

Pension Trends

23 June 2009

Chapter 5: State pensions

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*Type of information

NS	Information classed as National Statistics
Non-NS	Information not classed as National Statistics
Mixed	Mixture of NS and non-NS information

State pensions

- Compared with other OECD countries, the gross replacement rate of the UK mandatory (state) pension system is relatively low, at 31 per cent (Figure 5.1). The replacement rate measures how effectively pension systems are able to replace earnings from employment in retirement.
- The contributory state pension is made up of two parts: the Basic State Pension (BSP), which provides a flat-rate pension in retirement, and the additional state pension. A larger proportion of women than of men receive less than the full BSP. In September 2008, 2.3 million female pensioners received 60 per cent of full BSP or less (Figure 5.4).
- Non-contributory (income-related) Pension Credit is made up of two elements: a guarantee credit element which is designed to provide a minimum level of income for pensioners, and a savings credit element. Single women are the largest group of pensioners receiving guarantee credit, with 1.3 million women recipients in August 2008 (Figure 5.6).
- Parliament has recently enacted a number of pension reforms. These will transform the nature of state pension provision from 2010.
- Under the reforms, full BSP is forecast to increase strongly in 2009/10 price terms because the link with earnings will be restored (Table 5.8).
- Department for Work and Pensions modelling of BSP and additional state pension outcomes for male employees on low, median and high earnings shows that under the reforms, all three types of employee will remain above the Standard Minimum Guarantee level in 2010 to 2050, indicating that they would not qualify for guarantee credit (Figure 5.10).
- Employees with broken work histories – particularly women – will see immediate gains at the beginning of the reforms, although women will also face increases in State Pension Age from 2010. It will take longer for the new system to deliver its full benefits to carers (Table 5.11).
- By 2050, 95 per cent of both men and women pensioners should be on full BSP as a result of the reforms (Figure 5.12).
- During the transition period, as the new system replaces the old one, many pensioners will remain on mean-tested benefits. However, this should not undermine the incentives for private pension saving contained in the Pensions Act 2008 because the next generation of pensioners – in particular current employees – will be retiring under the new system.
- In 2007, the Government was expecting to pay just over half of one per cent of GDP more for state pensions and related benefits by 2050 as a result of the reforms than it would have done in their absence (Figure 5.13).

This chapter looks at state pension provision in the UK through the Basic State Pension (BSP), the additional state pension, Pension Credit and related benefits. It starts by comparing the UK's mandatory pension system – provided by the state – with that of other countries in the Organisation for Economic Co-operation and Development (OECD). It then examines the state pension system in place in 2009 (the current system) and outlines the reforms which will be implemented from 2010 as a result of recent legislation.

A key theme of this chapter is change. From 2010 the system will begin to change as a result of measures contained in the Pensions Act 1995 and the Pensions Act 2007. Those retiring from 6 April 2010 will be subject to increases in State Pension Age (SPA) and to different criteria to qualify for state pensions; while from 2012 (or 2015 at the latest) the BSP will be uprated in line with earnings rather than prices. Therefore, most people who are currently of working age will retire under a state pension system which is very different from the one in place at present. Nevertheless, there are at present an estimated 4.4 million men and 7.6 million women over SPA in the UK¹ who retired under the current system; these pensioners will experience only part of the changes. It is therefore of interest to understand how the current system and the reformed system compare, and what will be the impact of the changes in the next four decades.

Mandatory pension provision

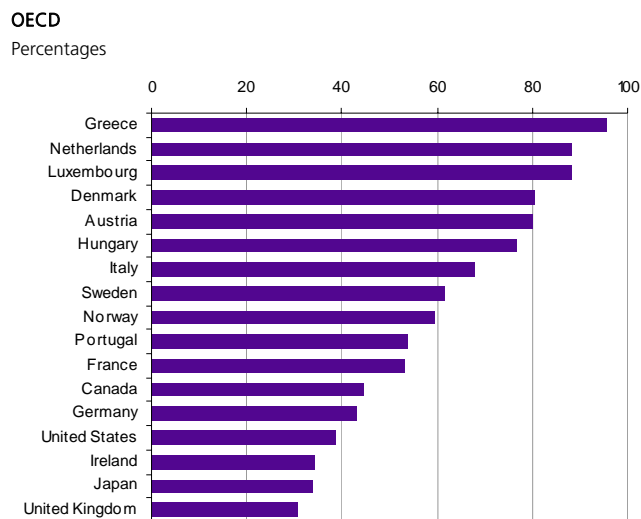
Pension systems are normally made up of two distinct components: a mandatory state component and a voluntary private component, although in some countries there is also a mandatory private component. Figure 5.1 compares gross 'replacement rates' for average earners from mandatory pension schemes for selected OECD countries. The replacement rate is a measure of how effectively pension systems are able to replace earnings from employment in retirement. The gross replacement rate is defined as gross pension entitlement divided by gross pre-retirement earnings². Figure 5.1 shows that the gross replacement rate of the UK mandatory state pension system is relatively low, at 31 per cent. Therefore private pension saving is important to ensure adequate income in retirement (see Chapter 6).

However, for many UK pensioners state pensions and related benefits are an important component of income in retirement. Chapter 11 shows that this is particularly the case for certain groups such as single women pensioners: in 2006/07, 61 per cent of the average gross weekly income of single women pensioners came from state pensions and related benefits. There were 3.4 million single women pensioners in 2006/07

according to the Pensioners' Income Series published by the Department for Work and Pensions (DWP).

