

**Pensions Bill -
Regulatory Impact Assessment**

Pensions Bill

Regulatory Impact Assessment

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Introduction

This regulatory impact assessment sets out the pension reform provisions in the Pensions Bill. This package of measures moves towards meeting the Government's five tests for pensions reform:

- **promoting personal responsibility** ensuring that individuals are responsible for their own plans for retirement.
- **be fair** by meeting the needs of the most vulnerable and establishing a new contributory principle that rewards "something for something".
- **be simple** to make the pension system simpler and ensure an individual's decision to save can be more straightforward.
- **be affordable** by balancing the financial needs of future pensioners with the financial capabilities of the taxpayer, and to ensure those needs are funded in a stable fiscal environment.
- **be sustainable** by clarifying the roles and responsibilities of individuals, employers and the state and to build trust in the UK pensions system.

The pension reform measures are based on the policy proposals set out in the White Paper *Security in retirement: towards a new pensions system*, published in May 2006. The White Paper was accompanied by an assessment of costs and benefits.

The Government has consulted widely on the package of reform measures in the Pensions Bill, through the National Pensions Debate and formal consultation following the publication of the White Paper.

The consultation findings were published in October 2006 in *Security in retirement: towards a new pensions system. Summary of responses to the consultation*.

The provisions in the Pensions Bill are largely as outlined in the White Paper. These include the uprating of basic State Pension by earnings growth; changes to the State Pension age; and modernisation of State Pension qualifying conditions to improve coverage. Following the results of the consultation and further policy consideration, four new measures are proposed. These are:

- new measures for reform of the State Second Pension to make it simpler to understand;

- reforms to enable a spouse (and in the future, a civil partner) to draw a pension based on their spouse's (or, in the future, civil partner's) insurance even if they choose not to retire; and
- confirmation of the uprating arrangements for adult dependency increases and other benefits as a consequence of uprating the basic State Pension by earnings;
- establishing a delivery authority with a limited remit, to prepare the documentation necessary to enable commencement, in July 2008, of the commercial process for the infrastructure of personal accounts.

This regulatory impact assessment analyses the costs and benefits of the measures set out in the Pensions Bill, including those set out above. It also includes an assessment of delivery costs.

The Government is also publishing:

- **The Gender Impact of Pension Reform** – a detailed gender analysis of the pension reforms, comparing outcomes for men and women;
- **Financial Incentives to Save for Retirement** - a technical analysis ;
- **Estimating the Economic and Social Welfare Impacts of Pension Reform** - an analytical working paper; and
- **Personal Accounts** – a White Paper and associated Regulatory Impact Assessment.

Chapter 1 – Overview

Objectives

- 1.1 The White Paper, *Security in retirement: towards a new pensions system*, (referred to hereafter as ‘the White Paper’ for ease of reference), set out the challenges facing the UK pensions system and the Government’s proposals for a long-term, sustainable solution.
- 1.2 The provisions in the Pensions Bill set out a package of reforms on state pensions, simplification measures in private pensions, and the establishment of the foundations for personal accounts. The reforms in the Bill do not include the establishment of personal accounts themselves which the Government will bring forward at a later date.

Background and rationale for intervention

- 1.3 In November 2005, the Pensions Commission published its second report, explaining the background and context to pensions issues for future pensioners, and making recommendations on how the system could be reformed to better meet future needs.
- 1.4 In May 2006, building on the analysis and recommendations made by the Pensions Commission, the Government published its proposals for pension reform, and the rationale for change, in its White Paper.
- 1.5 Average pensioner incomes today compare well with those of previous generations, and changes since 1997 have been successful in tackling pensioner poverty. But, as the Pensions Commission found, demographic and social trends evident today create challenges for the future:
 - life expectancy is increasing. This, along with lower birth rates, is resulting in older age groups becoming an increasingly large proportion of the population;
 - family structures are changing, with cohabitation and divorce now more common;
 - the trend of women’s growing participation in the labour market is continuing;

- as a result of the accumulation of 60 years of pensions legislation, the current pensions system is complex and difficult to understand;
- in addition, problems with savings incentives could develop if, in the long term, a pensions system evolved in which a significant majority of pensioners were entitled to Pension Credit. That has never been the intention of this Government;
- recent research estimates the number of people under-saving for their retirement to be around 7 million.

Consultation

- 1.6 The formal consultation period following publication of the White Paper ran from 25 May to 11 September. As well as written responses, the Government engaged with stakeholders and members of the public in a range of other ways to widen the debate and increase people's understanding of the issues.
- 1.7 The consultation was supported by on-line Pensions Forum debates with Ministers on the DWP website. To increase understanding, a number of fact sheets explaining key issues in more detail were also published on the Forum.
- 1.8 The Department held a seminar for employers and a seminar on carers' issues with stakeholder organisations and the public. Ministers also attended a number of regional road shows to meet stakeholders and members of the public.
- 1.9 A full summary and analysis of the consultation responses was published in October 2006 in *Security in retirement: towards a new pensions system. Summary of responses to the consultation*, (referred to hereafter as 'the White Paper Consultation Response' for ease of reference).

Options

Option 1: Do nothing

- 1.10 As the Pensions Commission's second report made clear, there is no current pensions crisis. Pensioners' incomes are higher, in real terms, than they have been before. But the Pensions Commission, and the Government's White Paper, set out the rationale for why doing nothing is not an option

1.11 For example, without reform to the state pensions system:

- inequalities between men and women will continue;
- if the Guarantee Credit is uprated with prices increasing numbers of pensioners will fall into low income and poverty;
- a result of maintaining an affordable State Pension as numbers of people aged over 65 increased, would be the value of the state support for pensioners falling relative to incomes; and
- the State Pension support for pensioners would grow in complexity and add to uncertainty for individuals about their retirement income.

Option 2: Package of reform

1.12 The Pensions Bill provides a package of reform to pensions that builds a solid foundation on which individuals can make private saving. These include: state pension reform to provide a fairer, more generous State Pension; reforms to simplify the existing private pension system; and setting up a system of personal accounts.

1.13 The key components of the Pensions Bill are:

Improving the coverage, generosity and sustainability of the State Pension by:

- linking the uprating of the Pension Credit standard minimum guarantee¹ and the basic State Pension to earnings;
- improving the entitlement to basic State Pension for women and carers by reducing the number of qualifying years for a full basic State Pension to 30 and revising and modernising credits for caring that will apply to both the basic State Pension and the State Second Pension;
- flat-rating and simplifying the State Second Pension; and
- gradually raising State Pension Age, including consequential changes for other social security benefits.

Establishing a delivery authority for personal accounts

- establishing a delivery authority with a limited remit, to prepare the documentation necessary to enable commencement, in July 2008, of the commercial process for the infrastructure of personal accounts. Personal accounts will provide an opportunity to contribute to a low cost savings vehicle.

¹ The standard minimum guarantee is the minimum level of income guaranteed to pensioners through the **Guarantee Credit** element of **Pension Credit**. Some groups of pensioners, such as severely disabled people and carers, will qualify for additional amounts.

Enacting simplification measures in private pensions by:

- permitting the trustees of defined benefit contracted-out occupational pension schemes to simplify their scheme structure by converting the Guaranteed Minimum Pension into ordinary scheme benefits which are of at least equal actuarial value;
- abolishing contracting out in defined contribution schemes, to remove complexity from pension savings decisions that currently arises from the difficult judgement about whether a person would be better off contracted-out or contracted-in to the State Second Pension;
- enabling occupational pension schemes to operate simpler internal dispute resolution procedures; and
- removing the requirement for the Secretary of State to approve actuarial Guidance Notes.

Costs and benefits

1.14 This Regulatory Impact Assessment presents costs and benefits for the reform package up to 2050, based on the best evidence currently available. There are inevitably uncertainties associated with these estimates. More detail on the methodology and assumptions involved in the estimates is in Annex A.

Costs

1.15 Figures 1.1-1.3 below show the costs of pensioner benefits (a) with no reform; (b) with an earnings linked standard minimum guarantee; and (c) with the full package of reform. They are presented in both cash, prices and as a percentage of GDP.

Figure 1.1: Total expenditure on pensioner benefits, cash, £ billion

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	56.2	84.7	137.9	204.7	285.2
SERPS / S2P	13.5	25.5	49.4	92.2	186.2
Pension Credit	7.3	5.9	4.6	3.1	2.1
Other Pension Benefits	3.0	3.4	5.0	7.2	10.4
Total pensions spending	80	119	197	307	484
Housing and Council Tax Benefits	8.6	6.7	7.5	9.4	14.6
Attendance Allowance & Disability Living Allowance	9.7	15.1	25.2	39.1	56.3
Total Pensioner Benefits	98	141	230	356	555
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	9.4	16.5	35.1	73.8	139.6
Total pensions spending	82	130	227	378	621
Housing and Council Tax Benefits	8.6	10.9	18.4	32.0	62.9
Total Pensioner Benefits	100	156	271	449	741
(c) with other reforms:					
Basic State Pension	56.2	98.0	185.3	327.6	519.1
SERPS / S2P	13.5	25.6	49.8	96.6	186.1
Pension Credit	8.9	10.3	11.9	13.4	15.1
Other Pension Benefits	3.0	3.4	4.9	7.0	10.1
Total pensions spending	82	137	252	445	730
Housing and Council Tax Benefits	8.6	10.3	14.6	22.2	40.7
Attendance Allowance & Disability Living Allowance	9.7	15.1	24.5	37.7	53.3
Total Pensioner Benefits	100	163	291	505	824

Figure 1.2 : Total expenditure on pensioner benefits, 2006/7 prices, £ billion

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	50.5	57.8	71.4	80.4	85.0
SERPS / S2P	12.1	17.4	25.6	36.2	55.5
Pension Credit	6.5	4.0	2.4	1.2	0.6
Other Pension Benefits	2.7	2.3	2.6	2.8	3.1
Total pensions spending	72	82	102	121	144
Housing and Council Tax Benefits	7.8	4.6	3.9	3.7	4.3
Attendance Allowance & Disability Living Allowance	8.8	10.3	13.0	15.3	16.8
Total Pensioner Benefits	88	96	119	140	165
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	8.5	11.3	18.2	29.0	41.6
Total pensions spending	74	89	118	148	185
Housing and Council Tax Benefits	7.8	7.5	9.5	12.6	18.8
Total Pensioner Benefits	90	107	140	176	221
(c) with other reforms:					
Basic State Pension	50.6	66.9	95.9	128.6	154.7
SERPS / S2P	12.1	17.5	25.8	37.9	55.4
Pension Credit	8.0	7.0	6.2	5.3	4.5
Other Pension Benefits	2.7	2.3	2.5	2.8	3.0
Total pensions spending	73	94	130	175	218
Housing and Council Tax Benefits	7.8	7.0	7.6	8.7	12.1
Attendance Allowance & Disability Living Allowance	8.8	10.3	12.7	14.8	15.9
Total Pensioner Benefits	90	111	151	198	246

Figure 1.3 : Total expenditure on pensioner benefits, per cent of GDP

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	3.5	3.2	3.2	3.0	2.6
SERPS / S2P	0.8	1.0	1.2	1.4	1.7
Pension Credit	0.4	0.2	0.1	0.0	0.0
Other Pension Benefits	0.2	0.1	0.1	0.1	0.1
Total pensions spending	4.9	4.5	4.6	4.5	4.4
Housing and Council Tax Benefits	0.5	0.3	0.2	0.1	0.1
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.6	0.5
Total Pensioner Benefits	6.1	5.3	5.4	5.2	5.1
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	0.6	0.6	0.8	1.1	1.3
Total pensions spending	5.1	4.9	5.4	5.6	5.7
Housing and Council Tax Benefits	0.5	0.4	0.4	0.5	0.6
Total Pensioner Benefits	6.2	5.9	6.4	6.6	6.8
(c) with other reforms:					
Basic State Pension	3.5	3.7	4.3	4.7	4.6
SERPS / S2P	0.8	1.0	1.2	1.4	1.7
Pension Credit	0.5	0.4	0.3	0.2	0.1
Other Pension Benefits	0.2	0.1	0.1	0.1	0.1
Total pensions spending	5.0	5.1	5.9	6.4	6.5
Housing and Council Tax Benefits	0.5	0.4	0.3	0.3	0.4
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.5	0.5
Total Pensioner Benefits	6.2	6.1	6.8	7.3	7.3

Notes: Figures refer to financial years, eg 2020 refers to 2020/21. Pension spending includes benefits specifically targeted at pensioners. Pensioner benefits include all benefits to which pensioners are entitled. More details – including knock on effects of pension reform on working age benefits - are given in Annex A.

Administration costs of reform

1.16 The administration costs of pension reform are set out below. They represent current best estimates. These represent the estimated implementation and administration costs associated with the reform package and costs for both the Department for Work and Pensions (DWP) and HM Revenue and Customs (HMRC). These costs will be refined as

these reforms are taken forward and more detailed planning is undertaken.

1.17 These show cost estimates of:

- £192m for state pension reforms up to 2022 including both the costs of implementation and ongoing operational costs;
- £21m for the personal accounts delivery authority which covers delivery authority costs up until the second Bill where further personal accounts legislation is intended;
- £8m costs for other private pension reforms (abolition of contracting out in defined contribution (DC) schemes and Guaranteed Minimum Pension (GMP) conversion) covering the period between 2007/08 and 2012/13
- in addition, there will be administrative savings for HMRC starting in 2013 that will arise as a result of abolishing contracting out for defined contribution schemes.

Figure 1.4 : Administration Costs of Reform, £ million

	07/08	08/09	09/10	10/11	11/12	2012-22	Total
State Pension reforms	13	31	47	30	14	57	192
Personal Accounts Delivery Authority	16	5					21
Private pension reforms	-	-	3	3	2	(10)	(2)
Total	29	36	50	33	16	47	211

*Costs expressed in nominal terms
Numbers in brackets, eg (2) reflect net savings.

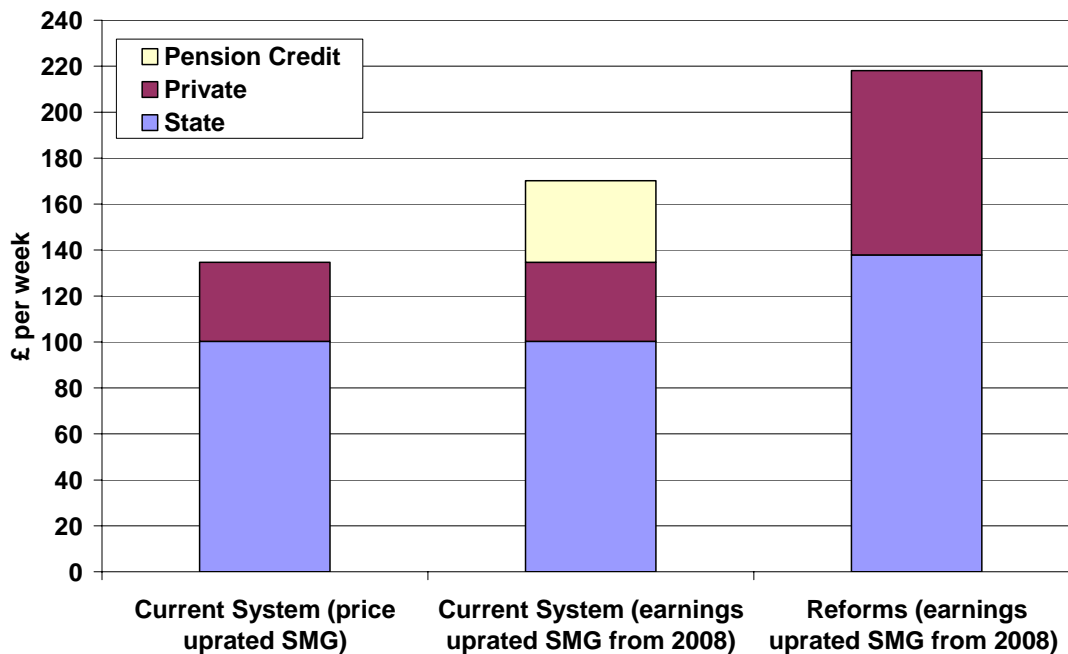
Costs and benefits to individuals

1.18 The pensions reform package will bring a number of benefits to individuals including:

- a greater number of people, over 90 per cent of people reaching State Pension age will have a full basic State Pension by 2025 due to improved coverage;
- a more generous State Pension with earnings uprating of basic State Pension. In conjunction with flat-rating of State Second Pension, will improve savings incentives for individuals;
- the poorest pensioners will benefit from a higher income with earnings uprating of the Pension Credit standard minimum guarantee;
- a simpler system of State Second Pension and private pension measures will make it easier for people to understand the pension they are accruing.

1.19 Figure 1.5 below compares pre and post reform gross retirement income for a median earner when they reach State Pension age. Because of the increase in State Pension age this chart shows income at 65 in 2050 pre-reform, and income at 68 in 2053 post reform. For consistency with charts produced in the White Paper RIA this chart includes income from personal accounts.

Figure 1.5: State Pension for a Median Earner at State Pension age (2050 before reform, 2053 with full reform package).



Source: DWP modelling

Note: In 2005/6 earnings terms. Assumes Median earner earns £440 a week. The current system (and with earnings uprating of Pension Credit standard minimum guarantee) assumes a working-life of around 40 years and reaches State Pension age in 2050. With reform assumes 43 working years and reaching State Pension age in 2053 (due to the pension age rises from 65 to 68). Assumes private saving of 4 per cent of income between lower earnings limit and upper earnings limit into a stakeholder pension, and with full reform into a personal account with 3 per cent employer contribution and 1 per cent tax relief.

1.20 In this Regulatory Impact Assessment most outcomes for individuals are presented in ‘earnings terms’. This gives a sense of how much income pensioners will have compared to typical earnings in the relevant year. Earnings tend to rise faster than prices, and so if pensioners’ incomes increase in line with earnings (remaining constant in earnings terms) then they will be able to buy more goods and services in the future than they can now. Putting outcomes in ‘earnings terms’ (as figure 1.5 does) shows how pensioners’ incomes would change relative to the rest of society.

Gender impact

- 1.21 Despite a number of changes designed to help parents and carers build up better State Pensions (such as the introduction of Carer's Allowance in 1976 and Home Responsibilities Protection in 1978), without reform, women's entitlements to a basic State Pension are still projected, on average, to remain behind men's until around 2025. Their State Second Pension entitlements would not catch up for many years after that.
- 1.22 The reform measures set out in the Pensions Bill will improve the State Pension outcomes for those with limited contribution records or with low pay. Women are disproportionately represented in these groups, so will benefit more than men at the outset.
- 1.23 State Pension reforms will:
- improve coverage by reducing the number of qualifying years required for a full basic State Pension to 30. Currently around 30 per cent of women reaching State Pension age are entitled to a full basic State Pension; with reform, this will rise to around 75 per cent in 2010 and to over 90 per cent from around 2025;
 - provide credits for caring, enabling more people (particularly women) to build up entitlement to basic State Pension and State Second Pension. Around 120,000 people, including 85,000 women, are estimated to gain credits for basic State Pension in 2010 as a result of the new Carers' Credit;
 - reform the State Second Pension to increase coverage for parents and carers, where about 90 per cent of those who benefit will be women;
 - provide a more generous State Pension through earnings uprating of the basic State Pension.
- 1.24 Sixty four per cent of those contracted-out through defined contribution schemes are men, and so the abolition of contracting out will affect more men than women. For most workers an informed decision to stay contracted-out in a defined contribution scheme requires complex consideration and many industry experts already advise people to contract back in to the State Second Pension. The withdrawal of contracting out for defined contribution schemes provides these workers with unequivocal rights to State Second Pension.
- 1.25 More detailed gender analysis of the pension reforms, comparing outcomes for men and women is published in The Gender Impact of Pension Reform.

Race impact

- 1.26 Some groups of Black and minority ethnic women are especially likely to accrue the basic State Pension primarily through Home Responsibilities Protection (HRP), or to have never worked in paid employment. These women in particular will gain from the conversion of HRP into credits.
- 1.27 The reduction in the number of qualifying years to 30 will help those who have spent a number of years not accruing basic State Pension. Thus the reforms benefit those who are disadvantaged in the labour market, and so are more likely to benefit some minority ethnic groups.
- 1.28 The exact assessment that can be made on the effect of the package on minority ethnic groups is limited by lack of data.

Impact on those caring for severely disabled people

- 1.29 Around 1.8 million individuals are caring for more than 20 hours a week.² A wide range of evidence³ suggests that those caring for more than 20 hours are more likely to experience detrimental effects in other areas of their lives. For example those caring over 20 hours have significantly lower employment rates, whereas those caring for less than 20 hours have very similar employment rates to the working age population as a whole.
- 1.30 Around 120,000 additional people could gain a carer's credit for the basic State Pension in 2010 following these reforms, and around 180,000 additional people could gain credits for State Second Pension in 2010.

Impact on employers

- 1.31 Within the overall reform package, the abolition of contracting out in defined contribution pension schemes is likely to have the most impact on employers because they will start to pay full rate National Insurance Contributions. However, since the employer rebate must be paid into the scheme, the additional National Insurance Contributions cost could be offset by a reduction in employer contributions overall.
- 1.32 There will be one-off costs from the abolition of contracting out in defined contribution schemes, but the Government believes these will be small. Only a small proportion of occupational schemes in the UK are contracted-

² Census 2001, Figures refer to Great Britain.

³ See for example Maher J and Green H, 2002, Carers 2000: *Results from the 2000 General Household Survey*, TSO.

out defined contribution schemes. There are around 4,000 contracted-out and contracted-out mixed benefit schemes with around 600,000 active members. This compares to a total of around 69,000 occupational schemes with around 4.7 million active members.⁴

- 1.33 Raising State Pension age is estimated to increase the labour supply. Such increases in labour supply are likely to have a beneficial effect on filling vacancies and have a restraining effect on wage growth.

Impacts on small firms and competition

- 1.34 The provisions of this Bill will not have any significant effect on small businesses.
- 1.35 The Government considers that the provisions of this Bill will have a neutral effect on competition.

Enforcement, sanctions and monitoring

- 1.36 The Government will continue to publish and monitor data on pensioners' incomes, detailed information on pensioner benefits, and pension contributions.
- 1.37 The Government will periodically commission reviews on increasing State Pension age, drawing on a range of independent expert advice in the light of emerging evidence on demographic change.

Implementation and delivery plan

- 1.38 The Pension Service has initiated a delivery programme to coordinate, manage and deliver those changes to State Pensions for which it is responsible for delivery, and to make necessary changes to its products and services to reflect other reform measures.
- 1.39 In addition, other delivery activities, including Her Majesty's Revenue and Customs' activities for the contracting out changes, are also being managed through over-arching programme arrangements. The majority of the administrative activity will be in delivering pension reforms scheduled for introduction from 2010, with the link between the basic State Pension and growth in average earnings following later. Implementation of the rise in State Pension age will occur over three decades (rising one year between 2024-26, 2034-36 and 2044-46).

⁴ Based on Government Actuary's Department (GAD) survey of Pension Schemes, includes all members of private pension schemes.

- 1.40 The scale of the changes, particularly to the many Information Technology systems affected, will necessitate long lead times for delivery plans, with the majority of the IT changes being developed between 2007 and 2012. The costs of these changes may be revised as further work on the detail of how they would be implemented is undertaken.
- 1.41 The costs of delivery include an extended publicity campaign to raise public awareness of the state pension reform changes, in particular for those customer groups most affected.

Post-implementation review

- 1.42 The Government propose periodically to commission reviews on whether the timetable for increasing State Pension age remains appropriate, drawing on a range of independent expert advice about the emerging evidence on demographic change.
- 1.43 The Department for Work and Pensions will continue to monitor State Pension awards and accruals, the level and distribution of pensioners' total incomes, and levels of understanding of the state pension system through analysis of administrative data, surveys and other sources. It will continue to report on progress against its Public Service Agreements in its annual and departmental reports.

Summary and recommendations

1.44 The figure below summarises the costs and benefits:

Figure 1.6: Summary of cost and benefits of reform

Measure	Costs	Benefits
A New Structure		
<p>Basic State Pension uprated with earnings.</p> <p>State Second Pension becomes flat-rate in accrual by around 2030.</p> <p>State Pension age rises to 68 by 2050.</p> <p>The savings credit maximum will be uprated by earnings from 2008 and then by prices from 2015.</p> <p>Adult Dependency Increases abolished.</p>	<p>Individuals born after April 1959 will receive State Pensions later, but on average a similar proportion of life will be spent in retirement.</p> <p>Higher earners will no longer get earnings-related pensions from the state – but everyone will get more contributory State Pension overall.</p> <p>Younger spouses of pensioners will no longer attract an Adult Dependency Increase.</p> <p>Some changes will be necessary to business payroll systems.</p> <p>Gradual reduction in the Contracted-out rebate (but DC pension schemes will no longer be contracted-out).</p>	<p>Basic State Pension uprating maintains the value of basic State Pension compared to working-age incomes. Pensioners will also see basic State Pensions uprated in line with earnings over the course of their retirement.</p> <p>A simpler structure will make it easier for individuals to understand what they can expect from the state. Along with less reliance on means testing this will clarify incentives to save and may result in more private saving.</p>
Improved Coverage		
<p>Qualifying years for basic State Pension reduced to 30.</p> <p>Home Responsibilities Protection reformed into a positive weekly credit – for people with care of a child up to 12.</p>	<p>Some individuals would have received NI credits until their youngest child reached 16, and will no longer do so – but this is offset by the reduction in qualifying years needed and extra accruals of State Second Pension for caring for children between 5 and</p>	<p>Benefits all who do not currently build up a full NI record.</p> <p>Particularly beneficial to women and carers who will be much more likely to achieve a full basic State Pension. In 2020 there are</p>

<p>Credits for childcare in State Second Pension available for people with care of a child up to age 12.</p> <p>A new weekly credit for carers providing 20 hours a week or more care.</p> <p>Minimum Contribution conditions abolished.</p> <p>25% <i>de minimis</i> rule abolished.</p> <p>Labour-market attachment test in State Second Pension abolished.</p>	<p>11 years old.</p>	<p>some additional 270,000 women receiving full basic State Pension.</p> <p>Large numbers of people will have more choice about undertaking education and other socially worthwhile activities such as caring and volunteering, without necessarily suffering a reduction in State Pension later in life.</p> <p>Every contribution will count – some people, particularly women who face cultural or other barriers to working, but who provide significant social contributions will get State Pensions for the first time.</p>
<p>Personal accounts delivery authority</p>		
<p>Personal accounts delivery authority is created to develop personal accounts.</p>	<p>Start up costs estimated at £21 million.</p>	<p>Develop the right mix of expertise to provide foundation on which Personal Accounts can launch from 2012.</p> <p>Ensure appropriate governance structure is in place to develop personal accounts.</p>
<p>Simplification of private pensions</p>		
<p>Abolition of contracting out of additional pension into DC schemes GMP conversion</p>	<p>Reduce contributions into DC schemes that have contracted-out members. Higher future spending on additional pension. Small one-off administrative cost to contracted-out schemes.</p>	<p>Removes complication that makes it easier to make informed decisions to save in a pension. Reduction in national insurance rebates. Small reduction in administrative cost.</p>

Declaration and publication

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

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Chapter 2 – State Pension Reforms

Objectives

- 2.1 The Government aims to reform the state pensions system to make it :
- fair – recognising the contribution of parents and carers in the same way as contributions from paid work;
 - provide a firm foundation for private savings;
 - simple – so people can understand their entitlement; and
 - be affordable and sustainable for the long term.

