance of excluding or minimising the entitlement of those with little connection to the UK. But too long a test would not significantly improve outcomes, leaving many people without a full basic State Pension. A short test may improve outcomes but would carry a greater **risk of fraud or abuse**. Some people could spend a relatively modest number of years in the UK yet accrue a substantial proportion of a UK pension which would then be exportable, and payable, for the rest of their life.
- Introducing a residence test for future accruals would mean running both residence-based and contributory entitlements to the basic State Pension in parallel for the next 45 years (if using the Pensions Commission proposal) and running an ongoing contributory system for State Second Pension beyond that. This **would make the system more complicated**, and make it more difficult for people to predict with confidence what their entitlement would be in the future, and thus become a disincentive to save.
- Residency is **not necessarily any more effective** at increasing coverage to state pensions than our reforms are. Depending on the design of the residence-based pension, both could mean that around 95 per cent of people receive full basic State Pension entitlement in the long term. However, a residence-based scheme for new accruals would take longer to reach this level.

### Box 3c: Why not a residence test? (continued)

**Figure 3.vi Percentage of people reaching State Pension age with full basic State Pension under different schemes**



Source: Based on projections from Government Actuary's Department's Retirement Pension Model, GB. Estimates for residence accruals are necessarily an approximation only.

The Pensions Commission also proposed an immediate and retrospective universal basic State Pension based on residency to the over-75s. Our analysis suggests that there would be few real gainers among the low- to moderate-income brackets, with higher basic State Pension entitlement largely just displacing Pension Credit entitlement. Yet there would be high costs.

- 3.76 This section sets out a number of reforms to elements of the contributory principle in order to ensure that a greater range of social contributions is recognised for the purposes of building rights to state pension entitlement.

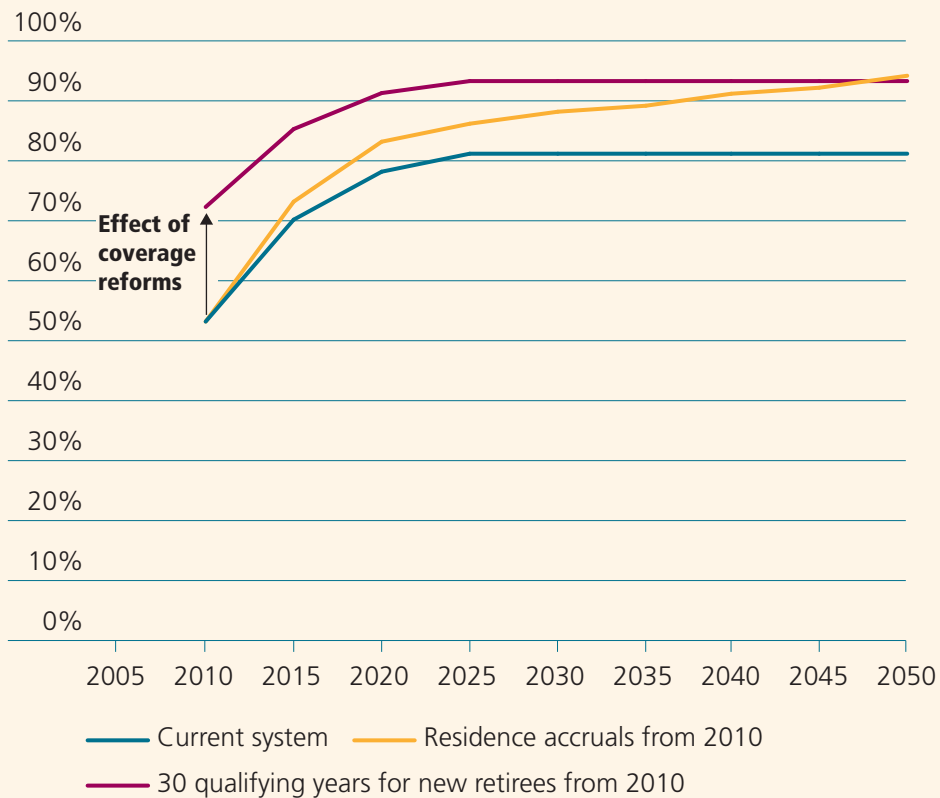
## Reducing qualifying years for a full basic State Pension