Figure 5.1

Gross replacement rate for an average earner from mandatory pension schemes in selected OECD countries^{1,2}



1. Norway and Sweden have a private component in their mandatory schemes.

2. For the UK, the model includes all state pensions (the basic and additional state pension and Pension Credit) in mandatory pension schemes; there is no private component.

Source: OECD pension models

It is important to note that the position of the UK in Figure 5.1 reflects the gross replacement rate of the current system in the UK compared with the current systems of other OECD countries. It does not take into account the impact of reform, which will be explored in this chapter. Nor does it provide an indication of the absolute (as opposed to the relative) value of income from mandatory pension schemes, now or in the future. It is also important to note that, as with all exercises in cross-country modelling, the OECD model relies on a number of simplifying assumptions³.

Contributory state pensions

In the UK, state pension provision is divided into 'contributory' and 'non-contributory' pensions. The contributory state pension is made up of two parts: the BSP, which provides a flat-rate pension in retirement⁴, and the additional state pension, under which employees (but not the self-employed) may add to the BSP by making extra contributions related to earnings in order to receive additional pension payments.

The additional state pension was first introduced as the state graduated retirement benefit scheme (GRAD) in 1961. It was

replaced by the State Earnings-Related Pension Scheme (SERPS) in 1978 and by the State Second Pension (S2P) in 2002. S2P provides a more generous additional state pension for those on lower earnings and extends coverage to include people receiving Child Benefit for a child under 6 or caring for a severely disabled person for at least 35 hours a week and, provided they had been in work for at least 10 per cent of their working life (from 1978 onwards), people with a long-term illness or disability.

To receive full BSP (£95.25 per week in 2009/10), a man needs 44 qualifying years and a woman needs 39 qualifying years. A qualifying year is one in which enough National Insurance (NI) contributions have been paid, normally through work. However, qualifying years may also be built up through credits or Home Responsibilities Protection (HRP – see **Box: Credits and HRP**). If a man has worked less than 44 years and a woman less than 39 years, they will receive a partial payment of BSP in proportion to the number of qualifying years, as long as they have at least one quarter of the full number of qualifying years (a minimum of 11 years for men and 10 for women) and at least one year comes from paid contributions rather than credits. The BSP is paid from SPA, which is currently 65 for men and 60 for women.

Credits and HRP

There are two ways that people can build up qualifying years for the BSP other than through work: through credits and Home Responsibilities Protection (HRP).

Credits are awarded to people who cannot work because of sickness or disability, people receiving Carer’s Allowance, Working Tax Credit, Statutory Maternity or Adoption Pay. They are also awarded to people who are unemployed and available for and actively seeking work, people on jury service, prisoners whose convictions have been quashed and people on an Approved Training Course.

HRP was introduced in April 1978. It is provided automatically for people receiving Child Benefit for a child under 16 and people on Income Support who are caring for a sick or disabled person. Registered foster carers and people caring for at least 35 hours a week for someone on Attendance Allowance, Constant Attendance Allowance or Disability Living Allowance can also apply for HRP. It works by reducing the qualifying years that are required for full BSP, and may also be used for S2P.

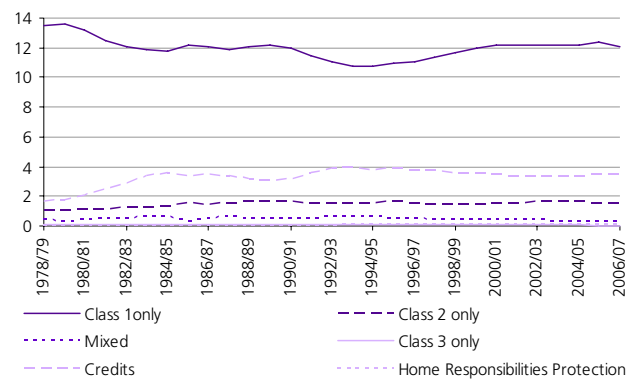
Entitlement to contributory state pensions is based on payment of NI contributions:

- Class 1 contributions are mandatory for all employees, and are paid by both the employee and the employer as a percentage of a band of earnings. There is partial rebate for members of private pension schemes which are ‘contracted out’ of S2P (see Chapter 8).
- Class 2 contributions are payable by the self-employed and are flat rate. Self-employed people also pay Class 4 (profit-related) contributions.
- Class 3 contributions are voluntary, and are often paid in cases where people have not built up a full contributory state pension entitlement through work.

Figure 5.2

Number of men accruing a contributory year: by type of contribution^{1,2,3}, 1978/79 to 2006/07

United Kingdom
Millions



- 1 The figures for 2005/06 and 2006/07 are provisional. They may change as further information becomes available.
- 2 ‘Mixed’ is combinations of credits and classes of NI contributions.
- 3 The data comes from DWP’s Lifetime Labour Market Database 1% sample of the National Insurance Recording System.

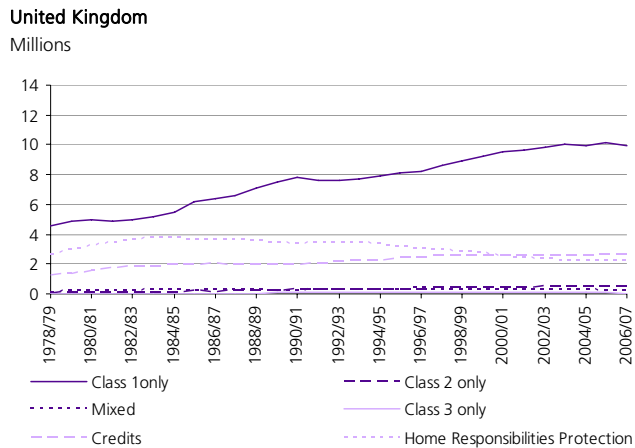
Source: Department for Work and Pensions

Figure 5.2 shows that most men build up entitlement to contributory state pensions by paying Class 1 NI contributions. There were an estimated 12.1 million men paying Class 1 only contributions in 2006/07, up from 11.0 million a decade earlier (1996/97) but down from 13.5 million in 1978/79. The number of men with NI credits has changed little over the past decade, and was estimated at 3.5 million in 2006/07. However, the number with credits rose in the recession and industrial restructuring of the early 1980s, from 1.7 million in 1978/79 to 3.5 million in 1984/85.