Background and rationale for government intervention

- 2.2 The White Paper set out proposed state pension reform measures, building on the analysis and recommendations of the Pensions Commission.
- 2.3 Pensioners' incomes are higher now in real terms than they have been ever before. Average pensioners' incomes have grown faster than earnings over the last two decades.
- 2.4 However this situation has masked growing inequalities between pensioners. This is why the Government introduced first the Minimum Income Guarantee, and then Pension Credit, to tackle existing pensioner poverty. The number of pensioners in relative poverty has fallen from 2.7 million in 1996/7 to 1.7 million in 2004/5 and a pensioner is now less likely to be in poverty than the rest of the population when incomes are measured after housing costs.⁵
- 2.5 The Pensions Commission's second report and the White Paper have set out a number of long term trends and existing circumstances which must be taken into account for the future:
- under saving and falling saving in private pensions which underline the importance of a state system that promotes saving;
 - demographics and changing family structure;
 - increasing participation by women in the labour market;
 - women's lower State Pension entitlement;

⁵ Households Below Average Incomes 2004/5

- the current pension system is complex, and if it continues to evolve as it is doing now it would result in a significant majority of pensioners becoming entitled to Pension Credit.

State Pension reforms: detail of proposed measures

- 2.6 The following state pension reform measures will be brought forward in the Pensions Bill (unless otherwise stated). Most of these measures were outlined in the White Paper. New proposals not presented in the White Paper, resulting from consultation feedback and further policy development, are clearly identified in the text.
- 2.7 Each of the reform measures is presented here with a summary of the Government's policy aims and the purpose and effect of each measure. Projected costs of state pension benefit expenditure are covered in Annex A.

A fairer system - improving coverage

Qualifying conditions – a single contribution condition

- 2.8 The Pensions Bill sets out provisions for a single contribution condition. The measure will:
- reduce the number of qualifying years to 30 years for a full basic State Pension - from 39 for women and 44 for men now;
 - remove the condition that at least one year must be paid, so that a record may be composed solely of credited contributions, for example through childcare; and
 - remove the *de minimis* rule so that every year of contributions or credits counts with 30 years providing a full entitlement to the basic element of the State Pension.
- 2.9 This single contribution condition will come into force for those people reaching State Pension age on or after 6 April 2010.

Qualifying conditions – current rules

The State Pension is paid to people who have reached pensionable age - currently 65 for men and 60 for women born before 6 April 1950. Pensionable age for women is already set to rise from 60 to 65 between 2010 and 2020 for women born after that date. To qualify for a full basic state pension, a person must have paid, been treated as paid, or have been credited with, National Insurance Contributions for at least 44 years (39 for women) . The amount of basic State Pension a person will receive depends on the number of qualifying years they have built up. To get a full rate basic State Pension, people must have qualifying years for about 90 per cent of their working life.

To qualify for any basic State Pension, people must satisfy two conditions:

- the first contribution condition requires a person to have one qualifying year from paid contributions only; and
- the 25 per cent *de minimis* requires a person to have a further 9 or 10 qualifying years from paid contributions or credits
- the “one year of paid contributions” rule is the basic entry test and would prevent people building entitlement on the basis of credits alone, through caring for example. The 25 per cent rule would prevent women with fewer than 10 qualifying years, even if one of them was from paid contributions, from getting any basic State Pension (men normally need 11).

Replacing Home Responsibilities Protection

- 2.10 The Government will replace Home Responsibilities Protection with a system of weekly credits for :
- parents who are awarded Child Benefit for children up to the age of 12;
 - foster parents of children up to the age of 12; and
 - carers who provide 20 or more hours care a week for one or more people receiving Attendance Allowance, Constant Attendance Allowance, or the middle or highest rates of the care component of Disability Living Allowance.
- 2.11 These credits will help build entitlement to the basic State Pension and certain bereavement benefits (Widowed Parent’s Allowance and Bereavement Allowance). The new system will help people be more certain about their State Pension entitlement. For those people reaching pensionable age on or after 6 April 2010, each complete year of HRP awarded under the existing rules of the scheme will be converted into a qualifying year for basic State Pension and relevant bereavement benefits.

Abolition of the Labour Market Attachment test

- 2.12 The Pensions Bill provides for the abolition of the Labour Market Attachment test for long-term disabled people from 2010. This will mean that people no longer have to work and pay contributions for 10 per cent of their working life for their credits to count towards the State Second Pension, thus benefiting those with a contribution history consisting largely of credits from incapacity benefits

Earnings factors for a qualifying year.

- 2.13 Similarly, the Government will introduce measures to allow people to combine contributions and credits in a tax year to earn a qualifying year for State Second Pension. Currently contributions and credits can be combined to earn a qualifying year for the basic State Pension, but not for State Second Pension. This measure will improve the pension outcomes for women and carers.
- 2.14 The measures also provide for new qualifying conditions and more generous access for the new State Second Pension. Parents will be credited into the State Second Pension until their youngest child reaches age 12 as opposed to age 6 under current rules. For the first time foster parents will be able to accrue State Second Pension. People benefiting from the new Parent's and Carer's credit will also be credited into State Second Pension.

A firm foundation for private saving

- 2.15 The Government's objective, subject to affordability and the fiscal position, is to uprate the basic State Pension in line with earnings from 2012, but in any event by the end of the next Parliament at the latest. This change allows people to plan with confidence for their retirement, providing a state underpin that rises with living standards, enabling people to predict what they are likely to receive from the State when they retire.
- 2.16 There are a number of consequential measures as a result of earnings uprating of the basic State Pension which leave the present prices uprating arrangements in place, or, in the case of Industrial Death Benefit continue to link the benefit rate to the level of the basic State Pension. These measures have little or no cost and are included here for completeness:

- **De-linking basic State Pension and lower earnings limit**

The lower earnings limit (effectively a “benefits entry point”) denotes the point at which a person starts to accrue basic State Pension entitlement, but a low earner is not liable to pay National Insurance contributions. Under current legislation, the lower earnings limit is linked to the value of the full rate basic State Pension and uprated with prices. The Government will retain the lower earnings limit as a benefits entry point and break the link with the level of the basic State Pension. The Government will separately consider the appropriate uprating of the lower earnings limit once the link with the basic State Pension is broken.

- **Uprating provision for Widow’s Benefit and bereavement benefits**

Widow’s and bereavement benefits, which are benefits payable to people under pension age, are currently linked to the rate of the basic State Pension. The Government would break the link between pensions and bereavement benefits to leave bereavement benefits uprated by prices. This maintains the current position and has no implications for state pension funding. Again, it is included here for completeness.

- **Uprating provision for Industrial Death Benefit.**

This is a preserved rights benefit under the Industrial Injuries Scheme. The benefit was abolished for new claims from 1988. Historically Industrial Death Benefit has been linked to the basic State Pension, the Government will retain this link.

- **Uprating provision for adult dependency increases**

The proposed abolition of adult dependency increases was announced in the White Paper. The Government committed to provide transitional protection for existing recipients for ten years until adult dependency increases are abolished. The adult dependency increases in payment for the transitional period until 2020 would be uprated by prices, as currently, rather than earnings. The Government cannot see any justification for increasing the rate of a benefit component that would be abolished for the next cohort of pensioners.

- **Uprating provision for pension increments**

A person who defers claiming his or her State Pension can earn an increase in the weekly rate: these increases are known as increments. They are paid in addition to basic State Pension, Additional Pension and Graduated Retirement Benefit and have been uprated in line with their

component parts of State Pension in recent years, that is, by prices. Changes to State Pension deferral were introduced in April 2005 which made deferral more generous by increasing the rate at which increments accrue from 7.5 per cent to 10.4 per cent per annum and also provided the opportunity for those who defer for 12 months or more to take a lump sum as an alternative to increments. Increments will also accrue on a more generous State Pension when the basic State Pension begins to increase in line with earnings. Taking these improvements into account the Government has decided that all increments in payment should continue to rise in line with prices.

Simplifying the State Pension

2.17 The Government has set out in its White Paper response its belief that the time is right to address the complexity in the state system. A simpler system is needed because:

- contributors need very clear information on their expected pension outcome from the state so they can take the savings decision that are right for them;
- a straightforward contract between the state and contributors makes for an enduring settlement.

Here we describe measures in the Bill which simplify the State Pension.

Basic element of State Pension

2.18 The introduction of a single 30 qualifying year contribution condition and the new credits for parents and carers now make the eligibility conditions of the basic element of State Pension clearer and more straightforward.

- **Removal of restrictions on entitlement for Category A and Category B pensions**

2.19 Under the current provisions, a married woman (and, in the future, a married man or a civil partner) cannot become entitled to a Category B spouse's retirement pension on her husband's insurance until her husband actually claims his own basic State Pension – the Category A pension. So if a married man defers claiming his pension, his wife automatically has to defer drawing her Category B pension. This has produced unfair outcomes when spouses take decisions which prevent their (often estranged) wives from drawing a pension.

2.20 The Government's policy intention is that entitlement to a Category B retirement pension based on a spouse (or civil partner's) contribution record should cease to be conditional on the spouse having claimed his own pension. This measure would be to simplify the deferral arrangements to enable spouses to make independent decisions on when (and whether) to claim retirement pension and remove disadvantages resulting from a spouse's decision.

2.21 This measure is a new reform measure since the publication of the pensions White Paper

- **Abolition of adult dependency increases**

2.22 Adult dependency increases would be abolished. These are currently awarded in addition to basic State Pension where the pensioner's spouse (or, from 2010, civil partner) is below State Pension age. No new awards would be made and any increase in payment at the time of abolition would be phased out over the following ten years.

2.23 The rationale for abolition of adult dependency increases from April 2010 is rooted in the principle that the reforms would enable a person to accrue pension entitlement in their own right. There are more households nowadays where both members of the couple are economically active. The abolition of adult dependency increases removes a disincentive for women to continue in work up to at least State Pension age and the Government's position is that the principle of dependency in the benefit system is outdated.

- **Phasing out of autocredits**

2.24 This is a measure to remove an element of pension calculations that will no longer be needed. This was outlined in the White Paper and, although the legislative provisions would be brought forward in Regulations, the measure is included here for completeness.

Second element of State Pension

2.25 The original structure of the State Earnings Related Pension Scheme (SERPS) was reasonably straightforward. Contributors would receive a pension of a quarter of the average of their best 20 years worth of earnings. However, reforms over the last decades have added complexity to the system.

2.26 Maintaining pensions scheme rights that have been built up in the past (which take many years to work themselves through) on top of a pension

system which has been shaped to deliver targeted social policy, has resulted in great complexity.

- 2.27 The Bill provisions make large-scale reforms to the State Second Pension to make a simplified state structure a reality. The Bill provides for the following:
- 2.28 The flat rate element of State Second Pension will be replaced with a new fixed rate amount. This will provide someone employed with earnings above £4,368, and those people credited into the system, with a weekly pension of £1.40 for each year of qualification. This amount (which is in 2006/07 earnings terms) will be uprated by earnings during a working life and prices in payment.
- 2.29 Accruals to the earnings (SERPS) element of State Second Pension will continue to start at earnings of £12,500 (the current level of the lower earnings threshold) and end at a new Upper Accrual Point (set at the same level as the upper earnings limit on introduction, but then frozen). This will allow for the gradual withdrawal of earnings related pension as recommended by the Pensions Commission and discussed in the White Paper.
- 2.30 Earnings between the lower earnings threshold and the upper accrual point will attract accruals of 10 per cent.
- 2.31 The current highly complex State Earnings Related Pension Scheme transitional arrangements will be withdrawn to coincide with the introduction of the new scheme.

Summary

- 2.32 From the time this new system is introduced, contributors will be able to determine their minimum pension outcomes by simple reference to the rate of basic State Pension and multiples of the fixed rate amount to reflect the expected length of their working life. Both basic State Pension and the fixed rate amount will accrue by earnings and therefore be set in a currency that contributors can relate to when they make savings decisions.
- 2.33 The Government will review its information products to ensure they meet the needs of those near to retirement and to savers and potential savers.
- 2.34 The measures here will provide for a straightforward State Pension where rights and responsibilities for pension provision are clear to all.

Impact on defined benefit schemes

- 2.35 There are two areas where changes being made to simplify State Second Pension will have an impact on contracting out for defined benefit (DB) schemes – National Insurance rebates and the Reference Scheme Test (the test DB schemes must meet if they wish to contract-out).
- 2.36 The Secretary of State sets a certain rebate rate percentage which represents a reduction in National Insurance contributions paid by employers and employees. This rebate rate is then applied to a certain band of earnings – at present the band is the lower earnings limit to the upper earnings limit (the same earnings band on which State Second Pension is accrued). The Bill provisions change this from the lower earnings limit to the new upper accrual point, to reflect the changes being made to State Second Pension.
- 2.37 Since 6 April 1997, occupational DB pension schemes wishing to contract-out their members from the State Second Pension must provide benefits which are broadly equivalent to, or better than, those which would be provided by a Reference Scheme Test. In order to satisfy the Reference Scheme Test, schemes must calculate their benefits by reference to the same band of earnings on which State Second Pension is accrued (ie earnings falling between the lower earnings limit and the upper earnings limit). It is therefore logical that if this band of earnings is changing for State Second Pension it should also change for Reference Scheme Test purposes. Therefore legislation will provide for amendments to the Reference Scheme Test calculation to refer to the band of earnings between the lower earnings limit and the upper accrual point.

Uprating arrangements for Pension Credit

Pension Credit standard minimum guarantee

- 2.38 The Government will continue to protect the poorest pensioner households by uprating the Pension Credit standard minimum guarantee in line with average earnings over the long term.
- 2.39 There is currently no mandatory requirement to uprate the standard minimum guarantee element of Pension Credit, although the Government has given a commitment to continue to uprate it every year by earnings until 2008. To formalise this current discretionary uprating strategy the Bill provides a mandatory requirement to continue uprating by earnings from 2008 and beyond.

Pension Credit Savings Credit

- 2.40 The structure of the Savings Credit, and the powers to set the level of the threshold in regulations, is already in Primary legislation. The threshold is increased each year as part of the Uprating Order, which is subject to approval by both Houses. No additional legislation is needed to provide for this element of pensions reform but, as a measure proposed in the White Paper, it is included here for completeness.

A sustainable system - State Pension age

- 2.41 The Government believes that a rise in State Pension age should form part of a combination of measures (along with encouraging people to work longer, save more and some increase in spending on pensioners) to ensure that people in the future have an adequate pension when they retire.
- 2.42 With fewer people of working age supporting an increasing number of people over pension age, the Government concludes that reform is needed to share more equitably the cost implications of rising longevity between those of working age and those of pension age.
- 2.43 The Bill provides for a rise in State Pension age by one year per decade from 2024 to 2046, broadly in line with predicted increases in average life expectancy, with each change phased in over two years.

Consequential impacts of the rise in State Pension age

- 2.44 Age thresholds within the benefit system that are already linked to State Pension age, including Jobseeker's Allowance and bereavement benefits, will rise automatically in line with rising State Pension age without the need for express amendment to those provisions. This is already factored in to the overall costs of the reform package. There is no direct impact on **Tax Credits** as there is no upper age limit on entitlement. The Bill however does amend provisions relating to the age threshold for Disability Living Allowance, Attendance Allowance and the Savings Credit within State Pension Credit.
- 2.45 The purpose of the upper age limit in **Disability Living Allowance (DLA)** and the lower age limit in Attendance Allowance (AA) is to focus the additional help with disability-related extra costs on people who are disabled in childhood or when of working age. This additional help takes the form of the higher and lower rates of the DLA mobility component and

- the lower rate of the DLA care component. They have no equivalents in AA.
- 2.46 Although the DLA/AA age 65 limits are not linked to State Pension age, and there is no statutory requirement to raise them in line with increases to that age, the equalisation of State Pension age in 2020 will more clearly make age 65 the boundary between working age benefits and pensioner benefits for both men and women. It will also more clearly link the DLA/AA age limits with that boundary.
- 2.47 The Bill provides that the upper age limit for DLA and the lower age limit for AA will, from 6 April 2024, be linked to State Pension age. As a consequence, these age limits will rise in line with changes to State Pension age described above.
- 2.48 The Bill would also amend the qualifying age for the Savings Credit element of **State Pension Credit**. This is already set at 65 and it is therefore consistent that this should increase in line with rising State Pension age.
- 2.49 The qualifying age for access to the State Pension Credit Guarantee Credit is linked to female State Pension age and so will gradually rise to age 65 by 2020 due to State Pension age equalisation. It has been suggested that the Guarantee Credit should continue to be available from age 65 when State Pension age rises above that from 2024 onwards. The Government believes that it is appropriate to consider this nearer the time, in the light of the contemporary evidence relating to life expectancy for different social groups.

Other schemes and concessions

- 2.50 Other Government departments administer a number of schemes and concessions for, or have duties with regard to, older people. In a very small number of cases, the age threshold is set by reference to State Pension age as defined by the social security legislation, and in these instances, the proposed change in the definition of State Pension age will read across automatically.
- 2.51 In other cases, where age thresholds are set at 60 or 65, the relevant departments are currently considering the implications of the changes to State Pension age, initially in the context of the forthcoming rise in female pension age and by extension the further increases for both men and woman from 2024. They will decide on whether changes to their own schemes are required in due course, taking account of the objective

justification for the respective age qualifications which may or may not be linked directly to State Pension age.

- 2.52 Similarly, the proposed increases to the State Pension age do not impose any requirement on non-statutory bodies and organisations which provide benefits such as age-related discounts for older people to follow suit. It will be up to each organisation to decide future policy in this area.

Pension scheme ages

- 2.53 The State Pension age is the minimum age at which people may start drawing their State Pension. The proposed changes do not directly affect the normal age for drawing a pension from non-State pension schemes, including those in the public sector.

Assessment of projected costs and outcomes of state pension reforms

Costs

- 2.54 Estimates of costs and outcomes of state pension reforms, shown here, have been updated since those presented in the White Paper in May 2006.
- 2.55 The main costs of the measures are in benefit expenditure. Figures 2.1-2.3 show the costs of benefits paid to pensioners with no reform, with an earnings linked standard minimum guarantee, and then with the full package of reform. They are presented in both cash, 06/07 prices and a percentage of GDP. Annex A contains further details on estimates of costs and the methodology that has been used to estimate them.
- 2.56 There are also some administrative costs associated with changing computer systems, and providing updated information to telephone callers, and revision of leaflets. Estimates of these costs are contained in Figure 2.4.

Figure 2.1: Total expenditure on pensioner benefits, cash, £ billion

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	56.2	84.7	137.9	204.7	285.2
SERPS / S2P	13.5	25.5	49.4	92.2	186.2
Pension Credit	7.3	5.9	4.6	3.1	2.1
Other Pension Benefits	3.0	3.4	5.0	7.2	10.4
Total pensions spending	80	119	197	307	484
Housing and Council Tax Benefits	8.6	6.7	7.5	9.4	14.6
Attendance Allowance & Disability Living Allowance	9.7	15.1	25.2	39.1	56.3
Total Pensioner Benefits	98	141	230	356	555
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	9.4	16.5	35.1	73.8	139.6
Total pensions spending	82	130	227	378	621
Housing and Council Tax Benefits	8.6	10.9	18.4	32.0	62.9
Total Pensioner Benefits	100	156	271	449	741
(c) with other reforms:					
Basic State Pension	56.2	98.0	185.3	327.6	519.1
SERPS / S2P	13.5	25.6	49.8	96.6	186.1
Pension Credit	8.9	10.3	11.9	13.4	15.1
Other Pension Benefits	3.0	3.4	4.9	7.0	10.1
Total pensions spending	82	137	252	445	730
Housing and Council Tax Benefits	8.6	10.3	14.6	22.2	40.7
Attendance Allowance & Disability Living Allowance	9.7	15.1	24.5	37.7	53.3
Total Pensioner Benefits	100	163	291	505	824

Figure 2.2 : Total expenditure on pensioner benefits, 2006/7 prices, £ billion

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	50.5	57.8	71.4	80.4	85.0
SERPS / S2P	12.1	17.4	25.6	36.2	55.5
Pension Credit	6.5	4.0	2.4	1.2	0.6
Other Pension Benefits	2.7	2.3	2.6	2.8	3.1
Total pensions spending	72	82	102	121	144
Housing and Council Tax Benefits	7.8	4.6	3.9	3.7	4.3
Attendance Allowance & Disability Living Allowance	8.8	10.3	13.0	15.3	16.8
Total Pensioner Benefits	88	96	119	140	165
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	8.5	11.3	18.2	29.0	41.6
Total pensions spending	74	89	118	148	185
Housing and Council Tax Benefits	7.8	7.5	9.5	12.6	18.8
Total Pensioner Benefits	90	107	140	176	221
(c) with other reforms:					
Basic State Pension	50.6	66.9	95.9	128.6	154.7
SERPS / S2P	12.1	17.5	25.8	37.9	55.4
Pension Credit	8.0	7.0	6.2	5.3	4.5
Other Pension Benefits	2.7	2.3	2.5	2.8	3.0
Total pensions spending	73	94	130	175	218
Housing and Council Tax Benefits	7.8	7.0	7.6	8.7	12.1
Attendance Allowance & Disability Living Allowance	8.8	10.3	12.7	14.8	15.9
Total Pensioner Benefits	90	111	151	198	246

Figure 2.3 : Total expenditure on pensioner benefits, per cent of GDP

	2010	2020	2030	2040	2050
(a) without reform:					
Basic State Pension	3.5	3.2	3.2	3.0	2.6
SERPS / S2P	0.8	1.0	1.2	1.4	1.7
Pension Credit	0.4	0.2	0.1	0.0	0.0
Other Pension Benefits	0.2	0.1	0.1	0.1	0.1
Total pensions spending	4.9	4.5	4.6	4.5	4.4
Housing and Council Tax Benefits	0.5	0.3	0.2	0.1	0.1
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.6	0.5
Total Pensioner Benefits	6.1	5.3	5.4	5.2	5.1
(b) with an earnings-indexed standard minimum guarantee:					
Pension Credit	0.6	0.6	0.8	1.1	1.3
Total pensions spending	5.1	4.9	5.4	5.6	5.7
Housing and Council Tax Benefits	0.5	0.4	0.4	0.5	0.6
Total Pensioner Benefits	6.2	5.9	6.4	6.6	6.8
(c) with other reforms:					
Basic State Pension	3.5	3.7	4.3	4.7	4.6
SERPS / S2P	0.8	1.0	1.2	1.4	1.7
Pension Credit	0.5	0.4	0.3	0.2	0.1
Other Pension Benefits	0.2	0.1	0.1	0.1	0.1
Total pensions spending	5.0	5.1	5.9	6.4	6.5
Housing and Council Tax Benefits	0.5	0.4	0.3	0.3	0.4
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.5	0.5
Total Pensioner Benefits	6.2	6.1	6.8	7.3	7.3

Notes: Figures refer to financial years, eg 2020 refers to 2020/21. Pension spending includes benefits specifically targeted at pensioners. Pensioner benefits include all benefits to which pensioners are entitled. More details – including knock on effects of pension reform on working age benefits - are given in Annex A.

2.57 The estimated administration costs of state pension reform (both DWP and HMRC) are set out in the table below.

Figure 2.4 : Administration costs, £ million

£m	07/08	08/09	09/10	10/11	11/12	2012-22	Total
State Pension Reforms	13	31	47	30	14	57	192

*Costs expressed in nominal terms

Source: *The Pension Service, Her Majesty's Revenue and Customs*

Effects on individuals

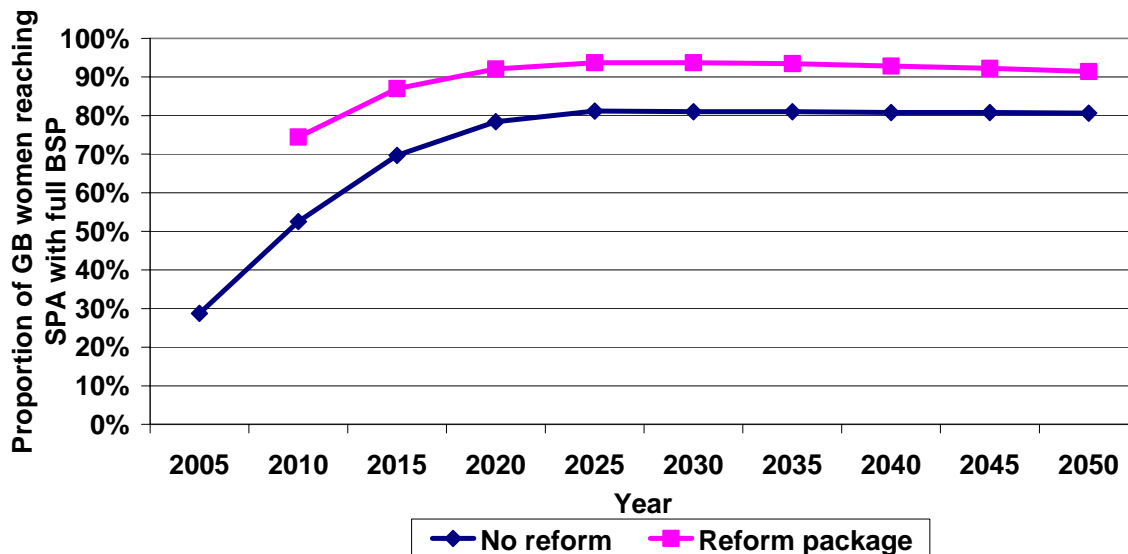
- 2.58 This section sets out the impact of the State Pension reform package on individuals. The analysis is set out in main sections on:
- **improved coverage of the State Pension** – reflecting changes to both the basic and State Second Pension;
 - **a firm foundation for private saving** – reflecting the more generous basic State Pension, and flat rating of State Second Pension;
 - **improved incentives to save** – with analysis on returns to save, and the number of people on Pension Credit; and
 - **the impact of changes to the State Pension age.**
- 2.59 Sections after this cover race and gender impact separately. Annex B also has additional detail on the analysis of the outcomes that people might expect.