3.77 The Government proposes that the number of qualifying years required to achieve a full basic State Pension be reduced from 44 for men and 39 for women to 30 years on an equal basis. This reform offers the appropriate balance between the need for modernisation of the conditions for entitlement to the basic State Pension with the objective of retaining the contributory basis of the system. Figure 3.vi shows the impact on pension outcomes for those reaching State Pension age after April 2010.

### Why 30 qualifying years?

- 3.78 We want to maintain the link between the basic State Pension and contributions to society. However, the current number of qualifying years excludes some people who have contributed during their working lives from the right to a state pension. Today's society is one where both men and women combine work and caring, and undertake higher or further education. Reducing the qualifying years required for a full basic State Pension gives these people the opportunity to build rights to a full basic State Pension, while not diluting the contributory basis of the system.
- 3.79 Under the current system, women aged 45 or over today are projected to have state pension entitlements which are, on average, projected to lag significantly behind those of men for around the next 20 years. Under our reforms this critical group will receive better state pension outcomes in their own right. A residence-based approach for new accruals would not help this group build up a much better basic State Pension. Outcomes under our proposals mean that over 90 per cent of women reaching State Pension age will get a full basic State Pension by 2025, but under the model proposed by the Pensions Commission the same outcomes would not be achieved much before 2050. Up to an extra 270,000 women will be getting a full basic State Pension by 2020 under our proposals – possibly in the region of 200,000 more than under a residence-based scheme. Figure 3.vii shows the proportion of women reaching State Pension age with full basic State Pension under our reforms and under a residence-based system.

**Figure 3.vii Percentage of women reaching State Pension age with full basic State Pension under different schemes**



Source: Based on projections from the Government Actuary's Department's retirement Pension Model, GB. Estimates for residence accruals are necessarily an approximation only.

Notes: Under residence accruals, 44 years are required for a full basic State Pension. Women's entitlement is based on their own and their husband's contributions.

### Converting HRP into a positive credit

- 3.80 HRP was introduced in 1978 to assist people who have caring responsibilities, and are either not in paid employment or have low earnings, to build entitlement to basic State Pension. It also helps protect entitlement to certain bereavement benefits for the carer's spouse or civil partner.
- 3.81 However, it is not widely understood, can be inflexible and it is difficult to determine whether the HRP recipient will qualify for a full basic State Pension until they reach State Pension age. In particular, for reasons explained in Annex B, women have lost out because only full years can be recognised for state pension purposes, and therefore periods shorter than this where caring has been undertaken do not count towards their basic State Pension.

- 3.82 We therefore plan to replace the system of HRP with new weekly National Insurance credits for care of children (where there will remain a link with Child Benefit) until the youngest child turns age 12. These changes will make it easier for recipients to understand their entitlement and make informed choices about working and saving for retirement.
- 3.83 The credits will be aligned to allow those caring for children up to the age of 12 to receive both basic State Pension and State Second Pension. Currently entitlements to State Second Pension are only given to those caring for children up to the age of 6, whereas in basic State Pension they are given to those caring for children up to the age of 16. Moving to age 12 could be perceived as making entitlements for parents less generous from 2010 as we are removing the opportunity to gain credits for four years of a child's upbringing. However, our reduction in the required number of qualifying years to 30 for a full basic State Pension means that we are reducing the number required for women by nine years.
- 3.84 Aligning credits for care of children up to the age of 12 should mean around an additional 780,000 women and 30,000 men will be accruing State Second Pension entitlements. Moving to age 12 is also consistent with Working Age initiatives to encourage lone parents to take steps into the labour market as their children reach secondary school age.<sup>7</sup>
- 3.85 Foster carers have only been able to protect their basic State Pension entitlement by applying for HRP since 2003. We propose to bring them into State Second Pension, again by application, from 2010 through the new crediting arrangements.
- 3.86 We plan to introduce transitional arrangements to ensure that any period of childcare undertaken before the reforms are implemented which would qualify for HRP under the existing rules of the scheme will be preserved, but converted into the new, more generous credits.