For women (Figure 5.3), the main change over the last three decades has been a steady increase in numbers building up entitlement to contributory state pensions through Class 1 NI contributions, as women’s participation in employment has increased and fewer women have been paying the ‘married

women’s stamp’ (see below). In 2006/07, there were an estimated 9.9 million women with Class 1 only contributions, compared with 4.5 million in 1978/79. Meanwhile, numbers of women contributing via HRP have fallen over the past decade, from 3.1 million in 1996/97 to 2.2 million in 2006/07.

Figure 5.3
Number of women accruing a contributory year: by type of contribution^{1,2,3}, 1978/79 to 2006/07



- 1 The figures for 2005/06 and 2006/07 are provisional. They may change as further information becomes available.
- 2 ‘Mixed’ is combinations of credits and classes of NI contributions.
- 3 The data comes from DWP’s Lifetime Labour Market Database 1% sample of the National Insurance Recording System.

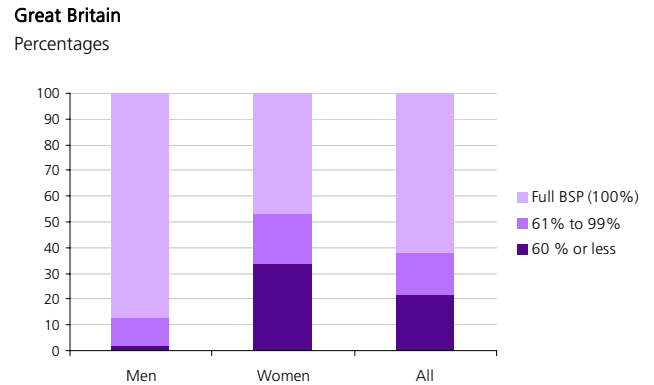
Source: Department for Work and Pensions

A key area of debate in relation to the BSP in recent years has been whether it should be uprated each year in line with prices or in line with earnings. The BSP has been uprated in line with prices since the early 1980s. This means that it is protected from inflation but, as the earnings of the working age population normally rise faster than inflation, the income that pensioners receive from BSP has fallen behind the earnings of working age people.

Another problem with the system that was identified by the Pensions Commission⁵ is that many women have failed to build up a full or near-full BSP entitlement because of broken work histories and part time work patterns. In addition, some women claim BSP through their husbands rather than in their own right. In such circumstances, women receive 60 per cent of the husband’s BSP (£57.05 if their husband receives full BSP in 2009/10) and no additional state pension. This group of women includes women who opted to pay the ‘married women’s stamp’ (reduced rate NI contributions) when in employment rather than building up their own entitlements. Women have been unable to opt to pay the married women’s stamp since April 1977, although they could continue to pay

it if they had already chosen this option; in 2006/07, fewer than 25,000 women were paying reduced rate contributions.

Figure 5.4
Proportion of pensioners on different percentages of Basic State Pension¹, September 2008



1 Excludes overseas cases.

Source: Department for Work and Pensions

Table 5.5
Additional state pension¹: numbers receiving and average amounts, September 2008

Great Britain	Men	Women	All
Numbers receiving (millions) ²	4.1	6.1	10.2
Mean amount (£ per week, gross)	61	22	36
Median amount (£ per week, gross)	60	9	22

1 Additional state pension includes GRAD, SERPS and S2P (both contracted out and not contracted out contributions).

2 Excludes overseas cases (around 1 million).

Source: Department for Work and Pensions

Figure 5.4 shows that a larger proportion of women than of men in Great Britain received less than the full BSP in September 2008: 34 per cent of female pensioners (2.3 million women) received 60 per cent of full BSP or less, compared with 2 per cent of male pensioners (under 0.1 million). Similarly, although 6.1 million women were receiving additional state pension in September 2008, compared with 4.1 million men (Table 5.5), the mean amount received per week by women was £22 compared with £61 for men. Moreover, the median amount received by women was only £9, indicating that 50 per cent of women received £9 or less per week in additional state pension. This is partly because when the additional state pension was first introduced, it was assumed that it would be accrued mainly by men, and women would receive a share of the entitlement after their husband’s death. Women who have reached SPA more recently – more

of whom have built up entitlement to additional state pension in their own right through employment – have higher levels of entitlement than previous cohorts of women.

Non-contributory state pensions and benefits

The non-contributory (income-related) Pension Credit⁶ was introduced in October 2003 to replace the Minimum Income Guarantee (MIG) for those aged 60 and over, which had been in place since April 1999. Pension Credit is made up of two elements: a guarantee credit element which is designed to provide a minimum level of income for pensioners, and a savings credit element, intended to provide an additional amount for pensioners with low or modest incomes in addition to the BSP and to encourage saving. The age for starting to receive guarantee credit is linked to women’s SPA, currently 60; savings credit is for those aged 65 and over⁷.

In 2009/10, the standard guarantee credit level is £130.00 per week for a single person and £198.45 per week for a couple (two people living together). These amounts are known as the Standard Minimum Guarantee because they aim to ensure that all pensioners have at least this minimum level of income. In addition to the Standard Minimum Guarantee, a carer may get an extra £29.50 per week and a disabled person may receive an extra £52.85 per week. Help with mortgage interest payments may also be provided. Guarantee credit is uprated in line with earnings⁸.