Improved coverage of the basic State Pension

- 2.60 Currently only around 30 per cent of women in Great Britain reaching State Pension age are entitled to a full basic State Pension, compared to around 85 per cent of men. The package of basic State Pension coverage reforms (which includes a reduction in the number of qualifying years needed for a full basic State Pension to 30, and more generous credits for parents and carers) will mean that:
- around three quarters of women reaching State Pension age in 2010 will be entitled to a full basic State Pension, compared to around half without reform;
 - in 2025, almost half a million extra women over State Pension age will have a full basic State Pension;
 - from 2025, over 90 per cent of both men and women reaching State Pension age will retire with a full basic State Pension;
 - by 2050, around 95 per cent of all GB pensioners will be entitled to a full basic State Pension.

Figure 2.5 below illustrates how the proportion of women reaching State Pension age with a full basic State Pension will be increased by the coverage reforms.

Figure 2.5: Proportion of women reaching State Pension age with full basic State Pension, with and without reform



Source: DWP projections using the Government Actuary's Department's Retirement Pension Model, GB.

Note: A woman's entitlement is based on her own and her husband's contributions.

Accrual of State Second Pension

- 2.61 In any one year some 70 per cent of the working age population are accruing or being credited with accruals to State Second Pension, a significant improvement to the situation under SERPs where around 55 per cent of the work age population accrued rights. Reforms propose to extend credits to those caring for children aged 6 to 12 and further extend credits for carers of sick and disabled people – these will both raise the proportion of the working age population accruing State Second Pension.
- 2.62 The main reason people do not accrue State Second Pension are due to periods of self-employment (around 13 per cent of the working age population) and unemployment (around 6 per cent of the population). Average durations of self-employment tend to be around 10 years,⁶ and some 80 per cent of the unemployed move out of unemployment within a year.⁷
- 2.63 Although reform should increase the number of people accruing rights to State Second Pension, these reforms will take time to significantly change

⁶ Labour Force Survey, Spring 2006.

⁷ The average duration of unemployment has fallen in recent years as the Government's active labour market policies and economic stability have reduced the average duration of unemployment.

outcomes. State Second Pension is calculated for each year of work or credited activity prior to the person being eligible for a State Pension. Figure 2.6 shows the maximum number of years of additional pension someone retiring at the start of each decade could have acquired. This shows that it will take time for reform to affect each cohort of retirees, with the number of years of State Second Pension exceeding that of SERPs for new retirees from the mid-2020s.

Figure 2.6 : Maximum number of years a person, reaching State Pension age between 2010 and 2050, accrues under State Earnings Related Pension SERPs and reformed State Second Pension.

Reaching State Pension age in:	Maximum number of years of ...			
	SERPs	S2P	S2P after reform	Total years of additional pension
2010	24	8	0	32
2020	24	10	8	42
2030	22	10	18	50
2040	13	10	28	51
2050	4	10	38	52

Source: DWP calculations.

Note: Shows maximum number of years for someone working from the age of 16. SERPs is accrued from when it was introduced in 1978 to 2002. State Second Pension is accrued from 2002 until reform in 2012. State Second Pension under reform is accrued from 2012 until the person reaches SPA or stops working / caring.

A firm foundation for private saving

Upating basic State Pension in line with earnings growth

2.64 The Government's objective, subject to affordability and the fiscal position is to uprate the basic State Pension in line with earnings growth from 2012, but in any event by the end of the next Parliament at the latest. Earnings uprating the basic State Pension ensures that it keeps its value and therefore continues to provide a solid base for people to save. Earnings uprating the basic State Pension would more than double its value in real price terms by 2050. The table below shows the value of the basic State Pension if it continued to be uprated by prices until 2050, the value of the basic State Pension with earnings uprating from 2012, and the gains from earnings uprating - all in earnings and prices terms.

Figure 2.7: Weekly full basic State Pensions entitlement, 2005/6 prices and earnings terms

	Earnings terms		Price terms	
	price uprated BSP	earnings uprated BSP	price uprated BSP	earnings uprated BSP
2012	£73	£73	£84	£84
2020	£62	£73	£84	£98
2030	£51	£73	£84	£120
2040	£42	£73	£84	£146
2050	£34	£73	£84	£178

Source: DWP calculations

Notes: Assumes receipt of full basic State Pensions when reaching SPA - which is 66 in 2030, 67 in 2040 and 68 in 2050. Price and earnings uprating starts from 2012.

State Second Pension

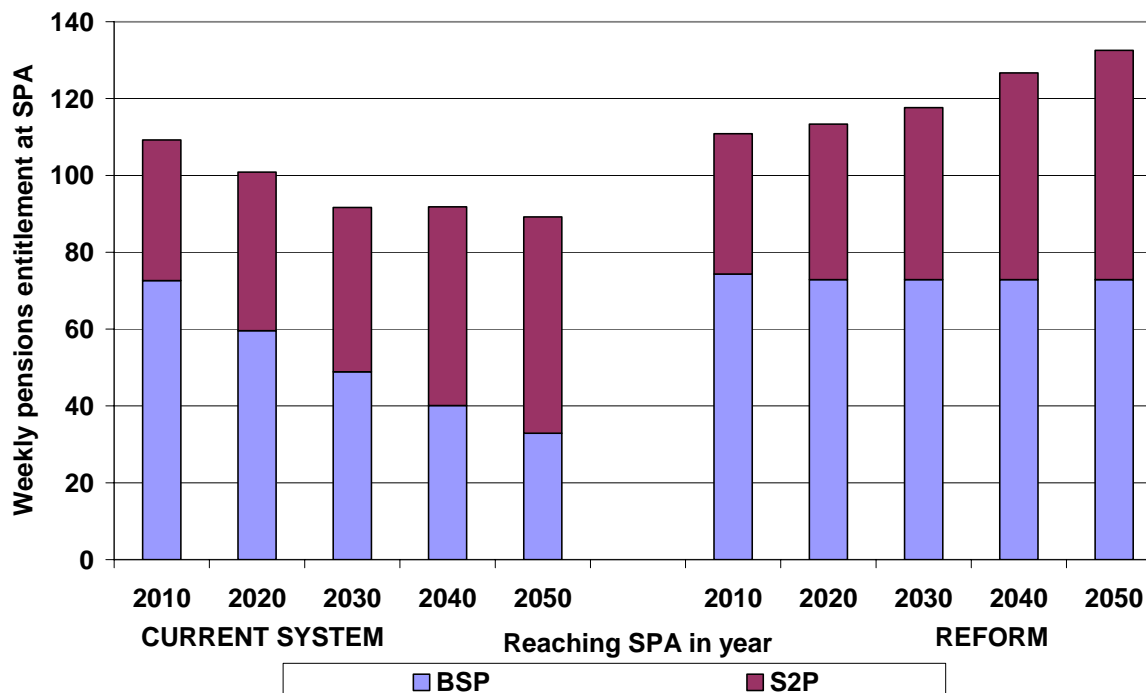
2.65 From 2012, every year of work or caring will be worth an extra £1.40 a week in retirement (in earnings terms). There will be a transitional earnings related element which will be phased out by around 2030. This further simplification will ensure that, in combination with the basic State Pension, the State provides a simple and solid underpin on top of which people can save.

An increasing State Pension underpin overall

2.66 Figure 2.8 shows the value of the State Pension (basic State Pension and Additional State Pension) at State Pension age for a low earner in 2010, 2020, 2030, 2040 and 2050 under the current system and after reform (further examples in Annex B). Under reform the amount provided through the basic State Pension remains constant in earning terms, the State Second Pension becomes increasingly flat rate – with each year of work or caring earning them an extra £1.40 a week in retirement. The result is that individuals would increasingly move towards an underpin of around £135 a week State Pension for working or caring from age 25 to State Pension age.

2.67 Increasingly the underpin provided by the State Pension (basic State Pension and State Second Pension combined) will take people out of Pension Credit. A median earner retiring in 2040 would have State Pension entitlement high enough to entirely avoid Pension Credit on reaching State Pension age. A low earner reaching State Pension in 2050 with 43 years work history would have sufficient State Pension alone to be above Pension Credit levels.

Figure 2.8: Basic State Pension and State Second Pension for low earner - reform compared to current system



Source: DWP calculations

Note: Assumes that a person has a good working life (works / cares from age 25 to State Pension Age) and earns £230 a week.

Upating the standard minimum guarantee by earnings

- 2.68 Upating the Pension Credit standard minimum guarantee in line with earnings in the long run, ensures a decent safety net for all pensioners, rising in line with working-age incomes. Without this, increasing numbers of pensioners would fall into relative poverty.
- 2.69 The table below compares the value of the standard minimum guarantee, upated by prices and earnings, from 2008 to 2050. Upating by prices ensures that pensioners in 2050 who rely on the standard minimum guarantee receive the same income in comparable terms as those in 2010 (see third column). However over time, relative to earnings, the value of the standard minimum guarantee would fall if it were upated by prices (see first column). Earnings upating maintains the standard minimum guarantee value in earnings terms, and more than doubles its value in prices terms by 2050.

Figure 2.9 : Weekly values for the Pension Credit standard minimum guarantee (SMG)

	In 05/06 earnings terms		In 05/06 prices terms	
	SMG uprated by prices from 2008	SMG uprated by earnings from 2008	SMG uprated by prices from 2008	SMG uprated by earnings from 2008
2010	105	110	114	121
2020	86	110	114	147
2030	70	110	114	180
2040	57	110	114	219
2050	47	110	114	267

Source: DWP calculations

Incentives to save

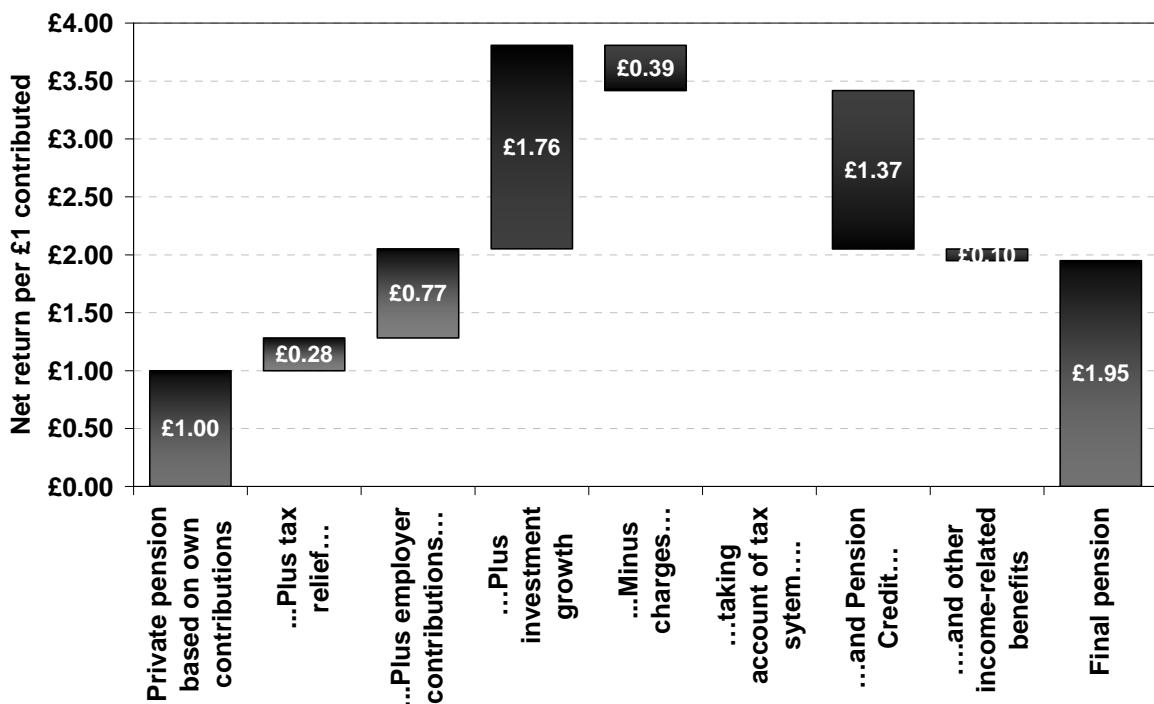
- 2.70 A key objective for State Pension reform is to allow most people to be confident that they can generally expect to get a reasonable payback from having saved. To test this is the case, analysis has been undertaken looking at what payback people can expect from saving in personal accounts. Results will depend upon many factors but for reasonable assumptions about such factors, under the reformed pension system, the large majority of people can expect to get more back, in real terms, than they have contributed. Analysis shows the benefit of tax relief and investment growth on pension saving (and in future it will also benefit from the presence of an employer contribution). There are also factors that operate in the opposite direction, including pension fund charges, tax, and/or lower benefit entitlements.
- 2.71 Commentators have suggested that income-related benefits discourage saving. Under the reformed system, most people can expect good payback from saving even if they are entitled to the savings credit – and under the reforms it is projected that only a third of people will be entitled to Pension Credit by 2050. In the following section effects are illustrated by considering the payback from savings, and numbers entitled to Pension Credit.
- 2.72 Results will depend upon many factors such as investment growth and annuity rates. The examples below show the expected payback from saving into a personal account for a median earner (£23,000 a year) aged 25 in 2012 under the current system with earnings uprating of the Guarantee Credit, and with the full package of state reform measures, based on reasonable assumptions about factors such as investment

returns.⁸ Both scenarios include the expected effects of personal accounts.

Without state pension reforms

2.73 Without state reforms, under these assumptions a median earner saving from age 25 to state pension age could expect a net payback of £1.95 for each £1 saved (Figure 2.10). This is made up of tax relief, the employer contribution and investment growth, less charges from the fund, tax on final income (where applicable), and less means-tested benefits which will be withdrawn because he now has higher private income.

Figure 2.10 : Projected payback from saving £1 – pre reform



Source: DWP modelling. This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

Notes: Assuming owner occupier in retirement. This chart shows returns on saving over retirement not at a particular point in retirement.

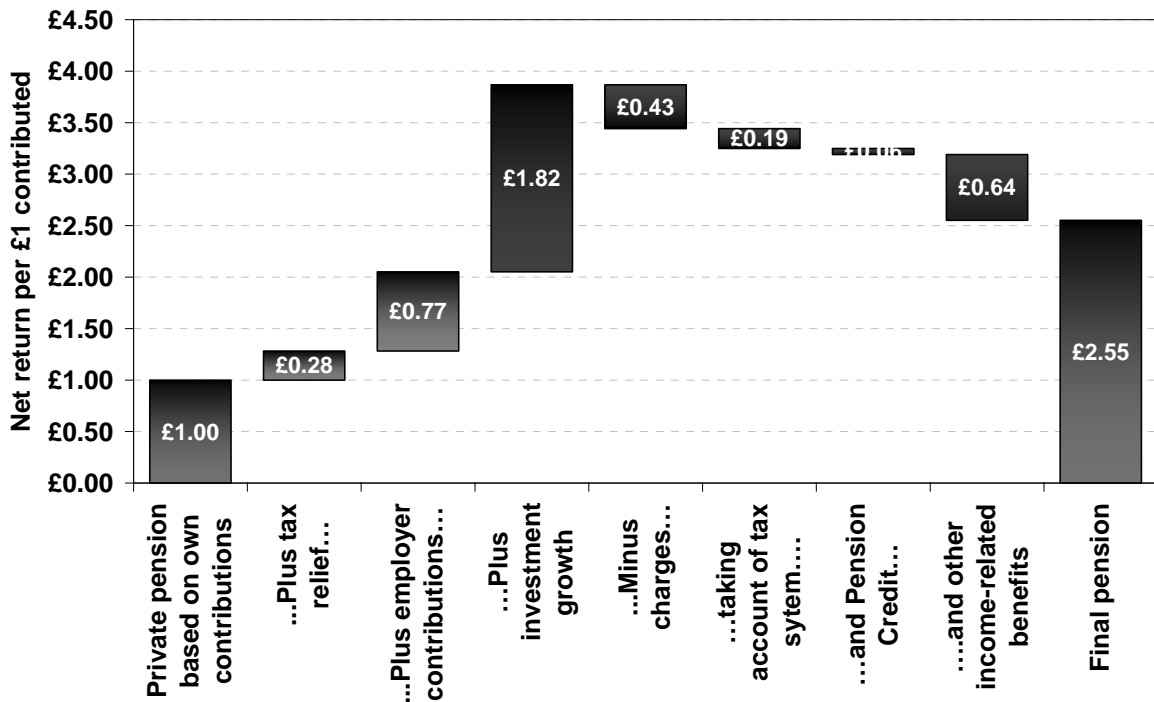
2.74 With state pension reform a person with earnings of £23,000 in 2006/7 can expect a very different payback to savings as a result of state pension

⁸ The most important of these are that real investment growth is 3.5 per cent and life expectancy is in line with Government Actuary’s Department projections. Full details are in Financial incentives to save for retirement

reforms. With state pension reforms he now faces a lower degree of Pension Credit withdrawal as he is eligible for a higher State Pension.

2.75 As a result of the reforms, he can expect a payback of £2.55 for every £1 that he contributes (Figure 2.11). He will face some income related benefit withdrawal due to Council Tax Benefit, but will be only marginally affected by Pension Credit later in retirement.

Figure 2.11 : Projected real payback from saving £1 – post reform



Source: DWP modelling. This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

Notes: Assuming owner occupier in retirement. This chart shows returns on saving over retirement not at a particular point in retirement.

2.76 Some groups may face lower returns than set out in this example, or may be better advised not to save for other reasons (for example those people with large debts). More information can be found in the publication: Financial incentives to save for retirement.

2.77 Over 85 per cent of people aged 50 to State Pension age have either built up some private pension provision or at least £6,000 savings.⁹ A male

⁹ Source: English Longitudinal Study of Ageing. Savings of less than £6,000 are not taken into account by Pension Credit.

- median earner aged 55 in 2012 with savings of £20,000 (which would represent a pension of approximately £20 per week) could expect a payback of £1.60 for each £1 he saves in a personal account.
- 2.78 A couple could expect different results again – these could be expected to be at least as high as for single people in most cases as Pension Credit and Council Tax Benefit entitlement would be shared by the couple but tax is calculated on an individual basis. For example, a male aged 25 in 2012 with median earnings could expect a return of £3.22, if his partner receives the same level of income in retirement.¹⁰
- 2.79 People with different working patterns through their life will see different levels of payback on their investment. More information is contained in the publication Financial Incentives to Save for Retirement.
- 2.80 Each of the example cases can expect to get back significantly more in real terms than they put in, including those who find part of their personal accounts pension is offset against Pension Credit but who are not on the Guarantee Credit element only. These results are likely to compare well to other investments with similar risk profiles, which would not attract the matching contribution but could nevertheless affect tax due and entitlement to benefits in retirement.

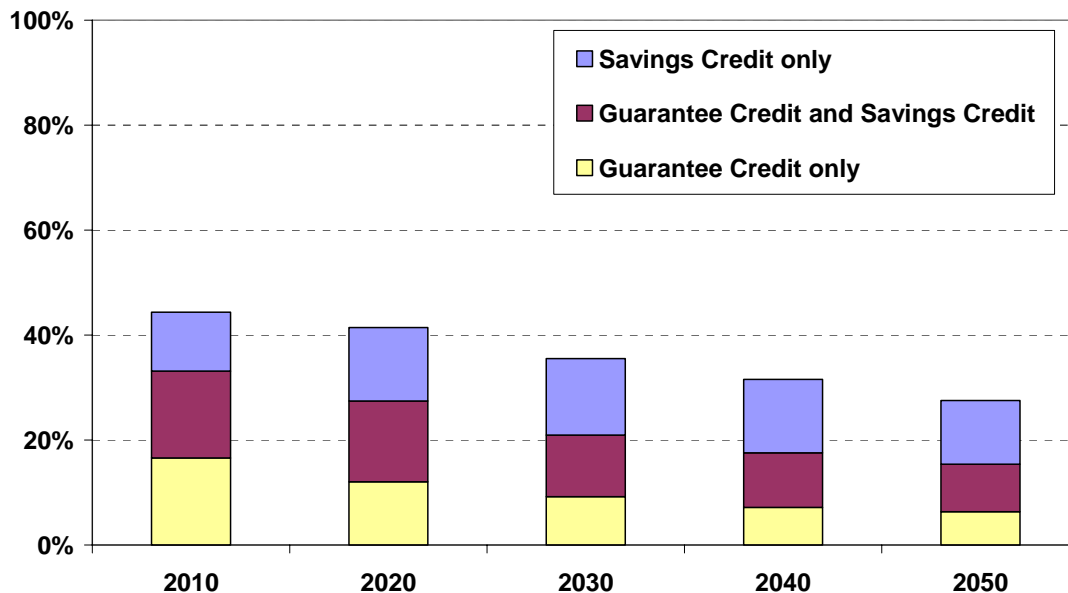
Numbers on Pension Credit

- 2.81 If the current uprating arrangements were to have continued over the long term, with the standard minimum guarantee uprated in line with earnings and the basic State Pension uprated in line with prices, then an increasing number of pensioners would have been entitled to Pension Credit – over 75 per cent by 2050. It has never been the Government's intention that this would have happened.
- 2.82 People can be entitled to Pension Credit and still see a reasonable return on their saving. The combination of a more generous State Pension and reforms to the Savings Credit will mean – over time - that fewer pensioners will be entitled to Pension Credit, at the same time as protecting the poorest by earnings uprating Pension Credit standard minimum guarantee.
- 2.83 Figure 2.12 shows the proportion of pensioners eligible for Pension Credit after the reforms. These projections show about 30 per cent of pensioners will be eligible for Pension Credit in 2050, with only about one in twenty

¹⁰ The returns for each individual assume that they remain in the couple until death. Where the individual outlives their partner their returns in the remaining years will be more like those of single people (though they may benefit from pension or other assets inherited from their late partner).

being eligible for the Guarantee Credit only. This is an updated version of projections presented in Figure 3.v in the White Paper. It takes account of revisions to modelling, assumptions and policy proposals since the White Paper (see box below).

Figure 2.12 – Proportion of pensioners eligible for pension credit over time



Source: DWP projections, using micro-stimulation modelling

Notes: This chart illustrates outcomes based on 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.

- 2.84 The projections of Pension Credit entitlement do not include the effect of personal accounts. If personal accounts increase private pension saving, the proportion entitled to Pension Credit will fall.
- 2.85 Eligibility is strongly linked to the higher Pension Credit rates for disability and caring. Approaching half of those eligible for Pension Credit in 2050 get higher rates of Pension Credit because they also receive disability benefits, are carers, or have additional housing costs.
- 2.86 Further details of the projections that underpin the Pension Credit estimates and analysis which demonstrates the robustness of the estimates have been set out in a factsheet - *Projections of Pension Credit entitlement* - published by DWP.¹¹

¹¹ On the DWP website at - www.dwp.gov.uk/pensionsreform/forum/docs/fs-pc-projection.pdf

Projections of Pension Credit entitlement

The projection of pensioner incomes that underpins the projections of Pension Credit entitlement is based on the Pensim2 dynamic micro-simulation model that has been developed in DWP. The model builds up projections of income from a series of equations and assumptions that generate labour market and pension histories for a representative sample of the population. It simulates the accrual of state and private pensions by working age individuals, based on their projected labour market status. The model therefore directly incorporates the impact of trends in pension provision – for example broadening coverage of basic State Pension and State Second Pension – and changes in pensions policy.

Projections in the White Paper were based both on Pensim2 and a more traditional ‘static’ microsimulation modelling approach. This reflected that Pensim2 was a relatively new model and so it was important to validate its findings against another model. In the light of further analysis since the White Paper, DWP analysts now consider that Pensim2 provides more robust projections of Pension Credit entitlement, where the distribution of individual pensioner incomes is the key determinant. In particular, Pensim2 provides a technically superior approach to projecting future changes in the distribution of incomes from state pensions when entitlement to these is widening considerably over time.

While all long-term projections are subject to a high level of uncertainty, analysis presented in *Projections of Pension Credit entitlement* suggests that for plausible changes in the assumptions, the range of variation in the projections is fairly small. More details of methodology and assumptions used in this modelling are in Annex A.

Increases in the State Pension age

- 2.87 Increasing State Pension age would maintain the proportion of male life spent in retirement close to its current rate of 30 per cent. The increases are based on Government Actuary’s Department’s 2004-based projections of life expectancy at 65 for the average man. The number of years spent post State Pension age, after its increase to 68, will be higher than that spent today, 21 years in 2046 compared with 20 years now.
- 2.88 While there can be no certainty around the pace of future changes in life expectancy, it is a key principle of these reforms that people are able to plan with confidence for their retirement. Thus individuals must be given enough notice of changes in State Pension age. That is why the reform will legislate for increases of State Pension age up to 2046.

2.89 Although there are likely to be some increased costs for working-age benefits from increasing the State Pension age, these are relatively small in comparison to the savings in State Pension benefits. Annex A, figures A.2, A.5, and A.8 provides estimates of the impact of raising the State Pension age on increased costs for working age benefits along with the savings from less spending on State Pension benefits.

Figure 2.13: Improvement in life expectancy across all social classes



Source: DWP modelling. Detailed life tables by social class provided by the ONS's Longitudinal Study Unit.