### **Combining contributions with credits to get a qualifying year for State Second Pension<sup>8</sup>**

- 3.87 Currently a person can build up entitlement to State Second Pension through the award of credits with certain benefits.<sup>9</sup> However, these benefits must normally be awarded over a complete tax year in order to get State Second Pension. It is not possible to be eligible for State Second Pension through a combination of credits from benefits or with contributions from earnings in any single tax year.

<sup>7</sup> The employment rate for lone parents (LP) with a youngest child aged 0–5 is 39.1 per cent, and for those with a youngest child aged 0–11 it is 50.1 per cent. For LPs with a youngest child aged 12 and over it is 71.1 per cent. The 12 and over category includes those with a youngest child aged 16–18 as long as that child is in full-time education. Source: *Labour Force Survey*, spring 2005.

<sup>8</sup> Currently either earnings equivalent to 52 weeks of the Lower Earnings Limit or credits are required to obtain a year of State Second Pension accrual.

<sup>9</sup> Child Benefit in respect of a child under age 6, HRP while looking after a sick or disabled person, Incapacity Benefit or Severe Disability Allowance (subject to the labour market attachment test), Carer's Allowance (or an underlying entitlement to it); or a tax year in which they have reckonable earnings equivalent to 52 weeks at the Lower Earnings Limit.

3.88 We propose to move from the current system of annual credits in the State Second Pension to weekly credits. This will provide more flexibility, enabling people to combine credits and paid contributions during a tax year to build up a year of State Second Pension. It ensures that we are recognising social contributions and earnings equally for the purposes of state pension entitlement and consistently in both tiers of the State Pension.

### A new credit for carers

3.89 The introduction of Carer's Allowance has helped recipients build up entitlement to the basic State Pension since 1976.<sup>10</sup> Recipients have also been able to get State Second Pension from 2002. Around 440,000<sup>11</sup> people, caring for 35 hours a week or more, are receiving Carer's Allowance.

3.90 Carer's Allowance is awarded to those who:

- do not earn above a set limit (£84); and
- provide regular and substantial care, that is for 35 hours or more; and
- care for one severely disabled person receiving the middle or highest rate of Disability Living Allowance care component, Attendance Allowance, or the equivalent rates of Constant Attendance Allowance.

3.91 While Carer's Allowance and HRP<sup>12</sup> provide comprehensive cover, they only do this for people who are effectively full-time carers – those who would have most difficulty engaging in the labour market. Those caring for less than 35 hours or for more than one disabled person are not recognised and we know that some caring responsibilities can compromise an individual's ability to work and build up a state pension.

3.92 *Women and pensions: The evidence* reported that employment rates of carers looking after someone for more than 20 hours a week are significantly lower across all age groups.<sup>13</sup> Additionally, those caring for more than 20 hours a week are more likely to suffer disadvantages from caring in terms of their health or other aspects of their life.<sup>14</sup>

<sup>10</sup> The predecessor to Carer's Allowance, Invalid Care Allowance, was first payable in 1976.

<sup>11</sup> 440,000 people were receiving Carer's Allowance at November 2005.

<sup>12</sup> Those caring for 35 hours or more not entitled to Carer's Allowance may apply for HRP, and Income Support recipients who are caring are automatically awarded HRP. (See Annex B for more detail.)

<sup>13</sup> *Family Resources Survey*.

<sup>14</sup> Maher and Green, 2002, analysing General Household Survey 2000.