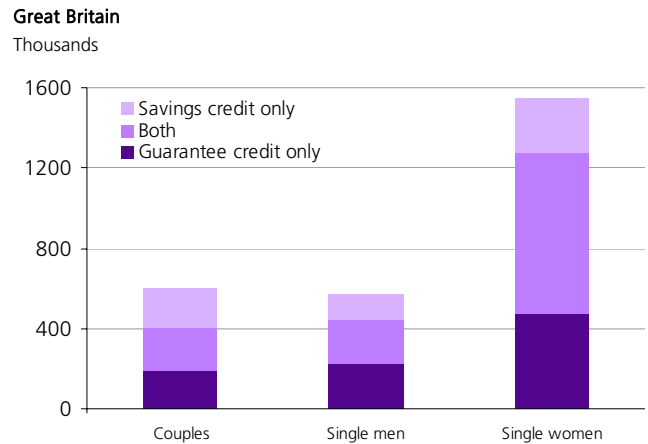
Pension Credit is non-contributory: to claim it, there is no requirement that a person must have made NI contributions. However, the guarantee credit element is means tested – in order to qualify, the pensioner’s income is assessed and guarantee credit is paid if income is below a certain level. This may provide a disincentive to low earners to build up private savings for their retirement, through pensions or other savings vehicles, because if they are assessed for guarantee credit when they retire, income from such savings may count against them. The Pension Credit system attempts to offset this disincentive effect by including the savings credit element, which rewards people over 65 for their savings with payments of up to £20.40 per week for a single person and £27.03 per week for a couple (2009/10). Increases to savings credit are approved by Parliament on a year-to-year basis.

Figure 5.6 shows numbers of Pension Credit claimants in Great Britain in August 2008, by type of claim: guarantee credit only, both guarantee and savings credit, and savings credit only. Single women were the largest group of pensioners receiving guarantee credit, with a total of

1.3 million women recipients (0.5 million on guarantee credit only, and 0.8 million on both guarantee credit and savings credit).

Figure 5.6

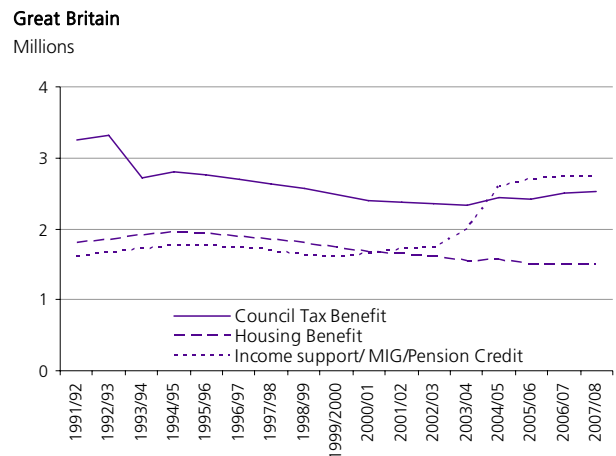
Pension Credit claimants: by type of claim, August 2008



Source: Department for Work and Pensions

Figure 5.7

Number of people aged 60 and over receiving income-related benefits^{1,2}, 1991/92 to 2007/08



1 Pension Credit was introduced in October 2003. Before this, the main income-related benefits for people over 60 were income support and the Minimum Income Guarantee (MIG).

2 Numbers cannot be added together to produce totals, as many individuals receive more than one benefit.

Source: Department for Work and Pensions

In addition to Pension Credit, there are two other important non-contributory (income-related) benefits for pensioners: Housing Benefit and Council Tax Benefit. These are designed to cover rental and council tax costs, which often represent a large part of the budget of pensioners on low incomes (see

Chapter 11). They are means tested, and pensioners who are in receipt of the guarantee credit element of Pension Credit are entitled to receive Housing Benefit and Council Tax Benefit covering their full rental and council tax costs.

Figure 5.7 shows that when the MIG was replaced with Pension Credit in 2003, there was a sharp increase in people aged 60 and over in Great Britain receiving this type of benefit. There has also been a slight increase in the numbers claiming Council Tax Benefit in the past five years, to 2.5 million in 2007/08, although this represents a fall in the numbers since the early 1990s, when there were over 3 million claimants. By contrast, the numbers of people aged 60 and over in receipt of Housing Benefit have declined steadily since the mid-1990s, from 1.9 million to 1.5 million in 2007/08.

The reformed state pension system

In recent years, Parliament has enacted a number of pension reforms. These will transform the nature of state pension provision from 2010. This part of the chapter looks at the nature of the reforms and what they will mean for people retiring in coming years.

The reforms which will be implemented from 2010 cover a number of areas:

- equalising and raising SPA;
- reducing the number of qualifying years for BSP;
- introducing a system of carer credits for BSP and S2P;
- restoring earnings uprating for BSP; and
- making S2P into a more flat-rate pension.

The first key change is the equalisation and raising of SPA. The Pensions Act 1995 increases women's SPA from 60 to 65 between 2010 and 2020, bringing it into line with men's. Thus, by 2020, women will be entitled to the BSP and S2P from age 65 rather than 60, as they are at present. This measure also has implications for the guarantee credit element of Pension Credit, which is linked to women's SPA: as women's SPA rises, the age at which people (including men) can begin to claim guarantee credit will rise. The Pensions Act 2007 provides for further changes to SPA, raising SPA for men and women from 65 to 68 between 2024 and 2046. Again, in principle, this increase reads across to other state benefits where entitlement is dependent on a person having attained SPA, such as Pension Credit (see Chapter 1).