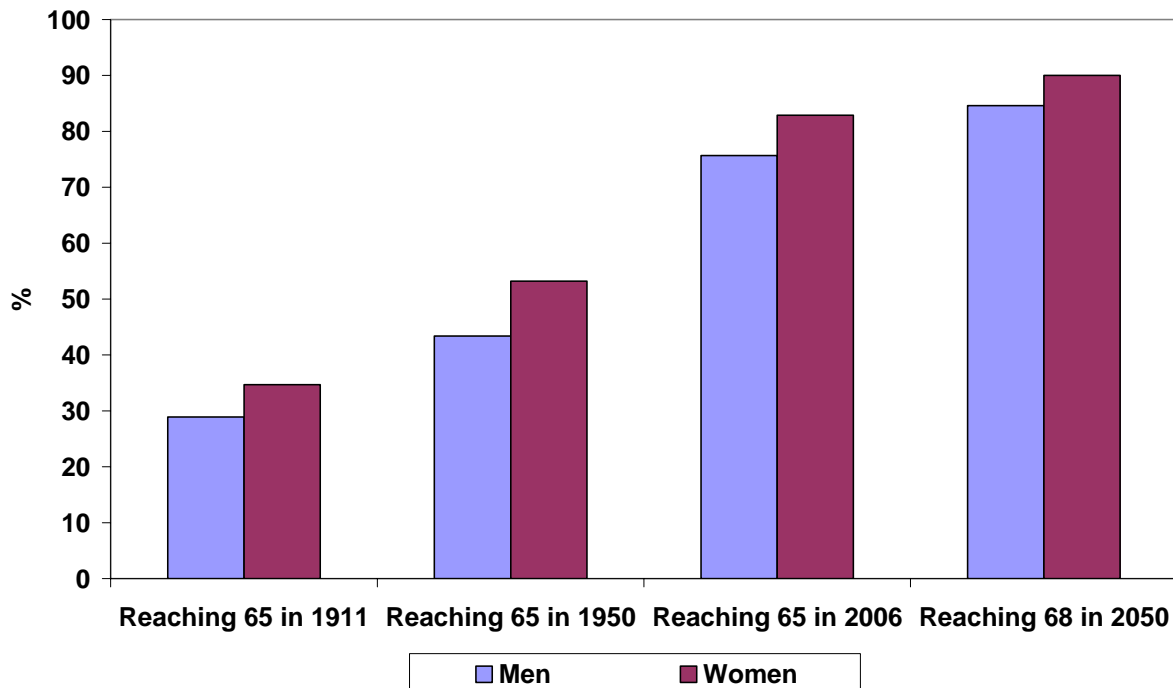
Note: This graph shows life expectancy in years after reaching 65 for an average of 1977-81 and after 67 for an average of 1997-2001. Social Class categories are I Professional, II Managerial and Technical / intermediate, IIINM Skilled non-manual, IIIM Skilled manual, IV Partly Skilled, V Unskilled.

2.90 Having the same State Pension age for all means that some groups will (on average) not receive the State Pension for as long as others. However it is also important to acknowledge that increases in longevity have over the last two decades been experienced by all groups in society. Data from the Office for National Statistics (ONS) Longitudinal Study shows that life expectancy for men at 67 in social class V in 2001 was higher than life expectancy for men at 65 in the same social class twenty years previously.

2.91 In 1950, those who reached State Pension age constituted just 50 per cent of their generation, today this proportion has risen to three-quarters.

By 2050, it is expected that those who reach the new State Pension age of 68 will constitute 90 per cent of their generation (Figure 2.14).

Figure 2.14: Proportions of a generation reaching a particular age by gender



Source: 2004-based Government Actuary's Department life tables

Note: Data for 1950 and 2006 estimated using England & Wales life table. Data for 2050 estimated using UK life table.

- 2.92 The Office for National Statistics does not compile projections of life expectancy by social class. But if the rate of increase seen in the last 2 decades persists, men in the lowest socio-economic group would not experience any reduction in the length of life after State Pension age.
- 2.93 DWP is publishing a technical working paper on the *Estimating the Economic and Social Welfare Impacts of Pension Reform*. This estimates the costs of State Pension age increases on labour market participation rates of older workers. The employment effects of the change once the rises in State Pension age are fully implemented (i.e. once State Pension age moves to 68 in 2044) range from approximately 300,000 under the lower bound estimate to 1.6m under the upper bound estimate. The middle estimate based on an average of these two gives an estimated employment increase of 900,000. Estimates of the resulting direct boost to the size of the economy in 2050 range from between 0.3 per cent and 2.5 per cent, with a central estimate of 1.4 per cent. Using a model of the whole economy to take into account the effects on the wider economy produces a central estimate of 2.0 per cent in 2050.

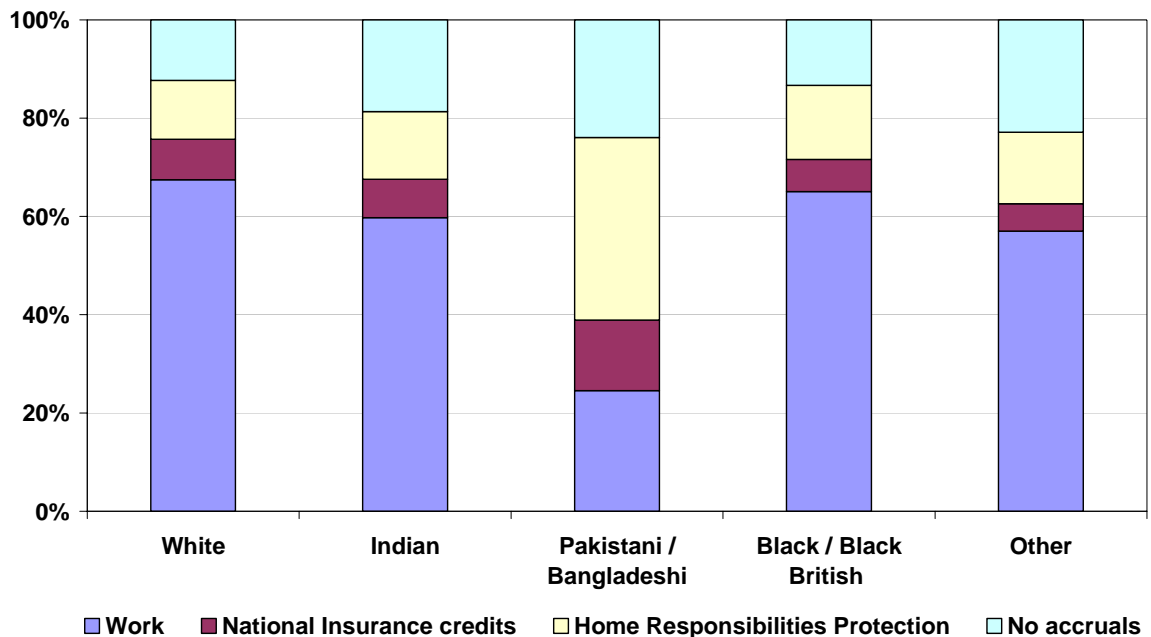
Race impact

2.94 Analysis on the basis of ethnic minority group is limited by:

- limited data on existing ethnic minority pensioners. About 2 per cent of current pensioners are from ethnic minorities, so that data from sample surveys, such as the Family Resources Survey, does not allow detailed analysis;
- administrative data, for example tax and contribution records do not contain data on ethnicity; and
- modelling of future trends depends heavily on the assumptions about ethnic minority employment rates and participation.

2.95 Figure 2.15 shows that some groups of ethnic minority women, particularly Pakistani and Bangladeshi women, are more likely to be entitled to HRP, less likely to be qualifying through earnings or credits and less likely to be accruing actual basic State Pension entitlement than women are on average.

Fig 2.15: Source of basic State Pension entitlement for women of working age by ethnic group



Source: Family Resources Survey. Average of 2002/03-2004/05.

2.96 Currently an individual cannot build up basic State Pension entitlement through HRP or credits alone. The abolition of the first contribution condition, and the measure to replace HRP with a system of positive weekly credits would therefore help those individuals whose working lives

- are significantly interrupted by caring responsibilities. The reduction in the number of years required for a full basic State Pension would provide greater flexibility for people to combine various activities other than those specifically recognised by the state system.
- 2.97 The equalisation of the upper age limit for credits for parents, until the youngest child reaches age 12, for both State Second Pension and the basic State Pension would also help those groups who do not return to the labour market until their youngest child attends secondary school. The age limit is decreasing for basic State Pension credits, and increasing for the State Second Pension, but as employment rates are lower for women with a youngest child aged under 12 than for those with one aged under 16, more women should gain credits than not.
- 2.98 Good evidence on past life expectancy trends by ethnicity does not currently exist, and it is therefore not possible to reliably assess whether raising State Pension age would have a disproportionate impact on people from different ethnic backgrounds. However, the ONS has this year set up a National Centre for Demography that should, in future, improve the evidence base. It has already published population estimates by ethnic group on an experimental basis.

Gender impact

- 2.99 The coverage reform measures will initially result in a larger increase in the proportion of women than men reaching State Pension age with a full basic State Pension, since only around half of women are projected to reach State Pension age with full basic State Pension without reform, compared to around 90 per cent of men. From 2025, over 90 per cent of men and women reaching State Pension age are projected to be entitled to a full basic State Pension under the reform measures.
- 2.100 For parents and carers, the replacement of Home Responsibilities Protection with weekly credits and the introduction of a new carer's credit would improve entitlement to State Pension. It is estimated that around 120,000 people, mainly women, could gain a credit for basic State Pension in 2010 through the carer's credit,¹² whilst approximately 900,000 women could accrue State Second Pension as a result of the reforms to the parent's and carer's credits. There are more details of the effect of coverage measures in Chapter 2 - paragraphs 2.59 to 2.62.

¹² This figure is based on estimates from the Family Resources Survey of the number of people who report that they are caring for 20 hours or more a week, and who are not otherwise qualifying for basic State Pension. Adjustments have been made to reflect a) estimates of the proportion of these carers who are caring for someone in receipt of a qualifying benefits, b) the latest departmental Carers Allowance caseload projections.

2.101 The Government is publishing The Gender Impact of Pension Reform – a detailed gender analysis of the pension reforms, comparing outcomes for men and women.

Impacts of State Second Pension flat rating on defined benefit contracting out

2.102 The calculation of the contracting out rebate is already gradually changing to reflect the flat-rating of State Second Pension (projected to occur around 2050 under the current system). The provision to accelerate flat rating – to be completed around 2030 – will increase the pace of this change.

2.103 Alongside this, individuals would benefit from a higher basic State Pension (due to earnings uprating) but some 7.6 million contracted-out members of Defined Benefit (DB) schemes (including 4.8 million in the public sector) could see a small and gradual reduction in the contracted-out rebate they receive. The maximum reduction will be incurred by high earners (those earning at or above the upper earnings limit). This group would see their contracting out rebate fall by around £6 a month in 2015 with its largest impact at around £11 a month in 2030. After 2030 the impact of reform on the rebate gradually declines.

2.104 In advising the Secretary of State on the appropriate level for the rebate for each quinquennium the Government Actuary will take into account any relevant changes to State Second Pension as well as a number of other factors including rate of return on assets and demographic trends.

2.105 However this would be balanced by other pay packet changes that could derive from other changes in the rebate (for example to cover longevity increases), changes to NI and tax thresholds, and general annual pay awards. Only very moderate general pay increases (far below inflation) are sufficient to ensure cash increases in pay packets year on year, despite the rebate changes that result from the reform.

Individuals: effect on pension entitlement

2.106 Any effect on individuals' ultimate pension entitlement would depend on the response of their scheme to these changes. If the scheme adjusted benefits in line with the changes to State Second Pension then, as with contracted-in individuals, they could face a lower pension entitlement from this part of their pension. However, this would be more than offset by the

increases from the basic State Pension being uprated in line with earnings growth.

Employers

2.107 As with members of contracted- out DB schemes, the sponsoring employer would see a gradual reduction in the level of the rebate leading to an increase in payroll costs and associated training costs for payroll staff. It would then be for schemes to restructure their benefits to reflect this if they wished.

Individuals and employers: aggregate reduction in rebate

2.108 Informal discussions between DWP and pension scheme professionals suggested that this gradual reduction in the rebate would not be expected, on its own, to lead to closure of DB schemes. Many DB schemes are facing a number of issues, such as longevity and poor investment returns, which have an impact on funding. These might lead to a review of the benefits provided by the scheme and changes to the rebate might be an additional factor to be considered as part of any such reviews.

2.109 The way in which the rebate reduces reflects the way in which the flat-rating of State Second Pension is being phased in. That is, calculating the rebate on a new band of earnings – from the lower earnings limit (LEL) to the upper accrual point¹³ – will mirror the band of earnings on which State Second Pension will accrue. This would introduce a further band of earnings (for National Insurance purposes) that employers would need to record on systems and end of year returns.

2.110 Initial analysis shows that contracted-out employers will have to make changes to their systems in order to calculate the contracted-out rebate on earnings between the LEL and the UAP rather than the LEL and UEL. Employers will need to report separately earnings between the UAP and UEL to HMRC.

2.111 It is estimated that there are currently around 5,500 contracted-out DB schemes covering 7.6 million employees. The Government estimates that the proposed changes will increase ongoing compliance costs for each such employer by around on average £200,000 per annum. The vast majority of this increased cost will be borne by large employers. Indeed, more than half of this increase will be faced by the public sector. There will

¹³ Currently the rebate is calculated on the band of earnings from the Lower Earnings Limit to the upper earnings limit.

also be a one-off cost for employers to train payroll staff and adjust payroll software to calculate full-rate National Insurance contributions payable on earnings between the upper accruals point and the upper earnings limit.

- 2.112 Employers will also need to take account of the effect on the Reference Scheme Test – which will effectively become a slightly weaker test over time to reflect the lower levels of State Second Pension given up by contracting out. The government do not expect there to be a significant cost for employers but they will need to update any relevant guidance, notification and possibly scheme rules (if these include details of the Reference Scheme Test).

Impacts on small firms

- 2.113 There are no specific impacts from these reforms on small firms. All employers will have to adapt their payroll systems to collect National Insurance Contributions beyond the (equalised) retirement age of 65, but payroll systems would generally be replaced in the normal course of IT renewal programmes anyway between 2010 and 2025.
- 2.114 The changes to the age thresholds for National Insurance Contributions as a consequence of increasing the State Pension age are likely to result in some additional but small costs to employers. Each increase to the State Pension age, from 65 to 66, 66 to 67 and 67 to 68 will be phased in over two years in each decade, following the same process as for the raising of female State Pension age by five years between 2010 – 2020. So, by the onset of these further changes in 2024, small firms will already have in place the systems needed to raise the pension age of their female employees. The precise impact on small firms will largely depend on two factors: the extent to which small firms continue to utilise clerical payrolls in the next 20 years and the future costs to small firms of payroll system changes. For small businesses which may still operate clerical systems when the first rise in State Pension age begins in 2024, some additional clerical activity, resulting in small administrative costs, would be required to calculate and manually record the employee's share of National Insurance Contributions for any employees aged over 65 but below the new State Pension age. Potential developments in IT and payroll systems in the next 20 years make estimating the likely costs to small firms as a result of the State Pension age changes very difficult until much nearer the time

Impact on competition

- 2.115 The state pension reforms do not raise any concerns regarding competition because the objective does not relate to specific markets or companies. Indeed, by providing greater clarity on the evolution of the state pension system, over time it enables financial services markets and employers to operate more efficiently.

Enforcement, sanctions and monitoring, implementation and delivery plan

Delivery

- 2.116 The Pension Service has initiated a Delivery Programme to coordinate, manage and deliver those changes to State Pensions where it is responsible for delivery, and to make necessary changes to its products and services to reflect other reform measures. Changes will be delivered through central programme teams coordinating activity of a number of projects working with the operational areas of both DWP and HMRC to bring about the necessary IT and operational changes.
- 2.117 The majority of the administrative activity will be in delivering those Pension reforms scheduled for 2010, with the link between the basic State Pension and rises in average earnings following later. Implementation of the rise in State Pension age will occur over three decades (2024-26, 2034-36 and 2044-46).
- 2.118 The scale of the changes, particularly to the many IS/IT systems affected, will necessitate long lead times for delivery plans, with the majority of the IT changes being developed between 2007-2012. The costs of delivery include allowance for targeted publicity to raise public awareness of the state pension reform changes, in particular for those customer groups most affected.

Monitoring and further information

- 2.119 The Government will continue to publish a wide range of statistics on: pensioners' incomes, benefit receipt, and take up, and undertake a range of research as it does now. The Government is committed to periodically report on older people following Opportunity Age .
- 2.120 The Government is working to improve the evidence base on pensions and retirement provision. One example is the new Household Assets

Survey, a collaboration between DWP, ONS and other government departments. This longitudinal study will provide robust data on how individuals accumulate assets and pension rights over time, and how saving and debt patterns relate to major life events. The Government will also continue to keep under review the range of other data on pensions that is published by outside organisations, including English Longitudinal Study of Ageing which provides valuable information on retirement transitions and incomes in later life.

Post-implementation review

- 2.121 DWP will continue to monitor State Pension awards and accruals, the level and distribution of pensioners' total incomes, and levels of understanding of the state pension system through analysis of administrative data, surveys and other sources. It will continue to report on progress against its Public Service Agreements in its annual and departmental reports.
- 2.122 The Government proposes to commission reviews periodically drawing on a range of independent expert advice in the light of emerging evidence on demographic change on whether the timetable for increasing State Pension age - as set out in legislation - remains appropriate.

Summary and recommendation

- 2.123 The Government recommends option 2 - the package of State Pension reform measures.

Chapter 3 – Creation of a personal accounts delivery authority (PADA)

Objective and background

- 3.1 In order to achieve commencement of the personal accounts scheme in 2012, as proposed in the White Paper, the commercial processes would need to be sufficiently progressed to be ready to issue Invitations to Negotiate in July 2008.
- 3.2 To enable the commercial process to remain on schedule, a substantial amount of preparatory work will be needed. This work will begin in the Department for Work and Pensions with analysis and advice to ministers on the consequences of policy options. To further this work the Bill provides for the establishment of a delivery authority that can bring in the necessary expertise to ensure this project is a success.
- 3.3 The personal accounts delivery authority (PADA) will precede the governance body/board of the personal accounts scheme. Its functions will be limited to advising on implementation issues and on the implications of proposed policy decisions on the setting-up of a personal accounts scheme.

Rationale for Government intervention

- 3.4 The establishment of a delivery authority distanced from Government and with private sector expertise has been welcomed by a wide range of stakeholders, including the ABI, Which? and the Investment Management Association as the best way to take forward the work needed to develop a system of personal accounts.
- 3.5 To be in a position to issue Invitations to Negotiate in July 2008 this Bill will legislate for an advisory delivery authority.
- 3.6 The Bill will establish the delivery authority with the limited remit to undertake preliminary work on a range of commercial, financial and technical products leading up to the issue of Invitation to Negotiate.
- 3.7 The Government will invite views on extending the functions and role of the delivery authority following the publication of a planned White Paper on personal accounts. The Government plans to bring forward legislation on the extended remit following consultation. This Regulatory Impact

Assessment only covers the creation of a time-limited delivery authority with a narrow remit.

Consultation

- 3.8 This is a new area of policy that has arisen since the publication of the White Paper.

Within Government

- 3.9 Discussions have been held with the Cabinet Office, Her Majesty's Treasury, Her Majesty's Revenue and Customs and the Department for Culture, Media, and Sport.

Public consultation

- 3.10 Discussions have taken place with stakeholders including the Association of British Insurers, Investment Management Association, National Association of Pensions Funds, Norwich Union, Which?, the Trades Union Congress, and consumer associations.

Options

Option A: Preliminary work undertaken by DWP.

- 3.11 In this option civil servants alone would advise on the preliminary work needed before July 2008. A major trawl would need to be made across all Government departments to identify and recruit civil servants with the specific skills and experience necessary to conduct this work. There is some uncertainty whether the more technical skills required would be available within the existing civil service pool.

Option B: contract consultants to work for DWP

- 3.12 In this option private sector expertise would be included through the use of consultants. The consultants would advise Government and facilitate preliminary work up to the point when an Invitation to Negotiate is issued.

Option C: establish a delivery authority

- 3.13 An alternative is to create a delivery authority, utilising experts from the private sector with knowledge of private pensions administration, which would initially advise Government and facilitate preliminary work up to the point when an Invitation to Negotiate is issued.
- 3.14 In its initial remit, the delivery authority would be limited to:
- advising the Government on the operational and commercial implications of policy options; and
 - preparing specific products which comprise a financial, technical commercial strategy prior to issuing an Invitation to Negotiate.
- 3.15 The delivery authority would be accountable to the Secretary of State for Work and Pensions.

Costs and benefits

Option A: Preliminary work undertaken by DWP.

Benefits

- 3.16 No expenditure is incurred in setting up a new body, although similar costs would be incurred by DWP if the work was to be done within the Department, the costs of a private sector competitive recruitment exercise would be saved.

Costs

- 3.17 This option will not meet the stakeholders' concerns that Government is not best placed to oversee the creation of such large scale financial products.
- 3.18 The failure to establish a delivery authority when there is stakeholder consensus in support of it would expose the Government to criticism of political interference.
- 3.19 There would be no line of responsibility for decisions through to the personal accounts governance body/ board.
- 3.20 Civil servants are unlikely to have sufficient levels of experience successfully to guide and prepare the processes necessary to secure the

services and infrastructure most appropriate to the creation of a personal accounts scheme.

- 3.21 Gathering civil servants with the necessary skills and experience from across government departments to undertake this work would have a negative effect on delivery of Government initiatives elsewhere.
- 3.22 Within the Department for Work and Pensions, the preliminary work crucial to the eventual personal accounts scheme would be competing with other priorities within the Department. Any delays on the part of the Department could lead to a failure to be able to issue an Invitation to Negotiate in July 2008, which would ultimately delay commencement of personal accounts beyond 2012.

Option B: contract consultants to work for DWP

Benefits:

- 3.23 Private sector expertise would be included through the engagement of contracted consultants.
- 3.24 The preliminary work would not be undertaken solely by civil servants.

Costs:

- 3.25 It is unlikely that this approach would convince stakeholders that processes are sufficiently and transparently removed from Government.
- 3.26 Consultant organisations would not necessarily be able to provide the levels of competencies needed which could be obtained through direct competitive recruitment from the private sector.
- 3.27 The use of consultants would not provide clear and transparent lines of accountability for underachievement or deviation from the remit, for example, failure to minimise the impact of set-up costs incurred on the live-running scheme's annual management charge.

Option C: establish a delivery authority

Benefits

- 3.28 The establishment of a delivery authority, at a distance from Government at this early stage would allow the public to identify the personal accounts scheme with a new body.

- 3.29 Appointments would be visible, and underline the Government's commitment to utilising the experience, skills and knowledge of the private sector to deliver Personal Accounts.
- 3.30 This approach would reassure stakeholders that the delivery of personal accounts would be free from political interference.
- 3.31 This approach should also tackle perceived weaknesses in Government delivering large scale systems and build confidence in the personal accounts scheme.
- 3.32 The establishment of a delivery authority, with a single task and focussed approach would reduce the risk of delays in preliminary work on commercial, financial and technical products being completed prior to issuing an Invitation to Negotiate in July 2008.
- 3.33 The delivery authority would most likely be classified as a Non Departmental Public Body and as such would provide clear and transparent lines of accountability and reporting to Parliament through the Secretary of State for Work and Pensions.

Costs

- 3.34 Some extra costs would be associated with the establishment of a delivery authority for recruitment.
- 3.35 It is estimated that establishing the delivery authority would have a funding requirement of £21 million between 2006/07- 2008/09. (Although accurate financial costings are not available for Options A and B, they would also involve a funding requirement)
- 3.36 The delivery authority would be funded from within the DWP DEL budget. As a Non Departmental Public Body this would be paid over as Grant in Aid.

Small firms impact and competition assessment

- 3.37 The creation of the delivery authority will not have an impact on small firms.
- 3.38 The legislation will create a single body corporate to act as the delivery authority, with a remit limited to preliminary work up to the point when an Invitation to Negotiate is issued. This will have no impact on competition.

- 3.39 The RIA for the White Paper on Personal Accounts will set out in more detail the impact of Personal Accounts themselves on small firms and competition.

Enforcement, sanctions and monitoring

- 3.40 Because the delivery authority at this stage has a limited lifespan of approximately one year and its function is to advise, it will be brought to an end by Order of the Secretary of State after the end of 2008 if its remit / lifespan has not been amended through subsequent legislation.

Implementation and delivery plan

- 3.41 The delivery authority will be established following Royal Assent of the Bill.

Post implementation review

- 3.42 The delivery authority will be required to submit both an annual report and accounts to Parliament through the Secretary of State for Work and Pensions. DWP, as sponsor Department, will have a stewardship role in relation to the delivery authority as it currently has with the Pensions Protection Fund and The Pensions Regulator.

Summary and recommendations

- 3.43 The main benefits of Option C are that it:
- Establishes a visible delivery authority distant from Government that utilises the expertise and skills found within the private sector.
 - Maintains stakeholder consensus and builds confidence in the system of personal accounts.
 - Gives the delivery authority some ownership over the documents that will form the foundation of delivering the infrastructure for a personal accounts scheme.
 - Provides clear and transparent lines for accountability and reporting.
- 3.44 The Government recommends Option C – the establishment of a separate delivery authority.

Chapter 4 – Private pensions reform

Strengthening existing private pension provision

Objectives

- 4.1 To simplify private pension provision in order to make it easier for employers and providers to administer and more transparent for individuals to understand.

Background

- 4.2 The United Kingdom has a long history of private pension provision. Traditionally, many employers have provided high quality pension schemes for their employees, supporting them with employer contributions. In 1978 the Government recognised this by allowing contracting out from what was then the State Earnings Related Pension Scheme (SERPS).
- 4.3 Since then successive Acts have added layers of regulation to the legislation surrounding private pensions, including the rules on contracting out. This has produced an extremely complicated system, both for schemes to operate and for members to understand.

The structure of contracting out

- 4.4 Contracting out provides a private sector alternative to the State Second Pension (which reformed SERPS in 2001), but in doing so adds significant complexity to the pensions system. Under the contracting out arrangements, employees forego all or part of their State Second Pension entitlement and, in return, pay lower rate National Insurance contributions and/or receive annual payments into their pension scheme. These reductions and payments are known collectively as the contracting-out rebate.
- 4.5 In a contracted-out defined benefit (DB) occupational scheme, the employer and employee pay reduced rate National Insurance Contributions and the scheme provides benefits that are calculated by reference to the individual's earnings and length of pensionable service. To get the rebate, DB schemes must meet an overall test of scheme quality called the Reference Scheme Test. This was introduced in 1997. Before that, contracted-out DB schemes were required to provide a Guaranteed Minimum Pension (GMP) under rules which were intended to broadly mirror SERPS.