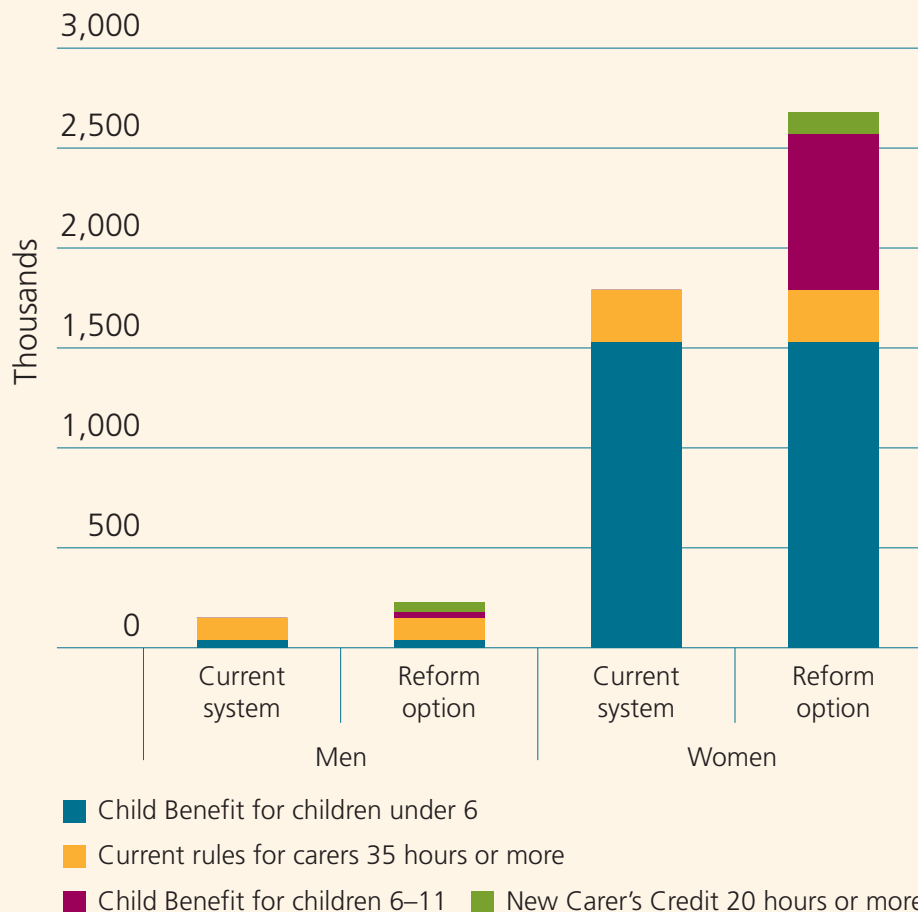
- 3.93 The Government now proposes that people who undertake care for the severely disabled for 20 hours or more a week should become entitled to credits for both basic State Pension and State Second Pension. We estimate that around 70,000 people a year could gain a credit for basic State Pension from this proposal, and over half of these will be women. The new credit for those caring for 20 hours or more should mean around 110,000 more women and 50,000 more men will be accruing entitlements to State Second Pension.
- 3.94 A system of certification will be required to claim the new credits. We will consult with key stakeholders on the most effective way to implement the new arrangements for those reaching State Pension age from 2010. We propose that the new crediting arrangements for carers, including the replacement of HRP with a weekly credit and the introduction of a new carer's credit, will apply to bereavement benefits.

### **Findings from the National Pensions Debate: extending coverage**

Proposals to increase entitlement for carers accords well with the public's view of the principles on which an additional State Pension should be based. At the National Pensions Day, participants were asked to give their views on what should count towards the State Second Pension. The majority believed that paid work, voluntary work, caring for children, caring for the sick, elderly or disabled and time spent long-term sick or disabled and unable to work, should count towards the State Second Pension. Of these, people agreed most strongly that paid work and caring for the sick, elderly or disabled should count.

- 3.95 The more generous crediting arrangements will mean up to 1 million more individuals (around 90 per cent of which are women) will be accruing State Second Pension credits in a given week – which should feed through to higher State Second Pension entitlements in retirement. Figure 3.viii shows the numbers accruing State Second Pension before and after changes to coverage.

**Figure 3.viii Numbers credited into State Second Pension before and after changes to coverage**



Source: Family Resources Survey average 2003–2005

Note: Lower Earnings Limit is assumed to be £82 per week in 2004/05, £79 per week in 2003/04 and £77 per week in 2002/03 cash terms.