The second key change – under the Pensions Act 2007 – is the reduction in the number of qualifying years for BSP. People reaching SPA on or after 6 April 2010 will only need 30 qualifying years to receive full BSP. This will be accompanied by an end to the rule that individuals must have accumulated at least one quarter of qualifying years (11 years for men and 10 years for women) to get any BSP.

The third key change is to the mechanisms by which people who are not working but are caring for others can build up BSP. HRP will be replaced with a new system of weekly 'carer credits' for parents receiving Child Benefit for children up to age 12, foster parents and people caring for one or more severely disabled person for at least 20 hours a week⁹. From 2010, people in these categories will be able to build up entitlement to S2P through the same system of credits as for BSP. Those who have already built up entitlements through HRP will have them converted: HRP accrued under the old system (up to a maximum of 22 years) will be converted into credits under the new system.

The second and third changes between them mean that it will be easier for people with broken work histories to build up state pension entitlement. There will also be an end to the rule that at least one year of the qualifying years must come from paying NI contributions through working, so people who have never worked will be able to qualify. These changes mean that more people will qualify for a full BSP and for S2P.

Table 5.8

Full Basic State Pension in earnings and price terms, 2012 to 2050

	United Kingdom			£ per week
	With reform ¹		Without reform ²	
	2009/10 earnings terms	2009/10 price terms	2009/10 price terms	
2012	97	101	101	
2020	97	116	102	
2030	97	142	103	
2040	97	173	105	
2050	97	211	106	

1 Assuming uprating by prices or 2.5 per cent underpin until 2012, and by earnings thereafter.

2 Assuming earnings link not restored.

Source: Department for Work and Pensions

The fourth key change is that for BSP, the link with earnings will be restored, so that BSP will be uprated in line with earnings rather than prices. The earnings link is expected to be restored in 2012, and must be restored by 2015 at the latest. Table 5.8 shows the impact of this change, modelled by DWP, assuming a start date of 2012. The table shows that if the current situation continued (the 'without reform' scenario), weekly full BSP would remain roughly the same between 2012 and 2050 in 2009/10 price terms¹⁰. By contrast, under the 'with reform' scenario weekly full BSP is forecast to increase strongly in 2009/10 price terms, from £101 in 2012 to £211 in 2050.

This means that in 2050, the purchasing power of BSP should be around twice that of BSP in 2012. This is because under reform, BSP will be uprated in line with earnings rather than prices, remaining constant (at £97 per week for full BSP) in 2009/10 earnings terms. It will maintain its value relative to the incomes of the working age population, which tend to increase ahead of inflation. According to DWP¹¹, "putting outcomes in 'earnings terms' gives people a better idea of how well off they may feel in the future if they compare their income against the earnings of working age people at the time, rather than against the living standards of today".

The final key change is the reform of the payments which people will receive through S2P. The Pensions Act 2007 provides for the earnings-related element of the additional state pension to be gradually withdrawn and replaced by a flat-rate accrual for each year of contributions and/or credits, to be uprated by earnings during working life and by prices from pension age. This is not an entirely new measure: the change to a more flat-rate approach began with SERPS in the 1990s, and has been applied to S2P since 2002. The Pensions Act 2007 increased the pace of change and introduced a fixed flat-rate amount. The fixed flat-rate S2P is expected to be in place by 2012, and must be in place by 2015 at the latest. Assuming a start date of 2012, the flat rate amount would be £1.60 per week in 2009/10 earnings terms per year worked, up to a maximum of 52 years. The transition to the flat-rate system should be complete by the 2030s.

An additional change, which affects women who paid the 'married women's stamp' (see above: **Contributory state pensions**), is that BSP payments to women in this position will no longer be conditional on the husband claiming his BSP. This is designed to prevent situations where married women over SPA (who may be separated or divorced) are unable to receive BSP because their husbands are not yet receiving it.

With and without reform comparisons

This section addresses the question of what the reforms mean for state pension provision in the UK. It looks first at the difference between the current system and the reformed system from the **individual** perspective. It then considers the comparison from the point of view of the state pension system as a whole (the **aggregate** perspective). The comparison from an individual perspective is relatively simple, as it involves thinking about the experiences of different types of individuals retiring under the new system, compared with the experiences of similar individuals who retired under the old system. The aggregate analysis is more complex. This involves making assumptions about how many individuals of each type will be in retirement at different points in the future.

Most of the debates which have arisen about the impact of the reforms focus on aggregate analysis relating to the 'transition period' - when the new system has been introduced but people who accumulated rights under the old system are still alive and drawing state pensions. During the transition period, some commentators have expressed concern that means testing will continue to create disincentives for saving. Transition issues will be discussed at the end of this section; but although they are important, it is equally important not to lose sight of what the new system will look like once it has been fully implemented.

The individual perspective

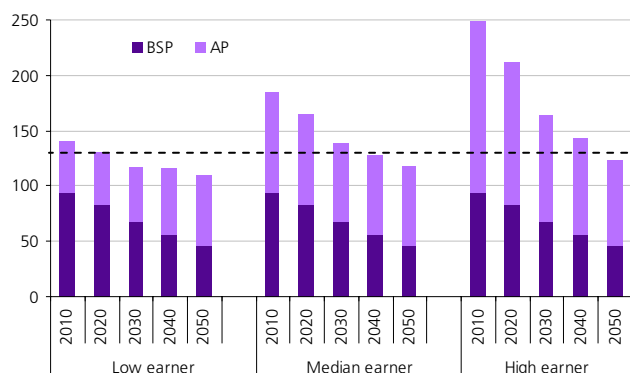
From the point of view of the individual, the impact of the reformed system on the BSP is relatively simple. People reaching SPA on or after 6 April 2010 will receive more BSP in many cases than those retiring before this date. The combination of fewer qualifying years and alternative ways of gaining qualifying years through carer credits mean that it will be easier to qualify for full BSP. Moreover, from 2012 (or 2015 at the latest), BSP will rise in line with earnings rather than in line with prices as it does at present. As time progresses, people will not be able to claim their state pension entitlements until later because of rising SPA, but when they do so, they will receive more generous payments.