- 4.6 In a contracted-out defined contribution (DC) occupational scheme, the employer and employee pay reduced rate National Insurance Contributions and the Government makes an annual payment into the scheme. In a contracted-out personal pension scheme (including a Stakeholder scheme) both the employer and the employee pay full unrebated National Insurance Contributions with the rebate being paid annually by HMRC direct to the scheme at the end of the tax year. There are restrictions on how the rebate is invested and annuities derived from the rebate are subject to specific legislative conditions over and above those that apply to annuities derived from other scheme rights.
- 4.7 Figure 4.1 below provides a summary of the numbers contracted-out and the rebate costs in 2003/4, the latest year for which data is available.

Figure 4.1: Contracted-out scheme membership and costs

Type of scheme	Membership (millions)	Annual Rebate Cash Flow Cost (£ billions)
Defined benefit, of which:	7.6	6.5
• Private sector	(2.8)	(2.5)
• Public sector	(4.8)	(4.0)
Occupational Defined contribution	0.6	0.5
Personal Pensions	2.9	3.1
Total	11.1	10.1

Source Second Tier Pension Provision 2003/04

- 4.8 Figure 4.2 sets out the contracted-out rebate rates from April 2007. These apply to earnings between the Lower Earnings Limit (£4,368 in 2006/07) and the upper earnings limit (£33,540 in 2006/07). They vary by the type of pension and, in DC schemes (both occupational and personal), by the age of the individual. The figure shows the rebate for both Stakeholder Pensions and Appropriate Personal Pension schemes (APPs)

Figure 4.2: Contracted-out rebate rates from 6 April 2007

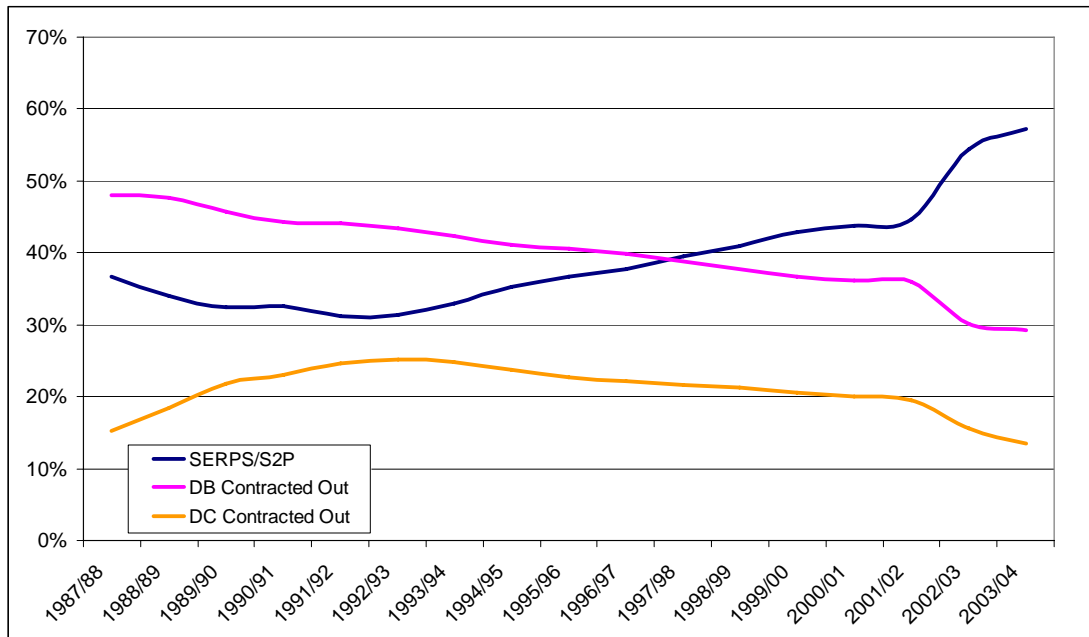
Rebate payable to	Pension scheme type			
	Defined benefit	Defined contribution occupational		APP/Stakeholder
		Flat-rate	Age-related top-up	
Employer	3.7%	1.4%	0.0%	0.0%
Employee	1.6%	1.6%	Between 3.0% and 7.4%, depending on age	Age-related rebate between 4.7% and 7.4%

Source: *The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2006: S.I. 2006 No. 1009*

Rationale for change

4.9 There is an ongoing shift amongst employers from DB to DC occupational pension schemes and this is accompanied by a move from contracted-out to contracted-in schemes, perhaps because of the legislative and administrative complexity associated with contracting out.

Figure 4.3: Proportion of employees with second tier pension provision by scheme type and contracted-out status, 1987/88 – 2003/04



Source: *Second Tier Pension Provision 2003/04*

- 4.10 Some personal pension providers have been advising policy holders to contract back in. Those that take this advice begin to build up their full entitlement to State Second Pension. Other providers are taking positive action to contract their policyholders back in, offering an opt-out option for people who wish to stay contracted-out. These moves reflect the complexity of decision making for individuals around contracting out.
- 4.11 Against this background, the Pensions Commission recommended the abolition of contracting out in DC schemes, the retention of DB contracting out because of the potential impact on overall DB pension provision that would arise through the withdrawal of the rebate, and the introduction of a facility to convert GMPs into ordinary scheme benefits. The Commission also noted that the rebate for DB schemes would be likely to be lower as a result of the proposed changes to State Second Pension.

Abolition of contracting out in DC schemes

- 4.12 In DC schemes, particularly personal pensions, the value of the rebate and the inevitable tension that arises from substituting a DB pension (the State Second Pension) with a DC pension that depends on investment return, introduces an element of risk into the decision. This makes it difficult for pension providers to advise individuals on whether they would be better off contracted-out.
- 4.13 With personal pension schemes, the decision to remain contracted-out is one that people should make annually. Additionally, in all DC schemes (including occupational schemes), contracted-out rights (known as protected rights) must be tracked separately from other scheme rights. This is because of the legislative conditions that apply mainly at the point of annuitisation. These add further to the complexity for advisors and individuals.
- 4.14 The reformed state pensions system, described in Chapter 2, provides a clear foundation for state pensions and the introduction of personal accounts will provide a simpler vehicle for additional pension saving. Employers operating occupational schemes will be able to apply for an exemption from personal accounts. Against this background, contracting out for DC schemes will no longer offer the stimulus to private pension saving that the Government seeks. The Government therefore proposes to abolish contracting out on a DC basis.

DB contracting out and State Second Pension changes

- 4.15 The decision on contracting out is not so easily reversed in DB schemes as in DC schemes. This is mainly because of the long-term nature of decisions made on contributions and benefit structures as well as funding levels. These considerations require a longer lead-in time for introducing

any changes to contracting out for DB schemes. Also, as the Pensions Commission recognised, a sudden and significant change affecting DB provision is more likely to prompt scheme closure than to spur additional savings. The Government therefore proposes to retain DB contracting out.

- 4.16 However, the proposed changes to State Second Pension mean that, unless consequential changes are made to scheme benefit or contribution levels, the reduction in the rebate as a result of State Second Pension moving to become flat rate would gradually increase employers' payroll costs and reduce employees' take home pay.
- 4.17 More detailed information on how the reform of State Second Pension will impact on DB contracting out is in Chapter 2.

GMP conversion

- 4.18 Although GMPs ceased to accrue from 1997 and were replaced by the Reference Scheme Test, contracted-out DB schemes are still liable to provide GMPs and they give rise to very considerable complexity. Proposals to allow schemes to convert GMPs into ordinary scheme benefits, on the basis of actuarial equivalence, have therefore been developed. The aim is to allow schemes to adopt a unified and streamlined benefit structure which will enable administrative savings to be made as well as offering advantages to members. Members would benefit from understanding their rights in the scheme and being able to transfer them to other schemes more easily.

Consultation

Abolition of contracting out in DC scheme

- 4.19 DWP has consulted with the insurance industry and engaged with individual insurance companies and pension schemes to identify the potential impact that the proposed contracting out reforms might have on private pensions.

GMP conversion

- 4.20 The proposal to convert GMPs into scheme benefits was first considered as part of the work leading up to the 2004 Pensions Act. At that time the Government ran a consultation exercise to consider three different methods of dealing with the GMP. The option allowing schemes to convert GMPs into ordinary scheme benefits on the basis of actuarial equivalence was the one which found most favour at that time.

Options for contracting out reform

Option 1: Do nothing

- 4.21 Under this option individuals would continue to be able to contract-out of the State Second Pension through a DC arrangement. The regulatory burden on firms is left unchanged and nothing is done to simplify the savings decision for individuals. By not giving contracted-out DB schemes the option to convert GMPs into scheme benefits, such schemes would have to continue to provide and track GMPs. Individuals would continue to find difficulty in being able to transfer these rights elsewhere.
- 4.22 The Government therefore rejects this option.

Option 2: Simplify contracting out

- 4.23 This option presents a package of proposals to simplify contracting out:
- abolish contracting out in DC schemes;
 - as a consequence of the proposals to hasten the flat-rating of State Second Pension, the contracting out rebate for DB schemes will be reduced in parallel. More information on the effect reform of State Second Pension will have on DB contracting out is in Chapter 2; and
 - allow schemes to convert GMPs into ordinary scheme benefits of an actuarially equivalent value.

This broadly reflects the Pensions Commission's recommendations and is the option that the Government proposes to adopt.

Consequences arising from abolishing contracting out in DC schemes

- 4.24 The abolition of contracting out in DC schemes would apply to both occupational and personal pension schemes including stakeholder schemes.
- 4.25 In contracted-out DC schemes, that part of an individual's pension fund derived from the rebate and its investment return and any tax relief on the employee's share of the rebate are known as protected rights. Certain conditions are attached to protected rights. The main ones are:
- investment is restricted to certain types of pension schemes;
 - an annuity securing protected rights must be provided on a unisex basis; and

- an annuity securing the protected rights of a scheme member who is married or in a civil partnership at the point of annuity purchase must make provision for a survivor benefit.

4.26 As stated in paragraph 4.13 above, these restrictions have been a source of complexity for schemes and members. The abolition of contracting out in DC schemes, means that active members will cease to accrue new protected rights. However, schemes will still hold such rights accrued prior to abolition.

Consequences for DB schemes arising from the flat-rating of State Second Pension

4.27 Although DB schemes will continue to be able to contract-out, because the earnings on which State Second Pension is accrued will gradually reduce, it will mean that the amount needed to replace it (the contracted-out rebate) will gradually reduce also.

Consequences for DB schemes arising from being able to convert GMPs into scheme benefits by way of actuarial equivalence

4.28 As noted above, prior to 1997, a contracted-out DB scheme was required to provide a pension that was at least as good as a statutory minimum - the GMP.

4.29 The Government proposes to allow GMPs to be converted into scheme benefits by way of actuarial equivalence. This would make scheme administration easier, reduce the complexity of the records schemes need to keep and make it easier for members to understand their entitlement.

Costs and benefits

Impact on individuals

Abolition of contracting out in DC schemes

4.30 With the abolition of contracting out in DC schemes, members of those schemes would start to accrue full rights to State Second Pension and would no longer have to make a complicated decision on whether to

contract-in or contract-out. They would be able to consider their pension savings options over and above what they would get from the State, making the decision more transparent and easier to understand.

- 4.31 As they would be building up full State Second Pension rights, members of personal pension and stakeholder pension schemes would no longer receive the age-related payment into their scheme at the end of the year. Similarly, employees in occupational DC schemes would start to pay full rate National Insurance Contributions and would no longer receive the age-related rebate at the end of the year. The increase in National Insurance Contributions could be offset by a reduction in occupational scheme contributions. As shown in table 4.iv below, the value of the rebate depends on the age and earnings of the employee. In each case they would instead begin to accrue full entitlement to State Second Pension.
- 4.32 The loss of the rebate would not prevent them from continuing to make their own contributions to a DC scheme (or to other savings vehicles) in addition to the rights that they will be building up in the State scheme.

Figure 4.4: Value of the age-related rebates in 2006/07

Earnings (per annum)	Age	Type of pension	Employee NICs	Age-related payment
£15,000	30	DC Occupational	£176	£99
		Personal pension	-	£842
£18,250	40	DC Occupational	£143	£230
		Personal pension	-	£1018
£32,760	50	DC Occupational	£292	£1110
		Personal pension	-	£2130

Source DWP estimate

- 4.33 Tables 4.5 and 4.6 show the distribution of individuals in all contracted-out schemes, broken down by gender, age and earnings. They show the largest group of individuals affected by the abolition of contracting out in DC schemes would be men aged 30-49 and those with earnings of less than £20,000 a year.¹⁴ These groups represent around 50 per cent of the people contracted-out into DC schemes. The age distribution is similar for men and women but there is a higher concentration of women in the central age groups (30 to 39 and 40 to 49).

¹⁴ Some of the individuals in this group are zero earners who are not making contributions to their personal pensions in that particular tax year - Source: Second Tier Pension Provision 2003/04

Figure 4.5: Percentage of individuals in contracted-out schemes – by age and gender

Age	Defined Contribution Schemes			Defined Benefit Schemes		
	Total	Men (% of total)	Women (% of total)	Total	Men (% of total)	Women (% of total)
Under 20	0%	0%	0%	1%	1%	0%
20 to 29	7%	4%	3%	14%	6%	8%
30 to 39	46%	27%	19%	29%	13%	15%
40 to 49	33%	22%	11%	31%	15%	17%
50 to 59	13%	10%	2%	23%	11%	12%
60 and over	1%	1%	0%	2%	2%	0%
Total	100%	64%	36%	100%	48%	52%

Source : Second Tier Pension Provision 2003/04

Figure 4.6: Percentage of individuals in contracted-out schemes – by amount of earnings on which national insurance has been paid and gender

	Defined Contribution Schemes			Defined Benefit Schemes		
	Total	Men	Women	Total	Men	Women
£5,000 - £9,999	14%	6%	8%	12%	2%	10%
£10,000 - £14,999	18%	10%	7%	17%	5%	12%
£15,000 - £19,999	20%	14%	6%	18%	8%	10%
£20,000 - £24,999	17%	13%	4%	17%	9%	7%
£25,000 - £29,999	13%	11%	3%	15%	9%	6%
£30,000 and over	18%	15%	3%	22%	15%	6%

Source Second Tier Pension Provision 2003/04

- 4.34 Overall, abolition of contracting out in DC schemes would affect around 3 million policyholders and 500,000¹⁵ members of around 14,000 occupational schemes.¹⁶ This group would begin to build up full State Second Pension rights.

GMP conversion

- 4.35 Converted members will benefit from obtaining pension rights which can be more easily understood, compared to the existing situation where there may be different tranches of benefit involving a complex mixture of rules. Furthermore, they should benefit from being able to transfer their post-conversion rights to another scheme more readily. At present, many occupational schemes will not accept an incoming transfer which includes GMP rights. The proposed legislation also includes a facility for schemes to convert an individual member's rights in order to facilitate the transfer of his or her rights out of the scheme, even where no scheme-wide conversion exercise is undertaken.
- 4.36 The requirement for actuarial equivalence in respect of the benefit rights to be awarded to each individual member in a converting scheme means that no-one will suffer any loss at the point of conversion. It is possible that actual experience of future variables such as inflation may differ from the assumptions made at the time. However, in these cases a member could receive more or less pension over the period of retirement than would otherwise have been the case. Such possible effects are unquantifiable but unlikely to be significant.

Impact on employers and occupational pension schemes

Abolition of contracting out in DC schemes

- 4.37 Employers running contracted-out DC occupational schemes would start to pay full rate National Insurance Contributions (the rebate is currently 1 per cent for employers). However, since the employer is currently required to pay an amount equivalent to the rebate into the scheme, the additional National Insurance Contributions cost would be offset by the removal of this requirement.
- 4.38 There is limited data available on the administration costs of defined contribution occupational pension schemes. On the basis of evidence obtained from several sources,¹⁷ DWP estimates the aggregate annual

¹⁵ STPP 2003/04. In contracted out DB schemes 50 per cent are men and 50 per cent women.

¹⁶ Source: GAD Occupational Pensions Schemes Survey 2005

¹⁷ Watson Wyatt – Pension administration cost survey 2006
IDS pensions service – Pension trustees and administration

administration cost for all occupational defined contribution schemes to be £34 million. These costs are based on the number of active members within contracted-out occupational DC schemes and the average administration cost per member.¹⁸ Since the administration costs due to contracting out are relatively small and the schemes would still incur the remaining administration cost after the abolition of contracting out in occupational DC schemes, the proportion of costs saved as a result of abolition would be small.

- 4.39 In the recent consultation exercise about the treatment of accrued protected rights and operational arrangements once contracting out for DC schemes is abolished, questions about one-off costs associated with abolition were asked. Responses suggested savings ranging between £4000 and £4.5 million per scheme – the former for an occupational DC scheme and the latter for a large insurance company. These costs arise mainly in respect of changes to scheme documentation and IT systems.
- 4.40 On the question about one-off costs associated with requiring schemes to surrender scheme certificates, respondents estimated these to be within a range of £300 per scheme for small schemes up to £0.5m per scheme for larger schemes. However automatic cancellation by HMRC of scheme certificates was estimated to be minimal by most respondents and within a range of £25-30k per scheme over a range of schemes by one respondent.

GMP conversion

- 4.41 GMP conversion would be an option for schemes; no scheme would be required to convert. The proposal would only affect DB occupational pension schemes that were contracted-out prior to April 1997.
- 4.42 The proposed legislation includes a requirement for trustees to obtain the prior agreement of the scheme's sponsoring employer before undertaking a conversion exercise.
- 4.43 There would be a one-off cost for a scheme to go through the conversion procedure, resulting from the need to modify IT software and incur legal, actuarial and other administrative costs. Once converted, a scheme will be able to benefit from ongoing administrative economies as a result of having adopted a unified benefit structure. These savings would arise through no longer having to purchase actuarial advice for GMP calculations, no longer having to deal with queries from members on their

GAD - Survey of expenses of occupational pension schemes 1997 (which has been up rated to today's prices)

¹⁸ GAD - Occupational pension scheme 2005 report and Survey of expenses of occupational pension schemes 1997 (which has been uprated to today's prices)

GMPs, simpler awards of benefit when members reach pensionable age and simpler uprating of pensions in payment.

- 4.44 Whilst costs and benefits will vary significantly according to the circumstances of the particular scheme, for the purposes of making a broad indicative estimate of the possible effects of this reform, we have assumed an average initial cost of £7,000 for smaller schemes and £12,000 for larger schemes. Using an assumption that 25-50 per cent of schemes may choose to convert their GMPs, the total initial cost across all schemes is estimated to be between £11m and £22m, with a total annual cost saving of £6m to £13m.

Impact on the financial services sector and on personal and stakeholder pensions

Abolition of contracting out in DC schemes

- 4.45 As already explained, the current trend in DC schemes is towards contracting back in. Informal discussions between DWP and insurance professionals have indicated that, whilst the rebate provides a reliable flow of income, the complexity surrounding decisions on contracting out and the level of understanding required to make such decisions outweigh the benefits of the rebate to providers. Consultation with some major insurance companies has also suggested that abolishing contracting out in DC schemes would not have a significant impact on the insurance industry because of the current trend to contract back in.
- 4.46 However, some commentators from the insurance industry have also argued that contracting out could help saving levels if the level of the rebate was increased to allow individuals and their advisors to make a straightforward decision on whether or not to contract-out.
- 4.47 In terms of premium income to insurance companies, the rebate for DC schemes was £3.5 billion in 2003/04. The total UK insurance net premium income from individual pensions, other pensions and the rebate was £54 billion in 2004.¹⁹ The rebate therefore constitutes only around 6 per cent of total net premium income.
- 4.48 Together with the introduction of personal accounts, therefore, these proposals will have some impact on the financial services sector, with a reduction in income from the rebate but a forecast net increase in savings of £4-5 billion from personal accounts. The Government will consider carefully the implementation of these proposals, and the timescale over

¹⁹ Source: Association of British Insurers

which they are implemented will provide the financial sector with time to prepare for the new opportunities and challenges.

GMP conversion

- 4.49 The GMP conversion proposals apply only to DB occupational pension schemes and would not therefore affect the financial services sector and personal/stakeholder pensions.

Impact on The Exchequer

Abolition of contracting out in DC schemes

- 4.50 The costs of the contracting out rebate presented in the White Paper were based on forecasts from Autumn 2005. The forecasts have since been updated to reflect the impact of the rebate review (S.I. 2007/1009) and new data on the numbers of people choosing to contract-out. The costs of the contracting out rebates under reform are estimated in Annex A (tables A3, A.6 and A.9).
- 4.51 Individuals who contract-out into a personal pension receive tax relief at the basic rate on the employee's share of the contracted-out rebate. This tax relief is paid by HMRC together with the end of year rebate payment. Abolishing DC contracting out will save the cost of this tax relief, as well as the cost of the rebate. This benefit will accrue to HMRC. HMRC estimate that the cost of tax relief for personal pension rebates was £171million in 2004/05 and £149m in 2005/06.
- 4.52 DB schemes will continue to be able to contract out, although the rebate will be affected by the changes to State Second Pension accrual. Table 4.7 below shows the estimated cash flow cost in millions of tax relief in future years. The estimates are based on the estimated number of people contracted-out into personal pensions now and in future and the income distribution of these people today. These figures are best estimates of the cash flow benefit from saving tax relief on personal pension rebates, but they are only rough estimates. These estimates assume that the tax system is unchanged and that the distribution of income of people who are contracted-out stays the same.

Figure 4.7: Estimated cost of tax relief on Appropriate Personal Pension rebates in future

	2012	2015	2020	2030	2040	2050
Cost of Tax Relief (£m, earnings terms)	150	140	130	100	70	70
Cost of Tax Relief (£m, 2006/07 prices)	170	170	170	170	140	170

Source: DWP estimates

4.53 In addition, these proposals will lead to one-off costs to the public sector as it prepares and adapts to the changes. For the package of private pension reforms, these are estimated at £8m up to 2011/12. In addition, there will be administrative savings for HMRC that will arise as a result of abolishing DC schemes starting in 2013.

GMP conversion

4.54 Initial HMRC's project and IT development costs arising from GMP conversion are estimated to be around £3 million.

Gender impact

4.55 As 70 per cent of those contracted-out into DC schemes are men,²⁰ changes to the contracting out regime for DC schemes will affect more men than women. However, both men and women who can no longer contract -out will start to build up rights to State Second Pension.

4.56 Current equal treatment legislation already requires occupational pension schemes to provide equal pensions to men and women. This will be reflected in the actuarial calculations carried out in converting GMPs into scheme benefits. There is no reason to expect that this proposal would have anything other than uniform impact on each gender.

²⁰ Source: Second Tier Pension Provision 2003/04

Race impact

4.57 The effects of these proposals will apply to all individuals. There is no data available on the ethnic breakdown of individuals who are contracted-out but there is no evidence to suggest that the contracting out proposals would have anything other than uniform impact on each ethnic group.

Impact on small firms

Abolition of contracting out in DC schemes

4.58 Data from the Employer Pension Provision Survey (EPP) 2005 can be used to make an initial assessment of the impact on small firms.

Figure 4.8: Distribution of employer size by scheme type

Size of employer	Contracted-out		Contracted-in		Partly contracted-out	
	Employees	Schemes	Employees	Schemes	Employees	Schemes
1 to 4	0.0%	0.3%	0.0%	0.5%	0.0%	0.0%
5 to 49	0.0%	3.2%	0.1%	11.6%	0.0%	1.5%
50 to 249	0.3%	8.6%	0.8%	16.3%	0.1%	4.5%
250 and over	99.7%	87.9%	99.1%	71.7%	99.9%	94.0%
Total	100%	100%	100%	100%	100%	100%

Source: Employer Pension Provision 2005

4.59 The results are shown in table figure 4.8 above. These figures show that the impact on firms is highly concentrated on larger firms, with nearly 100 per cent of affected employees and 88 per cent of schemes belonging to employers with more than 250 employees. About 3 per cent of schemes are run by employers with fewer than 50 employees. Only a small minority of small firms run pension schemes and would thus be affected.

GMP conversion

4.60 No significant differences are anticipated from GMP conversion according to business size. The initial one off costs are likely to vary depending on the size of firm (see costs set out above).

Impact on competition

4.61 The key markets that will be affected by the changes to contracting out are those that operate in private pension provision. The Government does not expect these changes to have any significant effect on competition.

Enforcement, sanctions, monitoring, implementation and review

4.62 The abolition of contracting out in DC schemes will be implemented at the same time as the basic state pension is up-rated in line with earnings. At that time, the rebate will cease to be paid by the Government and scheme members will no longer built up separate rights from other rights in the scheme that are subject to separate rules.

4.63 GMP conversion will be a permissive power. Legislation will allow for schemes to convert all or some of their GMPs, but it will be the scheme trustees, with the sponsoring employer, who decide whether or not to convert and which members should have their GMP converted. Where the conversion is done individually, on transfer, it will be for the member to ask for his GMP to be converted. The following measures to protect members will be in place:

- the Pensions Regulator will issue guidance on the consultation with members which the legislation will require schemes to conduct as part of the conversion exercise;
- the Pensions Regulator will be able to intervene in or suspend a GMP conversion exercise if it is not being conducted satisfactorily and will be able to apply sanctions where necessary; and
- members will have the right to complain to the Pensions Regulator.

4.64 The impact of the contracting out changes will be monitored as part of DWP's on going monitoring of the number of people who are contracted-out and of the overall level of saving. The number of schemes taking advantage of the GMP conversion provisions will also be monitored. The contracting out changes will also be included as part of the overall evaluation of the pensions reform package.

Summary and recommendation

Figure 4.9: Summary of Costs and Benefits

Option	Costs	Benefits
Contracting out reform		
Abolition of contracting out in DC schemes	Small one-off administration costs to contracted-out DC schemes	Simplified decisions. Small reduction in administration costs.
	Immediate saving to the Exchequer balanced by increase in long-term liabilities Individuals lose option of contracted-out rebate but gain state second pension entitlement	
GMP conversion	One off administration costs to schemes that choose to convert GMPs	On going reduction in administration costs to schemes that choose to convert GMPs. More transparency for scheme members.