The Family Resource Survey asks respondents about their activity in a given week.

Fifty-two weeks of State Second Pension accrual are needed for one qualifying year of State Second Pension. The survey is therefore likely to overestimate the number accruing a year's worth of accrual, as some weeks of accrual may be missed during the year.

## Ensuring that every year counts

3.96 Currently, to build up any entitlement to basic State Pension a person must satisfy two National Insurance conditions of entitlement. The first is satisfied through having earnings over the Lower Earnings Limit or by paying Class 2 or Class 3 contributions to make one qualifying year. The second is that they must then have at least 25 per cent of the number of qualifying years required for full basic State Pension – generally the equivalent of a further nine (for women) or ten (for men) qualifying years. This entitlement condition is known as the '25 per cent *de minimis* rule'.

- 3.97 These rules mean that small numbers of people have no entitlement to basic State Pension despite having up to nine years of contributions or credits. The two conditions of entitlement are more likely to affect some ethnic minority women who may feel or face cultural barriers to participating in paid work. Those women in this position usually contribute to society in other ways, such as through childcare or care of severely disabled people.
- 3.98 The Government proposes that the two conditions of entitlement are abolished. Up to 100,000 people a year reaching State Pension age could benefit from this.<sup>15</sup> These reforms underpin the other changes we are making to broaden the coverage of state pensions and in the context of the overall reform package – which includes more obvious recognition of caring responsibilities – they will have a far greater positive effect.
- 3.99 In State Second Pension there is no *de minimis* rule equivalent to that in the basic State Pension. There is however a ‘labour-market attachment test’. The test applies to long-term Incapacity Benefit recipients in respect of entitlement to additional State Pension.
- 3.100 The test requires that a long-term sick or disabled person must have paid, or be treated as having paid, Class 1 National Insurance contributions for at least one-tenth of their working life since 1978 (when additional State Pension through SERPS was first introduced). For example, a person reaching State Pension age in 2005/06 would have a working life of 27 years since 1978 and would have needed to have worked and paid Class 1 National Insurance contributions for three years (one-tenth of 27 years rounded to the nearest whole year) in order to receive entitlement to State Second Pension.
- 3.101 We propose to remove this complex procedure from 2010.

### Abolishing the adult dependency increase

- 3.102 The state pension system includes provision for a man or woman’s state pension to be increased if another adult is financially ‘dependent’ on him or her. These increases are known as adult dependency increases (ADIs) and have their origins in the immediate post-war period where single breadwinner households were the norm. We propose that ADIs will no longer be awarded from 2010. Annex B sets out in detail our proposals for abolishing ADIs.

### Autocredits

- 3.103 Since April 1983, National Insurance credits – known as ‘autocredits’ – have been available to men aged 60 to 64. They were introduced in 1983 as a response to high unemployment alongside the ending of the requirement that men aged 60 or over had to register as unemployed to qualify for Supplementary Benefit.

<sup>15</sup> This figure includes overseas cases, some of which benefit from reciprocal agreements.

- 3.104 In 1993, it was proposed that autocredits should become available to women, on the same basis as currently applies to men, as female State Pension age was increased from 60 to 65 between 2010 and 2020.
- 3.105 In developing our proposals for reform of the state pension system, we have reconsidered the rationale for these credits. Our conclusions are that:
- they are out of step with other measures the Government is taking to encourage people to extend their working lives to their full capacity; and
  - under our proposals to widen access to the basic State Pension they will become largely redundant.
- 3.106 We therefore propose that they should be phased out in line with the increase in women's State Pension age between 2010 and 2020.