Figures 5.9 and 5.10 show a comparison of outcomes under the 'without reform' and 'with reform' scenarios for three individual examples modelled by DWP. In all three examples, the individual is a male employee with a full work history, entitling him to full BSP – although the amount of time that he is required to make NI contributions to get full BSP is reduced to 30 years under the reformed system. The three

individuals represent a low earner, a median earner and a high earner.

Figure 5.9
Evolution of Basic State Pension and additional state pension without reform in 2009/10 earnings terms^{1,2}

United Kingdom
 £ per week



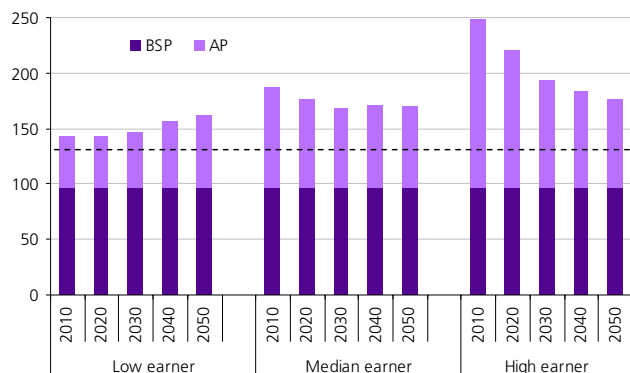
1 Assumes person is a male employee with a full working history from age 25 to SPA, qualifying him for full BSP and for additional state pension (AP). Low earner earns £13,930 per year, median earner earns £25,800, high earner earns £43,860.

2 The dotted line shows the level of Standard Minimum Guarantee for a single person: £130 in 2009/10.

Source: Department for Work and Pensions

Figure 5.10
Evolution of Basic State Pension and additional state pension with reform in 2009/10 earnings terms^{1,2,3}

United Kingdom
 £ per week



1 Assumes person is a male employee with a full working history from age 25 to SPA, qualifying him for full BSP (30 qualifying years) and for additional state pension (AP). Low earner earns £13,930 per year, median earner earns £25,800, high earner earns £43,860.

2 The dotted line shows the level of Standard Minimum Guarantee for a single person: £130 in 2009/10.

3 Assumes that BSP is re-linked to earnings from 2012 and that the fixed flat-rate S2P is in place from 2012.

Source: Department for Work and Pensions

The information is presented in 2009/10 earnings terms. Therefore, in Figure 5.9 the amount of BSP is projected to fall between from £94 a week in 2010 to £46 a week in 2050 (given that without reform BSP is uprated by prices, not earnings). By contrast, in Figure 5.10, BSP remains the same at £97 a week in 2009/10 earnings terms. The individual also receives additional state pension payments, depending on the amount of contributions he has made during his working life. There is little difference in additional state pension payments in the pre- and post-reform scenarios for someone with a full work history, mainly because the changes making SERPS and S2P more flat rate were initiated before the recent reforms, and are already being implemented (see previous section: **The reformed state pension system**).

Figure 5.10 shows that in the ‘with reform’ scenario, all three examples (low, median and high earner) remain above the Standard Minimum Guarantee level, indicating that they would not qualify for the guarantee credit element of Pension Credit because the amount of BSP and S2P which they receive is above £130 per week in 2009/10 earnings terms. By contrast, under the ‘without reform’ scenario, by 2050 all three fall below the Standard Minimum Guarantee level, with the low earner falling below this level shortly after 2020. This means that although all three examples have full work histories qualifying them for full BSP as well as for S2P payments, under the ‘without reform’ scenario they would all be able to claim guarantee credit by 2050.

The aggregate perspective

The individual perspective is a good starting point for looking at the aggregate impact of the reforms. However, the examples presented in Figures 5.9 and 5.10 are not representative of the retired population, which includes not only male employees with full work histories, but people with broken work histories (particularly women) and the self-employed.

Table 5.11 is a qualitative description of how different categories of working age individual will be affected by the reforms as they reach SPA over the next four decades. The table highlights the main categories of working age individual – employees; the self-employed; non-workers such as the unemployed accumulating qualifying years through credits; and carers, many of whom will be able to convert HRP entitlements built up before April 2010. The table is a simplification – there are more categories than those shown, and many individuals experience a combination of categories as they move in and out of employment – but it illustrates how the changes will affect different categories of individual over time.

Table 5.11 shows that employees with broken work histories will gain at the beginning (6 April 2010), as they will qualify immediately for full BSP with the minimum 30 qualifying years, as well as for AP (in proportion to the number of years they have made NI contributions, up to a maximum of 52 years). Women in particular are likely to gain because more female than male employees take breaks from work to care for children, and therefore fail to accrue full BSP though employment under the current system. However, women will also face increases in SPA from 2010.

For carers, it will take longer for the new system to deliver its full benefits, particularly for those who could not claim HRP under the old system. But by 2040, as a result of the new system of carer credits which will replace HRP from April 2010, all carers should be in a position equivalent to that of an employee with a full work history. Therefore, once the system is fully implemented, most people should be able to claim full BSP as well as sufficient additional pension to take them above the Standard Minimum Guarantee level.