Notes:

(a) The age-related (AR) top-up payable to members of Contracted-out DC occupational schemes includes the combined employer/employee flat-rate rebate payable through reduced-rate NICs. Actual top-up payable ranges between 0.0 per cent and 4.4 per cent.

(b) For individuals contracted-out with an APP or Stakeholder scheme, the whole of the rebate is delivered through the age-related rebate.

(c) The rebate is paid on earnings between the Lower Earnings Limit (LEL) = £4,368 (2007/8) and the upper earnings limit = £33,540 (2007/8)

Background to removal of the Secretary of State's approval of actuarial guidance

In order for actuaries to calculate pensions liabilities consistently, all actuaries are required to use agreed guidelines. These guidelines are called either "Guidance Note" (GN) or "Technical Memorandum" (TM). There are seven GNs and one TM referred to in pensions legislation. The Secretary of State is required by primary legislation to approve three of these GNs and the TM.

Historically the actuarial profession has produced these GNs. The professional bodies for actuaries - the Institute of Actuaries in England and Wales and the Faculty of Actuaries in Scotland - have combined the role of regulator with that of professional body. Because of the professions' dual role the Faculty and Institute of Actuaries are required to obtain the Secretary of State's approval of the GNs and TMs to maintain the public's confidence.

The Morris Review of the Actuarial Profession recommended in March 2005 that the Financial Reporting Council (FRC) should establish a new regime to set actuarial standards and to oversee the regulation of the profession. The FRC is the UK's independent regulator for corporate reporting and governance. The Government accepted this recommendation and the FRC has now set up the Board for Actuarial Standards (BAS) to promote confidence in corporate reporting and governance by setting high quality actuarial standards. The Faculty of Actuaries and the Institute of Actuaries continue to exist as the professional bodies for the profession in their respective jurisdictions.

On 6 April 2007 BAS will adopt and take responsibility for the existing versions of the pensions GNs and the TM. Since the FRC and through it BAS are the UK's independent regulator for corporate reporting and governance, the requirement for the Secretary of State to approve certain GNs and the TM will be removed from primary legislation.

Annex A – Benefit expenditure estimates: methods and assumptions.

- A.1 This Annex sets out more detail on the costs of State Pension reform and the methodology used to calculate these costs. It sets out the assumptions behind these estimates, the models used in calculating them, and the costs themselves.
- A.2 The material in this Annex draws upon and updates the information contained in Appendices A to C of the Regulatory Impact Assessment accompanying the White Paper.

Assumptions

Population projections

- A.3 Demographic projections underpinning expenditure projections are based on data produced by the Population Division of the Office for National Statistics (ONS) and by the Government Actuary's department (GAD).
- A.4 We have used the latest (2004-based) population projections for the United Kingdom and constituent countries, published in October 2005. The projection reflects the following assumptions on future rates of mortality, fertility and migration:
- mortality rates improving consistently into the future: at each age the year-on-year reduction in mortality rates converges from current rates to 1 per cent per year by 2029 for all ages, and mortality continues to improve at this constant rate thereafter;
 - the average number of children per mother remaining constant over time at 1.74 children; and
 - an annual net inflow of migrants of 145,000.

Policy assumptions

- A.5 Figures A1, A4 and A7 below contains expenditure projections assuming current policies continue into the future in cash, 2006/7 prices and GDP terms. The principal assumptions behind these projections are:
- standard minimum guarantee element of Pension Credit rises with prices from 2008/9;
 - the Savings Credit threshold is linked to the value of the basic State Pension;

- basic State Pension rises in line with the Retail Price Index (RPI), but with a minimum annual uprating of 2.5 per cent;
 - disability benefits are uprated by RPI;
 - The cost of free TV licences for the over-75s increases by 1.5 percentage points above RPI each year; and
 - Winter Fuel Payments are fixed in cash terms.
- A.6 For modelling purposes only, income tax allowances and thresholds are assumed to be indexed by earnings beyond 2010/11. National Insurance thresholds are uprated as currently set out in legislation, which is a mix of price uprating, earnings uprating and increases in line with the basic State Pension.
- A.7 Figures A.1c, A.4c, and A.7c shows expenditure on state pensions under the reformed system in cash, 2006/7 prices and GDP terms. The policy detail underpinning these projections is as set out in this document.
- A.8 All the figures reflect the equalisation of State Pension age for men and women between 2010 and 2020.

Economic assumptions

- A.9 The principal economic assumptions behind these projections cover inflation, employment and unemployment, and productivity growth. Earnings and GDP assumptions flow from these. For the period up to 2010/11, the economic assumptions are as presented in the Budget 2006 Financial Statement and Budget Report, updated to take account of more recent information. Beyond this, the main assumptions are as follows:
- For inflation, the Bank of England is assumed to meet its 2 per cent target for the Consumer Prices Index (CPI) on average, though with some variation around this (which in turn impacts on the average uprating for the basic State Pension, which is assumed to have a minimum uprating of 2.5 per cent per year). All other inflation assumptions (such as RPI) are determined relative to this CPI baseline, with differences between them to take account of the different coverage and methodology behind the different measures, and differential inflation in house prices, which we assume will rise in the long term in line with earnings.
 - Employment assumptions use the cohort projection method described in the Long-Term Public Finance Report, which generally results in fairly constant employment rates at each age. However, there are

bigger increases in employment rates for older women due to the feed through of strong cohort effects, and an adjustment for the equalisation of the State Pension age. The combination of an ageing population, with an assumption that older working age people will continue to have lower employment rates than younger groups, results in a small fall in economic inactivity, and a consequent small rise in employment rates of around one percentage point across the projection period. This change is mainly concentrated between 2010 and 2020, as equalisation occurs.

- Productivity is assumed to increase at 2 per cent per year beyond the medium term planning horizon, and it is assumed that real earnings growth follows productivity growth, implicitly assuming no change in the labour share of overall GDP. Real GDP growth is the combination of employment and productivity growth.

Other assumptions

- A.10 **Contracting out** of the State Second Pension is assumed to continue to decline in the future in the private sector, falling by two-thirds in 2050 compared with current levels. The majority of this reflects the feeding through of schemes that have already closed to new members, but there is a further decline as a result of assumed future closures. Defined contribution schemes (contracted-out money purchase and appropriate personal pension) have a further reduction assumed, resulting from the lowering of the cap on age related rebates in the recent contracted-out rebate review. It is also assumed that there is no change in contracting out in the public sector (where virtually all employees are contracted out).
- A.11 **Pensioner incomes** brought to account in Pension Credit are modelled in the Department's dynamic microsimulation model Pensim2, and these are based on a number of lower level assumptions about pension contributions and labour market histories consistent with Treasury's employment assumptions. More detail on the projections of pensioner incomes can be found in the factsheet on Projections of Pension Credit Entitlement.²¹
- A.12 **Pension Credit take-up** overall is assumed to remain at the 2007/08 level, which is projected to be around two-thirds of the eligible population. This is a change from the White Paper publication which assumed a take-up rate of around four-fifths, reflecting latest evidence on Pension Credit out-turns. The effect of switching to a lower take-up assumption for Pension Credit is to reduce the additional costs of Pension Credit reform by less than £0.5bn a year in the first 10 years and by under £1bn in 2050.

²¹ Published on the DWP website at: www.dwp.gov.uk/pensionsreform/forum/docs/fs-pc-projection.pdf

- A.13 **Rents** are assumed to rise in line with earnings, reflecting the general path of house prices over the past few decades.
- A.14 **Council taxes** are assumed to rise in line with earnings, consistent with Council Tax revenue remaining fairly constant as a proportion of total government revenue.
- A.15 **Personal accounts** have not been included in the projections – estimates are based on current savings behaviour.

Models

- A.16 The costs of changes to the state pension system proposed in the RIA have been estimated by using a number of models. All these models provide projections of expenditure under a set of assumptions about future trends in the key economic, demographic and policy variables. As with the long-term projections, these estimates should be considered with care as they are very dependent on assumptions about future trends.
- A.17 No single model is best suited to estimating cost changes across all the elements of State Pensions. The approach taken here is to use the most appropriate model for each main element of the cost, and combine these estimates to produce an overall costing. The estimates in the RIA incorporate the regular annual update to models, including new data and some changes to reflect improvements in methodology. The main changes from the White Paper approach are highlighted below.

Aggregate models

- A.18 Estimates of the costs of changes to the basic State Pension and State Second Pension have, as far as possible, been made from the same models used for the base long-term expenditure projections, originally developed by GAD. This follows the approach used in the White Paper.
- A.19 There are separate models for basic State Pension and Additional Pension (AP). Both are aggregate models – they project expenditure in respect of groups of pensioners (categorised, for example, by age, birth cohort and gender).

- A.20 The basic State Pension model uses administrative data on the entitlements of current pensioners together with assumptions to project expenditure into the future. The key assumptions include:
- population;
 - marital status; and
 - average entitlement.
- A.21 Population estimates are based on GAD's 2004-based principal population projection, with proportions by marital status from GAD's 2003-based marital status projections.
- A.22 Assumptions about average entitlement are based on administrative data, with forward projections based on trends derived from the analysis of data from the National Insurance Recording System 2 (NIRS2). This showed that the introduction of Home Responsibilities Protection in 1978 has had a considerable impact on increasing women's National Insurance contribution records and hence their entitlement to the basic State Pension. Men and women up to the age of 45 now have virtually identical entitlements. This is assumed to feed through into older age groups as these cohorts age.
- A.23 The assumptions used within the basic State Pension model have also been used to project outcomes – for example the proportions of people reaching State Pension age with full basic State Pension – under the current system and under reform proposals (showing, for example, the impact of changes to the number of qualifying years required for full basic State Pension).
- A.24 The Additional Pension model also uses administrative data on the accruals of current pensioners to project expenditure into the future. In addition, it makes use of NIRS2 data on National Insurance contributions to estimate current accruals for those below pension age.
- A.25 To estimate future contributions and rebates, a National Insurance model developed by GAD is used, which projects contributions based on population, mortality, earnings and contracting out assumptions.
- A.26 Population and mortality are based on GAD's 2004-based principal population projection, with an income related adjustment to mortality (since those with higher incomes tend to have lower mortality rates).
- A.27 Earnings are assumed to grow in line with the Treasury's economic projections. It is also assumed that the current distribution of earnings between age groups continues.

A.28 Contracting out for occupational schemes in the private sector is assumed to continue to decline by two thirds in the future, compared to current levels. Contracting out for personal pension schemes is also assumed to decline, and includes an allowance for the expected effect of revised age related rebate rates, which makes contracting out less attractive to those over 44 years old.

Pensim2

A.29 Pensim2 is a dynamic micro-simulation model that has been developed in DWP to inform analysis of likely future trends in pensioner incomes. Pensim2 builds up a picture of the future pensioner population by modelling future life events and work histories for a representative sample of individuals.

A.30 The model currently starts from a set of base data representative of the GB household population in 2001. This base data includes detailed information on the characteristics of individuals and their employment and pension histories to date. For each subsequent year, sets of equations are used to model, for each individual, the probability of certain events occurring, based on estimates from current data. The calculated probabilities are then used within the model to determine what happens to each individual in a given year.

A.31 The key elements that are simulated include:

- partnership formation and dissolution;
- mortality;
- fertility;
- education;
- labour market status and earnings; and
- accrual of occupational and personal pensions.

A.32 The individual labour market and pension histories generated by the model are used to calculate estimates of pensioner incomes in each year of the simulation. For contributory State Pensions, the rules of the state pension are used to calculate someone's entitlement given the extent to which they work or participate in activities that are credited. Entitlement to Pension Credit is then calculated based on all relevant income sources. Pensim2 does not at present model entitlement to Housing Benefit or Council Tax Benefit. Currently Pensim2 is used to simulate up to 2050.

A.33 The methodology and equations underlying Pensim2 were validated by the Institute for Fiscal Studies. Their findings and recommendations for further development were published in a working paper in 2004. This is

available on their website. Results from Pensim2 have been validated by comparing a range of key outputs against trends in recent administrative and survey data and the projections produced using other modelling approaches. These key outputs include demographic changes, cross-sectional and longitudinal labour market outcomes, and trends in the accrual of both state and private pensions.

- A.34 Pensim2 is particularly well-suited to long-term projections of expenditure on income-related benefits, where the distribution of future pensioner incomes is a key determinant of entitlement and expenditure. Pensim2 models the future accrual of pensions by individuals, based on their projected labour market status each year. So it captures directly key trends such as the maturing of the State Second Pension scheme, and widening coverage of basic State Pension. As such it is more likely to generate a robust distribution of future pensioner incomes.
- A.35 In view of the methodological advantages of the Pensim2 approach, and following further investigation of Pensim2 projections since the White Paper, long-term estimates of Pension Credit expenditure and entitlement in the RIA have been based entirely on estimates derived directly from Pensim2.
- A.36 Further details on Pensim2 are set out in Appendix F of the Second Report of the Pensions Commission, and in the factsheet on Projections of Pension Credit Entitlement.²² All models are constantly reviewed and refined, the version of Pensim2 used in the RIA analysis has been improved since the White Paper, for example State Second Pension expenditure growth is much closer to DWP dedicated expenditure model patterns (3.7 per cent for Pensim2 compared with 3.5 per cent for expenditure models).

Policy Simulation Model (PSM)

- A.37 The PSM is a model of the current benefit, tax and National Insurance system, which is used extensively in DWP to assess the effect of changes in benefit policy. The PSM is a micro-simulation model, which models the impact of changes on a representative sample of households. It is based on *Family Resources Survey* data for 2003/04 projected forward to 2005/06 in line with forecasting assumptions.
- A.38 Medium-term projections of expenditure on Pension Credit are made using a forecasting model based on the PSM, projected forward in line with assumptions about future growth in the main components of income and taking into account future changes in the number of pensioners, by

²² Published on the DWP website at: www.dwp.gov.uk/pensionsreform/forum/docs/fs-pc-projection.pdf

age group. These trends are then applied to current caseloads and expenditure estimates based on DWP administrative data. The PSM has also been used to estimate the impacts of pension reform measures on Housing Benefit and Council Tax Benefit expenditure, which are not included in Pensim2 yet.

Methods

A.39 All data and modelling is based on Great Britain. Adjustments are made to convert to a United Kingdom basis using relative expenditure per head and differing projected trends in population in relevant age groups. Basic State Pension and State Second Pension are also adjusted to incorporate pensions paid to individuals residing overseas, using a methodology developed by GAD.

Changes to State Pension age

- A.40 Changes to State Pension age result in savings in benefits paid to pensioners, but with some additional costs in working-age benefits, generally for people between age 65 and the new pension age.
- A.41 Savings on pensioner benefits are simply calculated by assessing how much expenditure would be paid to people aged between 65 and the new pension age. For the purposes of these estimates, it is assumed there are no additional accruals to State Second Pension and basic State Pension entitlement over the age of 65.
- A.42 Costs to working-age benefits – principally Incapacity Benefit and the associated elements of Income Support, Housing Benefit and Council Tax Benefit – have been calculated by extrapolating the pattern of receipt of these benefits, per capita, from the age groups below 65 up to the new pension age. In most cases receipt of these benefits rises steadily with age, and this is simple to extrapolate. However, it has not been assumed that the higher pension age leads to lower levels of benefit receipt for people in their fifties and early sixties, although this is a possible outcome (for example if employment rates increase among those groups).
- A.43 Disability Living Allowance costs are based on the patterns of flow onto the benefit in the ages immediately below 65, as it is assumed – for the purposes of these estimates – that the maximum age at which it can be claimed is moved in line with rising State Pension age. This in turn reduces the number of new claims to Attendance Allowance among pensioners, as a higher proportion already receive Disability Living Allowance.

A.44 It is likely that changes in State Pension age will have an impact on the ages at which individuals take occupational and personal pensions. This would affect the income received from those pensions (for example by affecting the period over which funds accumulate, or the annuity rate offered), which could in turn affect expenditure on income-related benefits. These effects will depend on individual and employer reactions to the changes in State Pension age and are therefore difficult to predict reliably. No account has been taken of them in this analysis.

- A.45 The effects of raising State Pension age on employment are very uncertain. A range of scenarios have been considered when looking at the effect of changing State Pension age on economic growth:
- **the low impact scenario** simply assumes those affected by the higher State Pension age change their labour market participation in the year in which they are affected – so, for example, when State Pension age is raised by one year from 65 to 66, participation is only affected for those aged 65 - and this is estimated by extending the labour force exit rates seen over the ages immediately below this to the new State Pension age
 - **For the high impact scenario**, it is assumed that labour force exit is delayed by the same amount as State Pension age is raised, for anyone over the age of 55. For example, for cohorts facing a one year increase in State Pension age, their participation at age 56 is what it was at age 55, and for cohorts facing a three year increase in State Pension age, participation at age 58 is what it was at 55; this continues as they age, up to age 70. This scenario means that the employment effects of raising State Pension age actually start 10 years before State Pension age is raised.
 - **The central projection** is simply the average of the high and low impact scenarios.

There is more information on the methodology and assumptions behind changing employment levels in the publication *Economic and social welfare impacts of pension reform*.

A.46 Estimates of benefit expenditure and National Insurance Rebates assume higher levels of employment resulting from State Pension age rises. Change in employment as a result of reform will impact on GDP. The costs in tables A.1, A.4, and A.7 - showing spending on pensioners under reform - assume that GDP rises slightly as a result of reform, based on the central projection above. This means that total spending on pensioner benefits is 7.5% in 2050 rather than 7.7% without any increase in GDP.

A.47 The central projection of employment increases due to rises in State Pension age are likely lead to an overall increase in National Insurance revenues. Assuming National Insurance rates remain comparable to now, the increase in National Insurance revenues could

be 0.1% of GDP (around £1bn in 0607 prices) from 2024 rising to 0.2% of GDP by 2050 (around £6 billion in 0607 prices).

Uncertainty

A.48 The costs presented in this annex are highly dependent on the underpinning assumptions. The main areas which may noticeably influence expenditure are:

Earnings and prices growth

A.49 As the basic State Pension is indexed by earnings, higher growth in real earnings will increase expenditure, and vice versa. Movements in real earnings growth tend to be correlated with similar movements in GDP, so costs expressed as a proportion of GDP may not be affected.

Employment

A.50 An increase in the employment rate has numerous effects. As the number of people in work grows, GDP and income from National Insurance Contributions will increase. Expenditure on State Second Pension may rise as individuals accrue greater entitlement. Potentially, future expenditure on income related benefits may fall as more people are able to save for their own retirement, or have improved basic State Pension and State Second Pension entitlements.

Mortality

A.51 Mortality rates have been falling for many years now, due to improvements in technology, healthcare, and preventative medicine. The mortality projections underpinning the analysis contained in this annex assume these trends will continue. Therefore, expenditure on pensioners will continue to rise as the stock of pensioners swells. The effect of any variation will build up progressively.

Fertility

A.52 Changes to the fertility rate will have a very long-term effect on pensions expenditure. For example, a greater number of births than predicted for a given year will take at least a further 16 years to have any effect – whenever this new generation can join the workforce. This generation will then take a full working lifespan to become pensioners.

A.53 A greater number of births will lead, initially, to a greater number of contributors and an increase in National Insurance Contributions;

eventually, these generations will retire and result in an increase in pensions expenditure.

Migration

- A.54 Changes in migration will have different effects on the projections depending on the composition of those entering or leaving the country.
- A.55 An increase in the number of working age migrants will positively influence the support ratio, and lead to a larger number of individuals in employment, contributing more to the economy. However, in the longer term, these migrants will become entitled to state pensions.
- A.56 An increase in the number of older migrants may lead to increased expenditure in the short-term. The precise effect will depend on their previous country of residence, and any reciprocal arrangement with the UK.

Savings behaviour and contracting out

- A.57 Any change in the proportions contracting out of Defined Benefit schemes will change both future expenditure on State Second Pension and on the contracted-out rebate.
- A.58 Costs do not include effect of personal accounts. Any increase in the numbers engaged in private pension saving may reduce expenditure on Pension Credit.

Costs, and Notes to the Tables

A.59 The tables below set the costs of pensioner benefits in cash (figures A.1 to A.3), 2006/7 prices (figures A.4 to A.6) and GDP terms (figures A.7 to A.9):

- **Figures A.1, A.4 and A.7** set out total spending on pensioner benefits with (a) no reform, (b) earnings uprating of the standard minimum guarantee, and (c) the whole reform package.
- **Figures A.2, A.5, and A.8** set out further details further details of the changes in benefit expenditure resulting from different aspects of reform.
- **Figures A.3, A.6 and A.9** show projections of the change in contribution income arising in respect of the individual proposals in the Bill.

A.60 Other notes for the tables are:

- Figures refer to financial years, for example 2020 refers to 2020/21.
- Figures exclude tax revenue implications of reform.
- The tables only contain projections of changes in expenditure and income. No estimate is made of the overall position of the National Insurance Fund.
- All expenditure projections in this Annex apply to the whole of the United Kingdom.

Pensions spending and pensioner benefits

Pension benefits include:

- NI benefits: basic State Pension, State Second Pension
- Non-NI benefits: Pension Credit, Winter Fuel Payments, over 75's TV licences, age related payments and Christmas bonus.

Pensioner expenditure also includes:

- Housing Benefit, Council Tax Benefit, Carers Allowance, Attendance Allowance and Disability Allowance.

Costs of state pension reform include knock on effects on:

- NI benefits: Incapacity Benefit, Jobseekers Allowance and Bereavement Benefit;
- Non NI benefits: such as Housing Benefit, and Council Tax Benefit.

Figure A.1: Summary of pensioner expenditure, cash, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
(a) without reform																
NI Pension Benefits:																
Basic State Pension	51.2	53.8	56.2	58.6	61.3	64.1	66.8	69.5	72.2	75.1	78.0	81.1	84.7	137.9	204.7	285.2
SERPS / S2P	11.5	12.5	13.5	14.5	15.6	16.7	17.8	19.0	20.2	21.4	22.7	24.0	25.5	49.4	92.2	186.2
Non-NI Pension Benefits:																
Pension Credit	7.5	7.4	7.3	7.3	7.2	7.0	6.9	6.7	6.5	6.2	6.2	6.0	5.9	4.6	3.1	2.1
Other Pension Benefits	2.9	2.9	3.0	3.0	3.0	3.0	3.1	3.1	3.1	3.2	3.2	3.3	3.4	5.0	7.2	10.4
Total Pension Benefits	73	77	80	83	87	91	95	98	102	106	110	114	119	197	307	484
Housing and Council Tax Benefits	7.9	8.3	8.6	8.6	8.3	8.1	7.9	7.7	7.5	7.3	7.1	6.9	6.7	7.5	9.4	14.6
Attendance Allowance & Disability Living Allowance	8.7	9.2	9.7	10.2	10.7	11.1	11.6	12.2	12.6	13.2	13.8	14.4	15.1	25.2	39.1	56.3
Total pensioner benefits	90	94	98	102	106	110	114	118	122	126	131	136	141	230	356	555
(b) with earnings indexed standard minimum guarantee:																
Pension Credit	8.2	8.8	9.4	10.0	10.6	11.1	11.8	12.3	13.0	13.6	14.6	15.4	16.5	35.1	73.8	139.6
Total Pension Benefits	74	78	82	86	91	95	99	104	108	113	119	124	130	227	378	621
Housing and Council Tax Benefits	7.9	8.3	8.6	9.0	9.2	9.4	9.6	9.9	10.1	10.3	10.5	10.7	10.9	18.4	32.0	62.9
Total pensioner benefits	90	96	100	105	110	115	121	126	131	137	143	149	156	271	449	741
(c) with other reforms:																
NI Pension Benefits:																
Basic State Pension	51.2	53.8	56.2	58.5	62.2	66.1	70.1	74.1	78.3	82.7	87.4	92.3	98.0	185.3	327.6	519.1
SERPS / S2P	11.5	12.5	13.5	14.5	15.6	16.7	17.8	19.0	20.2	21.4	22.7	24.0	25.6	49.8	96.6	186.1
Non-NI Pension Benefits:																
Pension Credit	8.0	8.4	8.9	9.3	9.5	9.6	9.9	9.9	10.0	9.9	10.1	10.1	10.3	11.9	13.4	15.1
Other Pension Benefits	2.9	2.9	3.0	3.0	3.0	3.0	3.1	3.1	3.1	3.2	3.2	3.3	3.4	4.9	7.0	10.1
Total Pension Benefits	74	78	82	85	90	95	101	106	112	117	123	130	137	252	445	730
Housing and Council Tax Benefits	7.9	8.3	8.6	9.0	9.2	9.3	9.5	9.6	9.8	9.9	10.1	10.2	10.3	14.6	22.2	40.7
Attendance Allowance & Disability Living Allowance	8.7	9.2	9.7	10.2	10.7	11.1	11.6	12.2	12.6	13.2	13.8	14.4	15.1	24.5	37.7	53.3
Total pensioner benefits	90	95	100	104	110	116	122	128	134	140	147	154	163	291	505	824