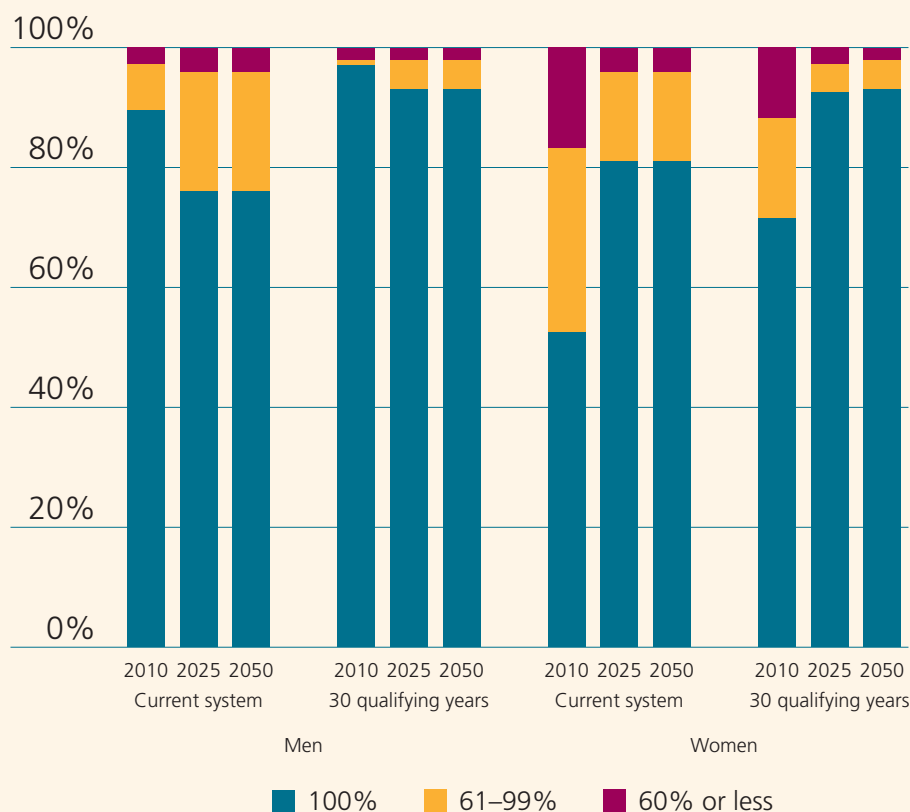
### Impact on Working Age benefits

- 3.107 This paper sets out the reforms we are proposing for pensions. People of working age have different needs and responsibilities. Any changes to their current arrangements will form part of our long-term aim to simplify the benefit systems for people of working age announced in the consultation document *A new deal for welfare: Empowering people to work*, published in January.
- 3.108 We do, however, seek views on the crediting arrangements for the State Second Pension following the proposals in *Empowering people to work* to replace incapacity benefits with Employment and Support Allowance (ESA) from 2008. These arrangements could be as now, with entitlement to credits beginning after 52 weeks of claiming ESA, after the 13 week assessment phase, or credits could be restricted to those entitled to the Support component only.

### Outcomes

- 3.109 Today around 30 per cent of women and 85 per cent of men reaching State Pension age are entitled to a full basic State Pension. By 2010 only around 50 per cent of women reaching State Pension age are expected to be entitled to a full basic State Pension compared with around 90 per cent of men. Introducing our reforms for those reaching State Pension age from 2010 will mean around 70 per cent of women reaching State Pension age in 2010 will have a full basic State Pension entitlement. By 2025 over 90 per cent of women and men reaching State Pension age are expected to get full basic State Pension entitlements compared with around 80 per cent if we do nothing. Figure 3.ix shows the impact of our reforms to the basic State Pension entitlements for new retirees in 2010, 2025 and 2050.

**Figure 3.ix Percentage of people reaching State Pension age with different proportions of the full rate of basic State Pension**



Source: Projections from Government Actuary's Department's Retirement Pension Model, GB

3.110 Importantly, these reforms taken together will see more people, especially women, building up entitlement in their own right, on the basis of their own actions. This will allow us to sweep away some of the complex and often outmoded rules that exist within the state pension system.

3.111 This chapter has set out how we will reform the structure of the state pension system and increase coverage of the state pension to address inequalities in order to provide a foundation to private savings. The next chapter goes on to look at working longer as an integral part of our reforms to meet the pensions challenge.