The self-employed and non-workers who build up qualifying years through credits, such as the unemployed (see **Box: Credits and HRP**) will benefit from the reform of BSP, but will not accrue rights to an additional pension. Their position with regard to the additional state pension will remain the same under the reformed system as it was in the old system. It is mainly individuals in these two categories who may continue to fall back on non-contributory (means-tested) benefits if they have no other source of income in retirement.

Although they are not explicitly included in Table 5.11, outcomes for individuals who experience a combination of categories are also important for the aggregate result under the reformed system. It is common for individuals to move in

and out of employment, or to move from working as an employee to being self-employed and vice versa. Although the self-employed receive no additional state pension under the new system, someone who ends their working life as a self-employed person but who has been employed earlier in life would have accumulated some additional pension entitlement. Similarly, women who have built up qualifying years though a combination of NI contributions from employment and HRP before April 2010 should gain when they retire under the new system, as they will need only 30 qualifying years (from the two sources) to receive full BSP.

Figure 5.12 shows calculations by DWP using the Government Actuary Department's retirement pension model for the number of people who will be in receipt of the BSP in 2010, 2030 and 2050. By 2050, 95 per cent of both men and women pensioners should be on full BSP in the 'with reform' scenario. For women, this will be an important change compared with the current position.

The 5 per cent of men and women who are expected to be on less than full BSP under the 'with reform' scenario in 2050 are people who have not made 30 years worth of contributions to their NI records during their working (or caring) lives. In 2050 this proportion of the pensioner population, together with those who qualify for full BSP but have been unable to accrue additional state pension – such as the self-employed and the unemployed – and have insufficient private savings, could be eligible for the guarantee credit element of Pension Credit (depending on their partner's income if they are living in a couple). A further group which will continue to receive guarantee credit is that of people who are entitled to additional amounts of guarantee credit above the standard level because of disability or caring needs.

Table 5.11

Entitlement to Basic State Pension and additional state pension for main categories of working age individual from 6 April 2010, by year individual reaches SPA¹

Categories of individual ²	2010	2020	2030	2040
Employees with 30+ qualifying years	Full BSP, and AP	Full BSP, and AP	Full BSP, and AP	Full BSP, and AP
Self-employed with 30+ qualifying years	Full BSP, no AP	Full BSP, no AP	Full BSP, no AP	Full BSP, no AP
Non-workers with 30+ qualifying years through credits	Full BSP, no AP	Full BSP, no AP	Full BSP, no AP	Full BSP, no AP
Carers with some/no HRP before April 2010	Some/no BSP, some/no AP	Full/some BSP, some AP	Full/some BSP, some AP	Full BSP, and AP

1 AP = additional state pension (GRAD, SERPS and S2P). The table does not attempt to quantify AP, but once AP becomes fully flat rate, 30 qualifying years will provide an AP of £48 a week and the maximum 52 qualifying years will provide an AP of £83 a week in 2009/10 earnings terms.

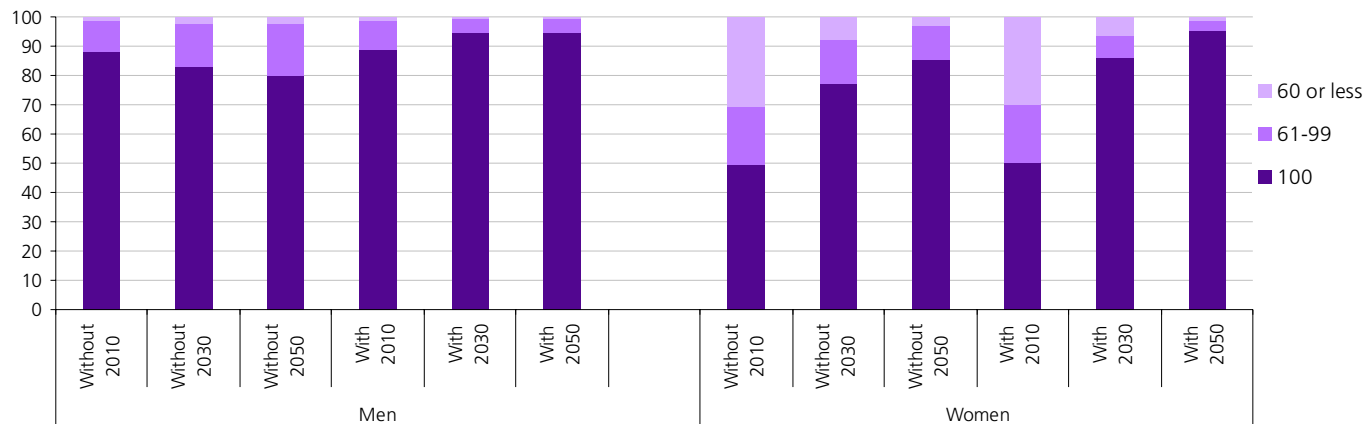
2 The categories of individual are not a comprehensive list, and many individuals will experience a combination of categories.

Source: Office for National Statistics analysis

Figure 5.12

Proportion of pensioners entitled to different proportions of Basic State Pension with and without reforms¹, 2010 to 2050

Great Britain
Percentages



¹ DWP calculations based upon the Government Actuary Department's retirement pension model.

Source: Department for Work and Pensions

Transition

The Pensions Act 2007 did not provide for a sudden replacement of the old system with a new one. Instead, the reforms involve a gradual transition. During the transition period, which begins on 6 April 2010, there will still be substantial numbers of pensioners claiming means-tested benefits in the form of the guarantee credit element of Pension Credit, Housing Benefit and Council Tax Benefit.