Figure A.2: Detailed additional benefit spend with whole reform package, cash, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
National Insurance Benefit Changes																
Basic State Pension																
- ADIs	0.0	0.0	-0.1	-0.2	-0.4	-0.5	-0.7	-1.0	-1.2	-1.5	-1.9	-2.3	-2.6	-3.5	-3.5	-5.2
- coverage	0.0	0.0	0.1	0.2	0.3	0.4	0.6	0.7	0.9	1.0	1.2	1.3	1.5	4.8	8.9	12.4
- earnings uprating	0.0	0.0	0.0	0.0	0.9	2.1	3.4	4.9	6.5	8.2	10.1	12.1	14.4	57.2	147.2	307.1
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-11.1	-29.8	-80.4
Total additional BSP spend	0.0	0.0	0.0	0.0	0.9	2.0	3.3	4.7	6.1	7.7	9.3	11.1	13.3	47.4	122.8	233.9
State Second Pension																
- abolition of contracting out in DC schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	1.8	7.0	14.1
- flat-rating	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.2	0.4	2.3	3.3
- coverage	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	1.1	4.4	11.8
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-2.9	-9.3	-29.3
Total additional S2P spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.3	4.4	-0.1
Total National Insurance benefits to pensioners	0.0	0.0	0.0	0.0	0.9	2.0	3.3	4.7	6.1	7.7	9.4	11.2	13.4	47.8	127.2	233.8
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.1	2.4	5.2
Total additional NI benefit spend	0.0	0.0	0.0	0.0	0.9	2.0	3.3	4.7	6.1	7.7	9.4	11.2	13.4	48.8	129.6	239.0
Non-NI Benefits																
Pension Credit																
- earnings uprating standard minimum guarantee	0.7	1.4	2.2	2.8	3.4	4.1	4.8	5.6	6.5	7.3	8.4	9.4	10.6	30.5	70.7	137.5
- offset due to increased BSP & S2P	-0.1	-0.2	-0.2	-0.2	-0.4	-0.7	-1.2	-1.6	-2.1	-2.7	-3.4	-4.1	-4.9	-19.7	-52.3	-109.2
- Savings Credit reforms	0.0	-0.2	-0.4	-0.5	-0.6	-0.7	-0.7	-0.8	-0.8	-0.9	-1.0	-1.2	-1.3	-3.3	-7.1	-13.4
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	-0.9	-1.9
Total additional Pension Credit spend	0.5	1.1	1.6	2.0	2.4	2.7	2.9	3.2	3.5	3.7	3.9	4.1	4.4	7.3	10.3	13.1
HB/CTB																
- earnings uprating HB/CTB	0.0	0.0	0.0	0.4	0.9	1.3	1.7	2.1	2.6	3.0	3.4	3.8	4.3	10.8	22.6	48.4
- offset due to increased BSP & S2P	0.0	0.0	0.0	0.0	0.0	-0.1	-0.2	-0.2	-0.3	-0.4	-0.4	-0.5	-0.6	-2.9	-7.7	-16.0

- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.9	-2.0	-6.3
Total additional HB/CTB spend	0.0	0.0	0.0	0.4	0.8	1.2	1.5	1.9	2.3	2.6	3.0	3.3	3.6	7.1	12.8	26.1	
Other Non-NI Benefits - reduction due to SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.8	-1.5	-3.3
Total Non-NI benefits to pensioners	0.5	1.1	1.6	2.5	3.2	3.8	4.5	5.1	5.7	6.3	6.9	7.4	8.0	13.5	21.6	35.9	
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.1	3.0	8.2
Total additional Non-NI benefit spend	0.5	1.1	1.6	2.5	3.2	3.8	4.5	5.1	5.7	6.3	6.9	7.4	8.0	14.7	24.6	44.1	
Total benefit spend																	
Total additional spend: pensioners	0.5	1.1	1.6	2.4	4.0	5.9	7.8	9.8	11.9	14.0	16.3	18.6	21.5	61.3	148.9	269.7	
Total additional spend: pensioners and working-age	0.5	1.1	1.6	2.4	4.0	5.9	7.8	9.8	11.9	14.0	16.3	18.6	21.5	63.5	154.3	283.2	

Figure A.3: Financial effect of contracting out rebates on National Insurance contributions, cash, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
Cost of DB rebate	8.1	8.3	8.5	8.8	9.6	9.8	10.1	10.3	10.6	10.7	10.9	11.2	11.5	15.2	22.1	31.4
Cost of DC rebate	1.9	1.9	1.9	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in contracting out rebate:																
- from flat-rating S2P	0.0	0.0	0.0	0.0	0.0	-0.2	-0.3	-0.5	-0.8	-1.0	-1.2	-1.5	-1.8	-5.9	-6.4	-4.3
- SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.4
Total	10.0	10.2	10.5	10.7	9.6	9.7	9.7	9.8	9.8	9.7	9.7	9.7	9.7	9.3	15.8	27.5

Figure A.4: Summary of expenditure on pensioner benefits, 06/07 prices, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
(a) without reform																
NI Pension Benefits:																
Basic State Pension	48.6	49.7	50.5	51.2	52.2	53.0	53.8	54.4	55.0	55.6	56.3	56.9	57.8	71.4	80.4	85.0
SERPS / S2P	10.9	11.5	12.1	12.7	13.3	13.8	14.4	14.9	15.4	15.9	16.3	16.8	17.4	25.6	36.2	55.5
Non-NI Pension Benefits:																
Pension Credit	7.1	6.8	6.5	6.3	6.1	5.8	5.6	5.2	5.0	4.6	4.5	4.2	4.0	2.4	1.2	0.6
Other Pension Benefits	2.7	2.7	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.3	2.6	2.8	3.1
Total Pension Benefits	69	71	72	73	74	75	76	77	78	78	79	80	82	102	121	144
Housing and Council Tax Benefits	7.5	7.7	7.8	7.5	7.1	6.7	6.4	6.1	5.7	5.4	5.1	4.8	4.6	3.9	3.7	4.3
Attendance Allowance & Disability Living Allowance	8.3	8.5	8.8	8.9	9.1	9.2	9.4	9.5	9.6	9.8	9.9	10.1	10.3	13.0	15.3	16.8
Total pensioner benefits	85	87	88	89	90	91	92	93	93	94	94	95	96	119	140	165
(b) with earnings indexed standard minimum guarantee																
Pension Credit	7.7	8.1	8.5	8.8	9.0	9.2	9.5	9.6	9.9	10.0	10.5	10.8	11.3	18.2	29.0	41.6
Total Pension Benefits	70	72	74	75	77	79	80	81	83	84	85	87	89	118	148	185
Housing and Council Tax Benefits	7.5	7.7	7.8	7.9	7.8	7.8	7.8	7.7	7.7	7.6	7.6	7.5	7.5	9.5	12.6	18.8
Total pensioner benefits	86	88	90	92	94	96	97	99	100	101	103	104	107	140	176	221
(c) with other reforms:																
NI Pension Benefits:																
Basic State Pension	48.6	49.7	50.6	51.2	52.9	54.7	56.4	58.1	59.7	61.3	63.0	64.7	66.9	95.9	128.	154.
SERPS / S2P	10.9	11.5	12.1	12.7	13.3	13.8	14.4	14.9	15.4	15.9	16.4	16.9	17.5	25.8	37.9	55.4
Non-NI Pension Benefits:																
Pension Credit	7.6	7.8	8.0	8.1	8.1	8.0	8.0	7.7	7.6	7.3	7.3	7.1	7.0	6.2	5.3	4.5
Other Pension Benefits	2.7	2.7	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.3	2.3	2.3	2.5	2.8	3.0
Total Pension Benefits	70	72	73	75	77	79	81	83	85	87	89	91	94	130	175	218
Housing and Council Tax Benefits	7.5	7.7	7.8	7.9	7.8	7.7	7.6	7.5	7.5	7.4	7.3	7.2	7.0	7.6	8.7	12.1
Attendance Allowance & Disability Living Allowance	8.3	8.5	8.8	8.9	9.1	9.2	9.4	9.5	9.6	9.8	9.9	10.1	10.3	12.7	14.8	15.9
Total pensioner benefits	86	88	90	91	94	96	98	100	102	104	106	108	111	151	198	246

Figure A.5: Detailed additional benefit spend, 06/07 prices, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
National Insurance Benefit Changes																
Basic State Pension																
- ADIs	0.0	0.0	-0.1	-0.2	-0.3	-0.4	-0.6	-0.8	-0.9	-1.1	-1.4	-1.6	-1.7	-1.8	-1.4	-1.6
- coverage	0.0	0.0	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.8	0.9	1.0	2.5	3.5	3.7
- earnings uprating	0.0	0.0	0.0	0.0	0.8	1.7	2.8	3.8	4.9	6.1	7.3	8.5	9.8	29.6	57.8	91.5
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-5.8	-11.7	-23.9
Total additional BSP spend	0.0	0.0	0.0	0.0	0.7	1.7	2.6	3.6	4.7	5.7	6.7	7.8	9.1	24.5	48.2	69.7
State Second Pension																
- abolition of contracting out in DC schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.9	2.8	4.2
- flat-rating	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	0.2	0.9	1.0
- coverage	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.6	1.7	3.5
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-1.5	-3.7	-8.7
Total additional S2P spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	1.7	0.0
Total National Insurance benefits to pensioners	0.0	0.0	0.0	0.0	0.7	1.7	2.7	3.7	4.7	5.7	6.8	7.8	9.2	24.7	50.0	69.7
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.6	0.9	1.6
Total additional NI benefit spend	0.0	0.0	0.0	0.0	0.7	1.7	2.7	3.7	4.7	5.7	6.8	7.8	9.2	25.3	50.9	71.2
Non-NI Benefits																
Pension Credit																
- earnings uprating standard minimum guarantee	0.6	1.3	1.9	2.4	2.9	3.4	3.9	4.4	4.9	5.4	6.1	6.6	7.3	15.8	27.8	41.0
- offset due to increased BSP & S2P	-0.1	-0.2	-0.2	-0.2	-0.3	-0.6	-0.9	-1.3	-1.6	-2.0	-2.5	-2.9	-3.4	-10.2	-20.6	-32.5
- Savings Credit reforms	0.0	-0.1	-0.3	-0.4	-0.5	-0.6	-0.6	-0.6	-0.6	-0.7	-0.8	-0.8	-0.9	-1.7	-2.8	-4.0
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.3	-0.6
Total additional Pension Credit spend	0.5	1.0	1.4	1.8	2.0	2.2	2.4	2.5	2.6	2.7	2.8	2.9	3.0	3.8	4.1	3.9
HB/CTB																
- earnings uprating HB/CTB	0.0	0.0	0.0	0.4	0.7	1.1	1.4	1.7	1.9	2.2	2.5	2.7	2.9	5.6	8.9	14.4
- offset due to increased BSP & S2P	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.2	-0.2	-0.3	-0.3	-0.4	-0.4	-1.5	-3.0	-4.8
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.5	-0.8	-1.9
Total additional HB/CTB spend	0.0	0.0	0.0	0.4	0.7	1.0	1.2	1.5	1.7	1.9	2.1	2.3	2.5	3.7	5.0	7.8
Other Non-NI Benefits - reduction due to SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	-0.6	-1.0
Total Non-NI benefits to pensioners	0.5	1.0	1.4	2.1	2.7	3.2	3.6	4.0	4.4	4.7	5.0	5.2	5.5	7.0	8.5	10.7
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.6	1.2	2.5

Total additional Non-NI benefit spend	0.5	1.0	1.4	2.1	2.7	3.2	3.6	4.0	4.4	4.7	5.0	5.2	5.5	7.6	9.7	13.1
Total benefit spend																
Total additional spend: pensioners	0.5	1.0	1.4	2.1	3.4	4.9	6.3	7.6	9.0	10.4	11.7	13.0	14.6	31.7	58.5	80.4
Total additional spend: pensioners and working-age	0.5	1.0	1.4	2.1	3.4	4.9	6.3	7.6	9.0	10.4	11.7	13.0	14.6	32.9	60.6	84.4

Figure A.6: Financial effect of contracting out rebates on National Insurance contributions, 06/07 prices, £ billion

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
Cost of DB rebate	7.7	7.7	7.7	7.7	8.1	8.1	8.1	8.1	8.1	7.9	7.9	7.9	7.8	7.9	8.7	9.4
Cost of DC rebate	1.8	1.8	1.7	1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in contracting out rebate:																
- from flat-rating S2P	0.0	0.0	0.0	0.0	0.0	-0.1	-0.3	-0.4	-0.6	-0.7	-0.9	-1.1	-1.2	-3.1	-2.5	-1.3
- SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
Total	9.5	9.5	9.4	9.3	8.1	8.0	7.8	7.7	7.5	7.2	7.0	6.8	6.6	4.8	6.2	8.2

Figure A.7: Summary of expenditure on pensioner benefits, per cent of GDP

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
(a) without reform)																
NI Pension Benefits:																
Basic State Pension	3.5	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.3	3.3	3.2	3.2	3.2	3.2	3.0	2.6
SERPS / S2P	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.2	1.4	1.7
Non-NI Pension Benefits:																
Pension Credit	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.1	0.0	0.0
Other Pension Benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total Pension Benefits	5.0	5.0	4.9	4.9	4.8	4.8	4.8	4.7	4.6	4.6	4.6	4.5	4.5	4.6	4.5	4.4
Housing and Council Tax Benefits	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.1	0.1
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5
Total pensioner benefits	6.2	6.1	6.1	6.0	5.9	5.8	5.7	5.7	5.6	5.5	5.4	5.3	5.3	5.4	5.2	5.1
(b) with earnings indexed standard minimum guarantee																
Pension Credit	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.8	1.1	1.3
Total Pension Benefits	5.1	5.1	5.1	5.0	5.0	5.0	5.0	5.0	4.9	4.9	4.9	4.9	4.9	5.4	5.6	5.7
Housing and Council Tax Benefits	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.5	0.6
Total pensioner benefits	6.2	6.2	6.2	6.2	6.1	6.1	6.1	6.0	6.0	5.9	5.9	5.9	5.9	6.4	6.6	6.8
(c) with other reforms:																
NI Pension Benefits:																
Basic State Pension	3.5	3.5	3.5	3.4	3.5	3.5	3.5	3.5	3.6	3.6	3.6	3.6	3.7	4.3	4.7	4.6
SERPS / S2P	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.2	1.4	1.7
Non-NI Pension Benefits:																
Pension Credit	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.3	0.2	0.1
Other Pension Benefits	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total Pension Benefits	5.1	5.1	5.0	5.0	5.0	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.9	6.4	6.5
Housing and Council Tax Benefits	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.4
Attendance Allowance & Disability Living Allowance	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5
Total pensioner benefits	6.2	6.2	6.2	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.1	6.8	7.3	7.3

Figure A.8: Detailed additional benefit spend, per cent of GDP

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050	
National Insurance Benefit Changes																	
Basic State Pension																	
- ADIs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	
- coverage	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	
- earnings uprating	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.3	0.4	0.4	0.5	0.5	1.3	2.2	2.8	
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	-0.4	-0.7	
Total additional BSP spend	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.5	1.1	1.8	2.1
State Second Pension																	
- abolition of contracting out in DC schemes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	
- flat-rating	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
- coverage	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.3	
Total additional S2P spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	
Total National Insurance benefits to pensioners	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.5	1.1	1.9	2.1	
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Total additional NI benefit spend	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.3	0.3	0.4	0.4	0.5	1.1	1.9	2.2	
Non-NI Benefits																	
Pension Credit																	
- earnings uprating standard minimum guarantee	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4	0.7	1.0	1.3	
- offset due to increased BSP & S2P	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.5	-0.8	-1.0	
- Savings Credit reforms	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Total additional Pension Credit spend	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	
HB/CTB																	
- earnings uprating HB/CTB	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.3	0.3	0.4	
- offset due to increased BSP & S2P	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	
- SPA increase	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	
Total additional HB/CTB spend	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	
Other Non-NI Benefits - reduction due to SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	

Total Non-NI benefits to pensioners	0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
State Pension Age - increase in working-age spend	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Total additional Non-NI benefit spend	0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
Effect of higher GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.2
Total benefit spend																
Total additional spend: pensioners	0.0	0.1	0.1	0.1	0.2	0.3	0.4	0.5	0.5	0.6	0.7	0.7	0.8	1.4	2.1	2.3
Total additional spend: pensioners and working-age	0.0	0.1	0.1	0.1	0.2	0.3	0.4	0.5	0.5	0.6	0.7	0.7	0.8	1.4	2.1	2.4

Table A.9: Financial effect of contracting out rebates on National Insurance contributions, per cent of GDP

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
Cost of DB rebate	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.3	0.3
Cost of DC rebate	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in contracting out rebate:																
- from flat-rating S2P	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
- SPA change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total	0.7	0.7	0.6	0.6	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.2	0.2	0.2

Annex B – Outcomes for individuals - case studies

B.1 This Annex sets out further analysis relating to the costs and benefits section of Chapter 2. Specifically examples of outcomes for individuals and couples at State Pension age, and State Pension outcomes (both basic State Pension and State Second Pension) for median and high earners in 2010, 2020, 2030, 2040 and 2050.

Outcomes for individuals

- B.2 An important part of reform is to ensure a more generous, simpler State Pension to act as a solid foundation for private saving. Key features are:
- Commitment to uprate the basic State Pension by earnings ensuring a foundation in the long term – means basic State Pension retains its value relative to earnings.
 - Flat rating State Second Pension which provides an additional £1.40 in retirement for each year in employment or caring.
 - So for someone with 30 years of working or caring will get £115, someone with 40 years of working or caring £129 a week.
- B.3 Figures B.2 – B.4 below show the level of income at the point of state pension age in 2050/53 for pensioners who were low, median and high income earners through their working life. They show outcomes under:
- the current system with standard minimum guarantee uprated in line with prices from 2008;
 - the current system with the standard minimum guarantee uprated in line with earnings from 2008; and
 - the whole reform package, including personal accounts (for consistency with similar charts published elsewhere).
- B.4 These charts are presented in constant earnings terms. Increases between the current system in 2050 and under state reform reflect pensioners getting better off faster than earnings growth more widely – ie their income is increasing relative to those of working age. The table below sets out the assumptions for people’s earnings, and working lives.

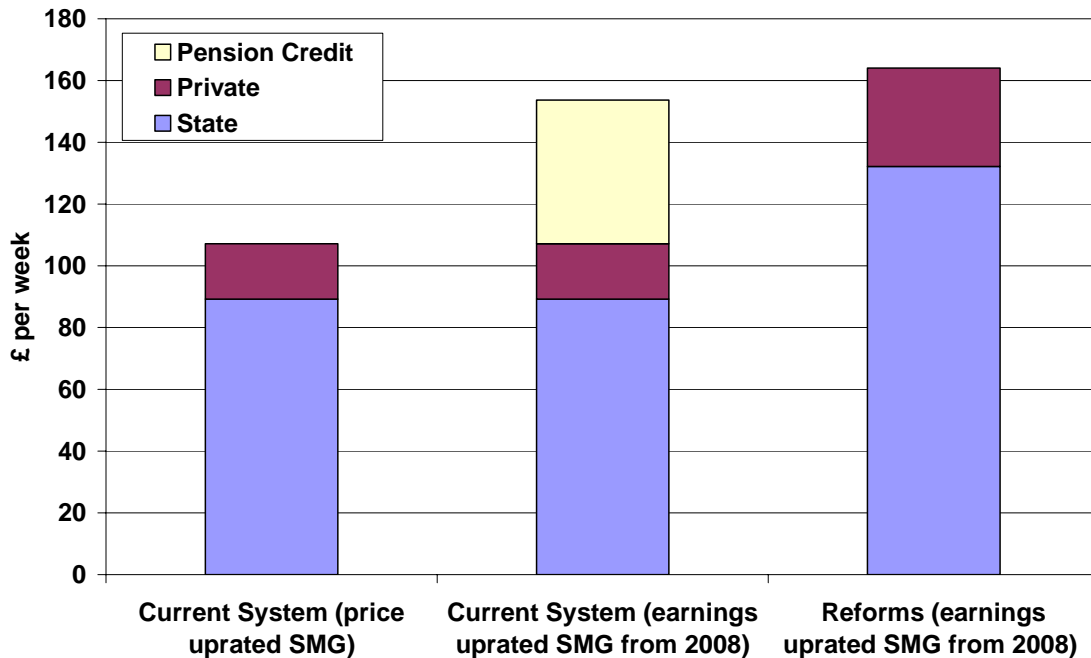
Figure B.1: Table of assumptions:

	Employed from	labour market status	Weekly earnings	Gender
Individuals				
Low earner	25 to SPA	Employed	£230	Male
Median earner	25 to SPA	Employed	£440	Male
High earner	25 to SPA	Employed	£630	Male
Couples				
Low income , made up of:				
Broken work history	25 to SPA	Employed with spells of unemployment.	£180	Male
Medium career break	21 to SPA	Employed with career break for child between 28 and 39.	£420	Female
Moderate income , made up of:				
Median earner	25 to SPA	Employed	£440	Male
Uncredited carer	16 to SPA	Employed then leaves paid employment at 50 because of caring responsibilities, but not eligible for credits.	£220	Female
High income , made up of:				
High Earner	21 to SPA	Employed	£860	Male
Career Break	16 to SPA	Employed with career break from 26 to 33 and works part time from 33 to 40	£240	Female

Notes: After reform, time credited and working are treated the same for the purpose of accruing State Pension. However, individuals are assumed not to be contributing to a personal account during years when they are credited for State Pension. Gender only affects the return from private pensions due to differing annuity rates for men and women.

- B.5 Example of outcomes, especially for people with broken work records, is contained in the Gender Impact of Pension Reform.
- B.6 Figures B2-B4 show that under reform people reaching State Pension age receive more contributory state pension than they would under the current system (with price uprating of standard minimum guarantee and basic State Pension) rolled forward. This is due to earnings uprating the basic State Pension, and for the low earner flat rating of the State Second Pension. These increases in incomes from contributory state pensions as a result of reform will give greater savings incentives as people will see clearer returns on private saving.

Figure B.2. : Low earner’s weekly gross income at State Pension age – current system with Pension Credit uprated by prices or earnings and under reform.



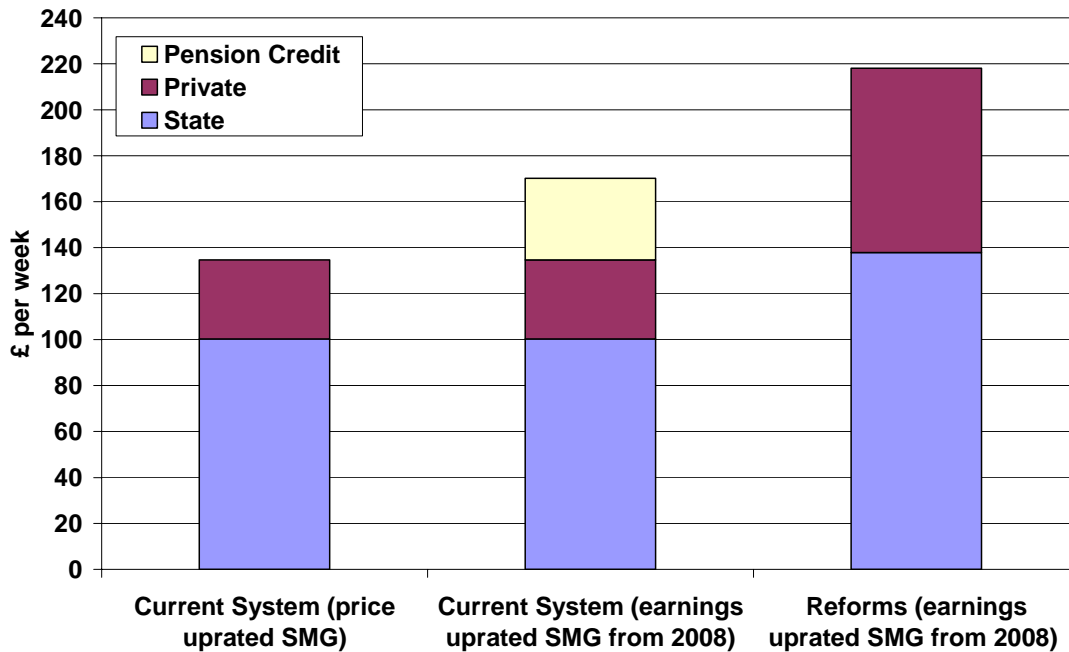
Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes low earner earns £230 a week, has a good working life (40 years of saving and working) and reaches state pension age in 2050 under the current system or 2053 (43 years of saving and working) after reform due to the pension age rises from 65 to 68.

Under the current system it is assumed that saving is 5% of salary between the primary threshold and UEL into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.

After reform it is assumed that saving is 8% of salary between the primary threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

Figure B.3: Median earner’s weekly gross income at State Pension age – under current system with Pension Credit uprated by prices or earnings and under reform.



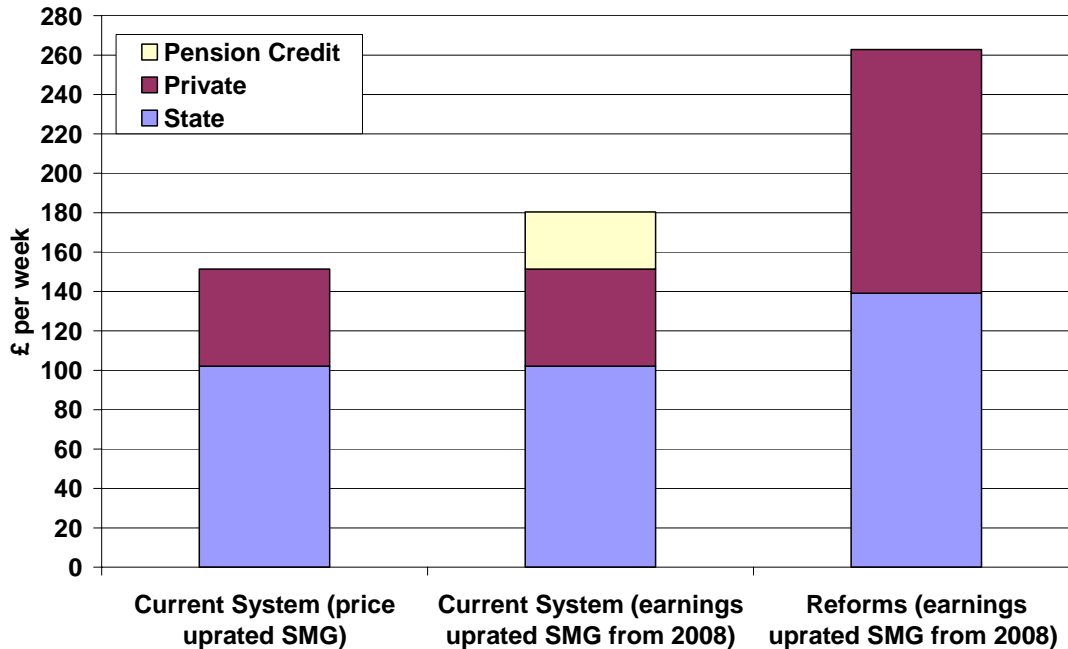
Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes low earner earns £440 a week, has a good working life (40 years of saving and working) and reaches state pension age in 2050 under the current system or 2053 (43 years of saving and working) after reform due to the pension age rises from 65 to 68.

Under the current system it is assumed that saving is 5% of salary between the Primary Threshold and UEL into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.

After reform it is assumed that saving is 8% of salary between the primary threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

Figure B.4: High earner’s weekly gross income at State Pension age – under current system with Pension Credit uprated by prices or earnings and under reform



Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes low earner earns £630 a week, has a good working life (40 years of saving and working) and reaches state pension age in 2050 under the current system or 2053 (43 years of saving and working) after reform due to the pension age rises from 65 to 68.

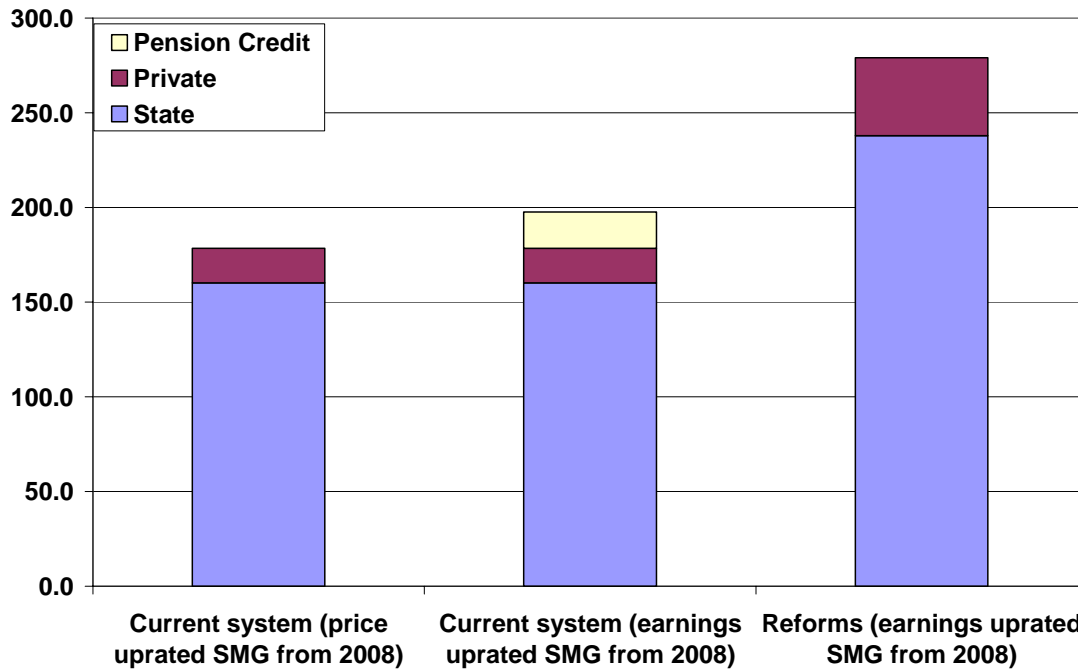
Under the current system it is assumed that saving is 5% of salary between the Primary Threshold and upper earnings limit into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts. After reform it is assumed that saving is 8% of salary between the Primary Threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

Outcomes for couples.

B.7 The following charts show the results for hypothetical couples. This shows that all the hypothetical couples receive:

- an increasing amount of income from contributory State Pension, due to improved crediting arrangements for the basic State Pension and State Second Pension;
- more private income, which reflects the introduction of Personal Accounts; and so
- a higher total income in earnings terms.

Figure B.5: Low income couple – broken work history and median career break



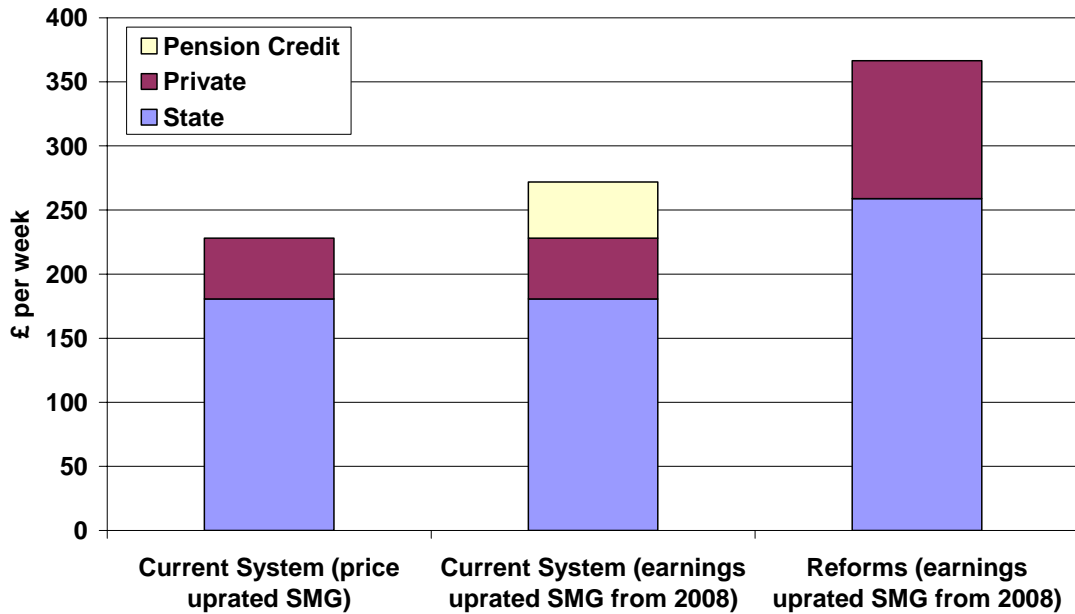
Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes one person with a broken work history and one with a median career break (See assumptions table for full breakdown). They reach state pension age in 2050 under the current system or 2053 after reform due to the pension age rises from 65 to 68.

Under the current system it is assumed that saving is 5% of salary between the Primary Threshold and UEL into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.

After reform it is assumed that saving is 8% of salary between the Primary Threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

Figure B.6: Moderate income couple – median earner and uncredited carer



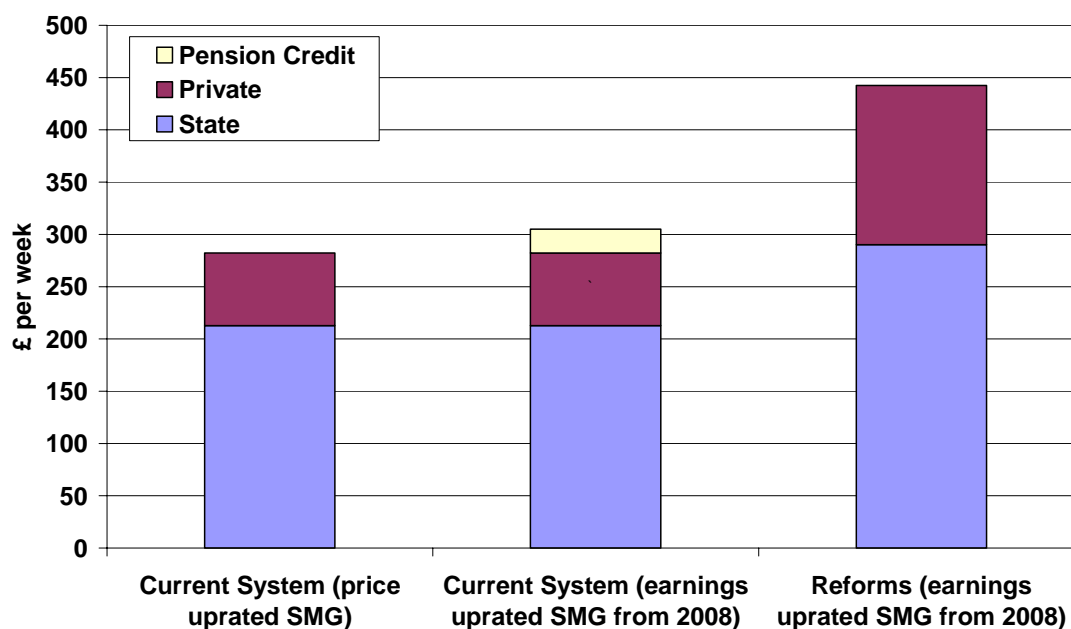
Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes one person is a median earner and one is an uncredited carer (See assumptions table for full breakdown). They reach state pension age in 2050 under the current system or 2053 after reform due to the pension age rises from 65 to 68.

Under the current system it is assumed that saving is 5% of salary between the Primary Threshold and UEL into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.

After reform it is assumed that saving is 8% of salary between the Primary Threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

Figure B.7: High income couple - high earner and career break.



Source: DWP calculations

Notes: In 2005/6 earnings terms, income shown before tax. Assumes one person is a high earner and one has a career break (See assumptions table for full breakdown). They reach state pension age in 2050 under the current system or 2053 after reform due to the pension age rises from 65 to 68.

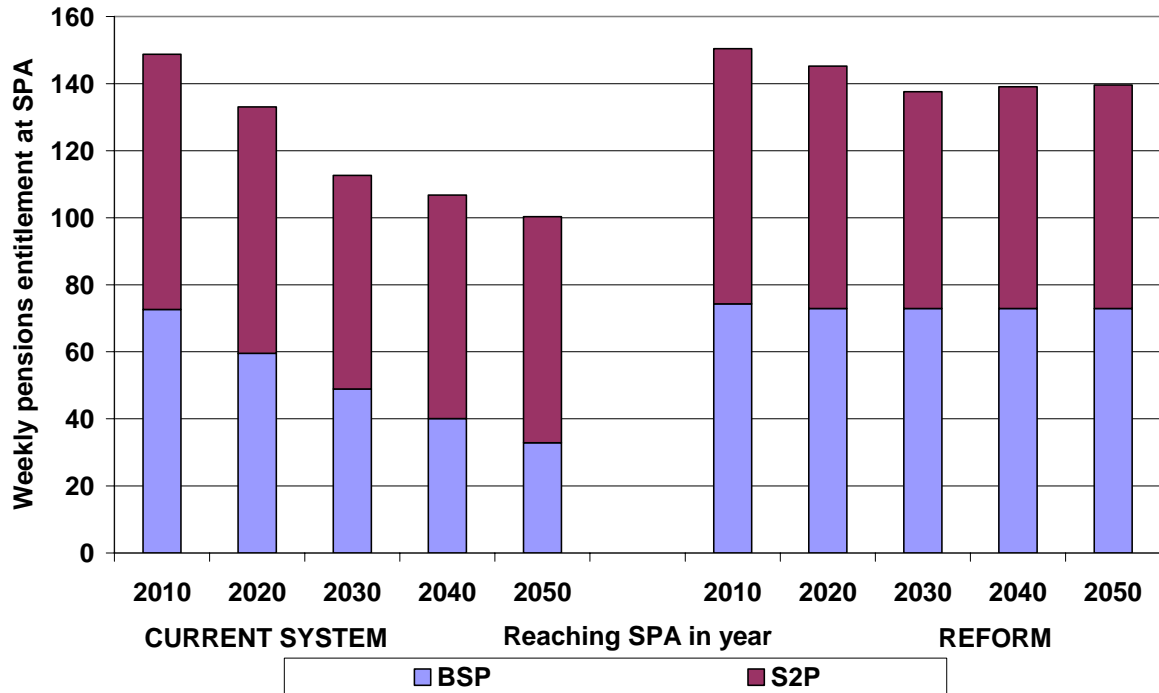
Under the current system it is assumed that saving is 5% of salary between the Primary Threshold and UEL into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.

After reform it is assumed that saving is 8% of salary between the Primary Threshold and the UEL into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).

State Pension outcomes

- B.8 Chapter 2 set out State Pension outcomes for a low earner with a full work (or crediting) history, showing how the State Pension entitlement changes over time – showing that the State Pension increases towards about £140 in earnings terms due to flat rating of State Second Pension. The graphs show these results for median and high earners. The charts show the median and high earners receiving more from the State Pension than they would have, had the current system rolled forward – this is due to earnings uprating of the basic State Pension. Reforms to State Second Pension essentially speed up a process of flat-rating that was already occurring.
- B.9 Figures B.8 and B.9 are in constant earnings terms – showing changes relative to earnings overall. The State Pension is expected to increase in real terms for all pensioners, meaning that pensioners should be able to purchase more in future than they can now.

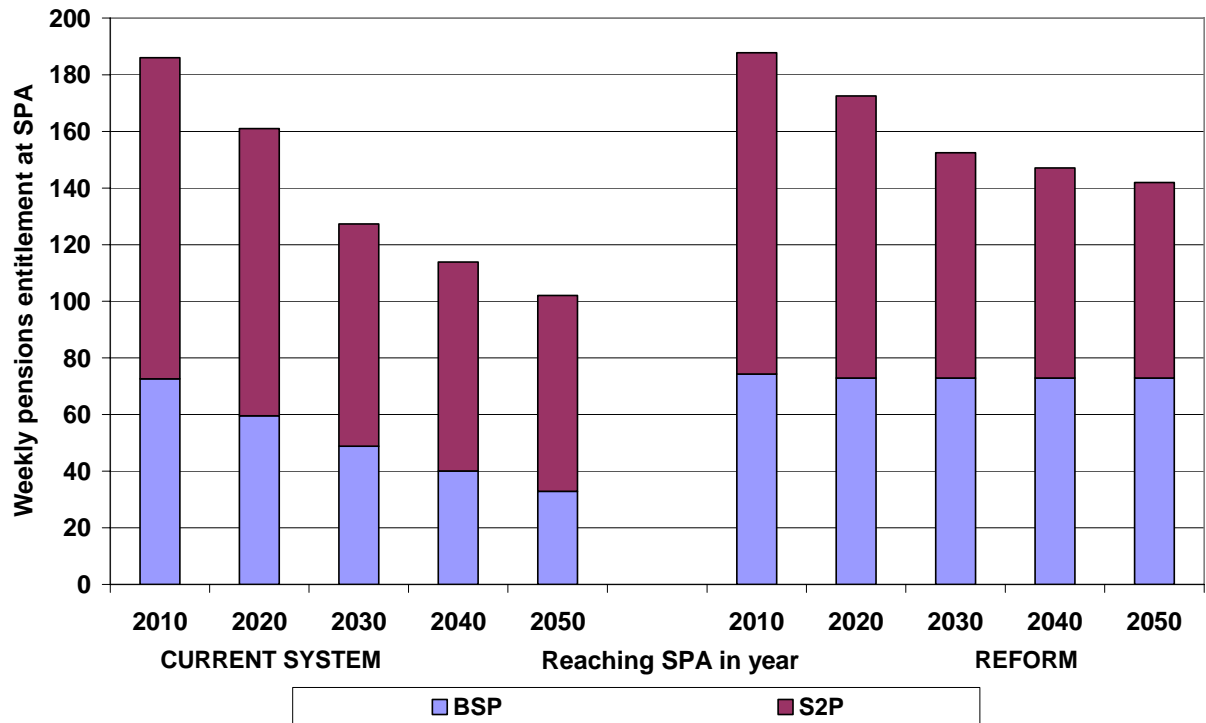
Figure B.8: Basic State Pension and State Second Pension for median earner (£440 per week) - reform compared to current system



Source: DWP calculations

Notes: Assumes that a person has a good working life (works from age 25 to SPA).

Figure B.9: Basic State Pension and State Second Pension for high earner (£630 per week) - reform compared to current system



Source: DWP calculations

Notes: Assumes that a person has a good working life (works from age 25 to SPA).

Glossary

Active members	Active members are current employees who are contributing (or having contributions made on their behalf) to an organisation's occupational pension scheme. The scheme may be open or closed but cannot be frozen.
Additional Pension (AP)	The earnings-related state pension paid in addition to the Basic State Pension . From 1978-2002 it accrued under the State Earnings Related Pension Scheme (SERPS) and from 2002 under the State Second Pension (S2P) scheme.
Annuity	Purchased with an individual pension pot, which has been built up in a defined contribution pension scheme , to provide a pension that is usually payable for life. A single-life annuity pays benefits to an individual. A joint-life/survivors annuity pays benefits to the spouse/dependent partner after death of the first. A level annuity pays constant payments whereas an index-linked annuity pays benefits relating to an index (for example the Retail Prices Index).
Attendance Allowance	A non-means tested, non-contributory and tax free benefit paid as a contribution towards the extra costs faced by severely disabled people who claim help with those costs when over the age of 65.
Baby Boom	A temporary marked increase in the birth rate. There were two baby booms in the second half of the twentieth century: immediately following the Second World War and in the early 1960s.
Basic State Pension (BSP)	There are four main types of Basic State Pension
Category A	Based on contributions paid or credited over a persons working life. Normally person needs 44 years of contributions or credits to qualify for a full basic pension (women born between before 6 April 1955 need less) but the number of years needed can be reduced by Home Responsibilities Protection . Payable on claiming at State Pension Age at the rate of £84.25 per week (2006/07). Those with less than full contribution records receive a pro rata amount subject to a <i>de minimis</i> of 25%. There is an age addition of 25p per week for individuals aged over 80.
Category B	Pension payable under the same conditions as Category A except that the contribution record used is the spouse's contribution record. Widows and widowers receive Category B pension at the same rate as Category A pension. Married women (and married men and people in civil partnerships from 2010) receive Category B pension at £50.50 (approximately 60% of the Category A rate.)
Category C	Largely obsolete – non-contributory pension now only paid to the widows of men who had already reached State Pension

	Age when the National Insurance scheme started in 1948.
Category D	Non-contributory pension paid to residents of the UK aged over 80 and satisfying a residency test of at least 10 years in any continuous 20 year period after their 60th birthdays. The pension is £50.50 per week (2006/07)
For more details see 'A guide to State Pensions', 2005	
Contracting out	The system by which individuals can choose to opt-out of State Second Pension and use a proportion of their National Insurance Contribution to build up a funded pension. There are four types of schemes, into which an individual may contract-out. The rules and rebate levels are different for each. These are: contracted-out salary related scheme, contracted-out mixed benefit scheme, contracted-out money purchase scheme and approved personal pension .
Defined benefit (DB) pension scheme	A pension scheme where the pension is related to the members' salary or some other value fixed in advance.
Defined contribution (DC) pension scheme	A scheme where the individual receives a pension based on the contributions made and the investment return that they have produced. They are sometimes referred to as money purchase schemes.
Disability Living Allowance	A non-means tested benefit, non-contributory and tax free benefit paid as a contribution towards the extra costs of severely disabled people who claim help with those costs when under the age of 65.
Flat-rate provision	The pension rights accrued in the scheme are on a flat-rate basis. Thus the level of earnings is not taken into account by the formula, which is based on the number of contribution years. The alternative to flat-rate provision is earnings-related provision
Funded	Pension schemes in which pension contributions are paid into a fund which is invested and pensions are paid out of this pot.
Gross Domestic Product (GDP)	A measure of economic activity in a country. It is calculated by adding the total value of a country's annual output of goods and services.
Guarantee Credit	A means-tested benefit which is part of the Pension Credit and brings pensioners' income up to a guaranteed minimum level. In 2006/07 the standard minimum guarantee for a single person is £114.05 per week. For a couple the level is £174.05 per week. The guaranteed minimum is higher for some groups, such as disabled people and carers, who qualify for additional amounts.
Guaranteed Minimum Pension (GMP)	The minimum pension that must be provided by a contracted-out salary-related scheme for pensions accrued between 1978 and 1997. The GMP is roughly equivalent to the foregone SERPS from contracting out .
Her Majesty's Revenue and Customs (HMRC)	The new department responsible for the business of the former Inland Revenue and HM Customs and Excise. It is the

	department responsible for National Insurance .		
Home Responsibilities Protection (HRP)	This helps protect the National Insurance records of people who have caring responsibilities by reducing the number of years of contributions or credits they need to qualify for a full basic pension.		
Incapacity Benefit	Benefit paid to people incapable of work and who have either paid or been credited with sufficient National Insurance contributions, or became incapable of work in youth		
Large firm	For statistical purposes, the Department of Trade and Industry usually defines a large firm as one with 250 or more employees.		
Life expectancy	<p>Life expectancy (or the expectation of life) at a given age, x, is the average number of years that a male or female aged x will live thereafter, and is calculated using age and gender-specific mortality rates at ages x, x+1, x+2 etc. Period life expectancy is calculated using age-specific mortality rates for the period under consideration and makes no allowance for changes in age-specific mortality rates after that period. Cohort life expectancy is calculated allowing for subsequent known or projected changes in age and gender-specific mortality rates after that period as he or she gets older. For example, a period life expectancy calculation for a male aged 50 in calendar year 2000 would use male mortality rates for age 50 in 2000, age 51 in 2000, age 52 in 2000 (and so on). The cohort life expectancy would be calculated using male mortality rates for age 50 in 2000, age 51 in 2001, age 52 in 2002 (and so on). The cohort definition is the better measure of true life expectancy.</p>		
Longevity	Length of life.		
Lower Earnings Limit (LEL)	The level of earnings at which an individual is treated as if they have made National Insurance contributions. In 2006/07 the limit is £84 per week or £4,368 per year.		
Means-tested benefits	State benefits where the amount paid depends on the level of income and capital and other personal circumstances.		
Median	The median of a distribution divides it into two halves. Therefore half the group are above the median value and half below.		
National Insurance (NI)	The national system of benefits paid in specific situations, such as retirement, based on compulsory or voluntary contributions. There are four main classes of contributions.		
	Employment Status	Contribution level	Income band

Class 1	Employed	12.8% for the employer and 11% for the employee unless contracted-out.	Pay from Primary Threshold to Upper Earnings Limit (UEL) but credited from Lower Earnings Limit to UEL
Class 2	Self-employed	Flat-rate payment of £2.10 per week for 2006/07.	If earnings below £4,465, eligible for certificate of small earnings exemption.
Class 3	Voluntary	Flat-rate contribution of £7.55 (2006/07).	Voluntary for those not contributing through class 1 or 2.
Class 4	Self-employed	8%	Between Lower Profits Limit (£5,035 in 2006/07) and Upper Profits Limit (£33,540 in 2006/07).
<p>There are special rates of class 1 contributions for mariners and of class 2 for share fishermen and volunteer development workers. In relation to pensions, class 1 contributions accrue rights to Basic State Pension and State Second Pension, while class 2 and 3 contributions accrue rights only to the Basic State Pension. Class 4 contributions do not accrue rights to any benefit.</p>			
National Insurance Recording System (NIRS2)	The HM Revenue and Customs IT system which holds and reconciles contribution records and calculates contributory benefits and personal pension schemes.		
Occupational pension.	A pension which is provided via the employer, but the pension scheme takes the form of a trust arrangement and is legally separate from the employer		
Pension accrual	The build up of pension rights. In a Defined Benefit scheme this may be based on the number of years of contributions.		
Pension Credit	The main means-tested benefit for pensioners, which combines the Guarantee Credit and the Savings Credit .		
Personal pension	A pension which is provided through a contract between an individual and the pension provider. The pension produced will be based on the level of contributions, investment growth and annuity rates. A personal pension can either be employer provided (a Group Personal Pension) or purchased individually.		
Price-indexed	Increasing each year in line with inflation.		
Protected rights	The element of the Defined Contribution pension arising from Contracted-out rebates		

Real terms	Figures have been adjusted to remove the effect of increases in prices over time (i.e. inflation), usually measured by the Retail Prices Index . Thus if something shown in real terms increases then it is rising faster than prices, whereas if it is constant, it rises at exactly the same pace as prices.	
Retail Prices Index (RPI)	This is an average measure of the change in the prices of goods and services bought for consumption by the vast majority of households in the UK.	
Savings Credit	Part of the Pension Credit . It is a means-tested benefit for people aged 65 or over, which accrues at the rate of 60p for each £ of income above a threshold (currently the equivalent of the full basic State Pension) up to a maximum amount (£17.88 for a single person, `£23.58 for a couple).	
Small and Medium Enterprise (SME)	For statistical purposes, the Department of Trade and Industry usually defines a SME as a firm with 249 or fewer employees.	
Small firm	For statistical purposes, the Department of Trade and Industry usually defines a small firm as one with 49 or fewer employees.	
Class	Description	Examples of occupations
Non-manual		
I	Professional	Doctors, chartered accountants, professionally qualified engineers
II	Managerial & technical/ intermediate	Managers, school teachers, journalists
IIN	Skilled non-manual	Clerks, cashiers, retail staff
Manual		
IIIM	Skilled manual	Supervisor of manual workers, plumbers, electricians, goods vehicle drivers
IV	Partly skilled	Warehousemen, security guards, machine tool operators, care assistants, waiting staff
V	Unskilled	Labourers, cleaners and messengers
Standard minimum guarantee	The minimum level of income guaranteed to pensioners through the Guarantee Credit element of Pension Credit . (The guaranteed level for some groups of pensioners, such as severely disabled people and carers, who qualify for additional amounts is higher than the standard minimum guarantee.)	
State Earnings Related	The forerunner of the State Second Pension , which provides	

Pension Scheme (SERPS)	an earnings-related National Insurance pension based on contributions.
State Pension Age (SPA)	The minimum age at which an individual can claim their state pension. It is currently 65 for men and 60 for women born before 5 April 1950. The State Pension Age for women born on or after that date will gradually increase to 65 between 2010 and 2020.
State Second Pension (S2P)	The earnings related National Insurance pension paid on top of basic pension – gives - a more generous pension than would have been provided by SERPS for: Low and moderate earners Carers who are looking after young children or a disabled person Long-term disabled people with broken work records
Tax credits	There are two main types of tax credit. Working Tax Credit is an income related credit for working adults and Child Tax Credit is an income-related credit payable to families with responsibility for children, whether they are in or out of work.
Tax relief	Individuals making contributions to tax approved pension schemes receive tax relief at their marginal tax rate (e.g. a standard rate taxpayer will receive tax relief at 22%). Individuals contributing to Stakeholder Pensions receive tax relief at a minimal rate of 22%. Individuals with very low or no tax liabilities can also receive “tax relief” at 22% on contributions of up to £2,808 per year. Employers’ contributions are made from gross profits and thus are both tax and National Insurance privileged.
Unemployment	The number of unemployed people in the UK is measured through the Labour Force Survey following the internationally agreed definition recommended by the International Labour Organisation, an agency of the United Nations. Unemployed people are: without a job, want a job, have actively sought work in the last four weeks and are available to start work in the next two weeks, or: out of work, have found a job and are waiting to start it in the next two weeks. For some of the ELSA analysis unemployment is not so strictly defined.
Upper Earnings Limit (UEL)	The upper limit on earnings for the purposes of calculating entitlement to State Second Pension . Also the upper limit for most employee National Insurance contributions. In 2006/07 it is £33,540 per year or £645 per week.
Upper Accrual Point (UAP)	Upper Accrual Point in State Second Pension is a mechanism to erode earnings relation
Working age population	Generally defined as those aged 16-59 for women and 16-64 for men.