The main category of individuals affected by the gradualness of the transition is that of people with broken work histories – such as women who have taken time off work to care for children – who are currently over SPA or who will reach SPA between now and 6 April 2010. For this category of individuals, the old rules governing the accrual of state pension entitlements apply. In addition, there is the category of carers who will reach SPA on or after 6 April 2010 and who will not have enough time to build up a full entitlement under the new system before they reach SPA (see Table 5.11). These two categories of people will be part of the pensioner population for some years to come. This is why there are still expected to be 14 per cent of women with less than the full BSP in 2030 under the 'with reform' scenario in Figure 5.12.

Therefore means testing of pensioners on a relatively large scale is likely to continue for some time. However, this should not undermine the incentives for private pension saving contained in the Pensions Act 2008, as some commentators have suggested. There are two reasons for this:

- Means testing of pensioners on a relatively large scale is likely to continue because there are still many pensioners who have built up state pension entitlements under the old system, which was less generous. However, these people are already retired, or are about to retire. It is the next generation of pensioners – people currently of working age – which is saving for retirement. As a result of the Pensions Act 2007, this generation faces a different set of rules because they will be retiring under the new system.
- The Pensions Act 2008 is about encouraging private pension provision in the workplace. It targets employees, particularly those on low earnings who are less likely to participate in pension schemes than those on higher earnings (see Chapter 7). Under the reforms, few employees are likely to fall below the Standard Minimum Guarantee level; even employees on low earnings should remain above this level (see Figure 5.10).

Nevertheless, the continuing existence of means testing during the transition period could have an impact on the savings decisions of those who are currently of working age, particularly low-paid employees, if they assume that their experience in retirement will be similar to that of the previous generation. This would be the result of an information gap rather than a direct impact of the way the reforms have been designed, but such an information gap could affect saving behaviour.

The cost of state pensions

The final part of this chapter compares expenditure on state pensions in the 'with reform' and 'without reform' scenarios. The analysis in Table 5.13 is in 2007/08 prices, as it was prepared at the time that the Bill which became the Pensions Act 2007 was going through Parliament. It assumes a start date of 2012 for earnings uprating of BSP and the move to the fixed flat-rate S2P.

The main impact of the reforms between 2010 and 2050 is expected to be a shift between categories of spending. In 2007/08 prices, expenditure on BSP was expected to rise from £52 billion in 2010 to £156 billion in 2050 with reform, whereas without reform it would have risen to £86 billion. On the other hand, expenditure on Pension Credit was expected to fall from £8 billion in 2010 to £5 billion in 2050 with reform, whereas without reform it would have risen to £42 billion. This shift in expenditure is by design, as the reforms aim to move most pensioners onto full BSP by 2050 and keep their income above the level of the Standard Minimum Guarantee, which means that they would not qualify for the guarantee credit element of Pension Credit.

Table 5.13 also forecasts that public expenditure on state pensions and related benefits will rise from 6.2 per cent to 7.2 per cent of Gross Domestic Product (GDP) between 2010 and 2050 under the reforms. Without reform, it was projected to rise to 6.6 per cent of GDP by 2050. Thus, in 2007, the Government was expecting to pay just over half of one per cent of GDP more for state pensions and related benefits by 2050 as a result of the reforms than it would have done in their absence. At 7.2 per cent of GDP, the cost by 2050 would be below the 'range for debate' of 7.5 to 8.0 per cent of GDP discussed by the Pensions Commission in its second report (2005)¹².

Table 5.13

Total expenditure on pensioner benefits with and without reform, 2010 to 2050

United Kingdom

£ billion, 2007/08 prices

	2010	2020	2030	2040	2050
Without reform¹					
Basic State Pension	52	60	73	82	86
SERPS/S2P	13	18	26	37	56
Pension Credit	9	12	19	30	42
Other pension benefits	3	2	3	3	3
Housing benefit and council tax benefit	8	8	10	13	19
Attendance Allowance and Disability Living Allowance	9	11	13	16	17
Total	93	110	143	179	222
Total as % of GDP	6.3	5.9	6.3	6.5	6.6
With reform					
Basic State Pension	52	69	98	131	156
SERPS/S2P	13	18	26	39	56
Pension Credit	8	7	6	5	5
Other pension benefits	3	2	3	3	3
Housing benefit and council tax benefit	8	7	8	9	12
Attendance Allowance and Disability Living Allowance	9	11	13	15	16
Total	92	114	154	201	248
Total as % of GDP	6.2	6.1	6.8	7.2	7.2

1 Without reform scenario assumes earnings-uprated Standard Minimum Guarantee.

Source: Department for Work and Pensions *Pension Reform Fact Sheet*

References

- 1 2006-based population projections for 2009 (ONS) – see **Sources and further reading**.
- 2 Individual lifetime average earnings for an average earner with a full career re-valued in line with economy-wide earnings growth.
- 3 For further details, see Antolín and Whitehouse (2009) and OECD (2009) in **Sources and further reading**. See also *Pension Trends* Chapter 6.
- 4 Although the BSP is mainly contributory, there are two non-contributory elements: Category C and Category D. Category C is payable to people over SPA on 5 July 1948 and their widows. Category D is paid to people who reach age 80, satisfy certain residency conditions, and failed to qualify for a pension through their own or their spouse's National Insurance contributions, or receive less than the non-contributory rate of BSP.
- 5 First Report of the Pensions Commission, 2004 – see **Sources and further reading**.
- 6 The DWP classifies Pension Credit as an Income Related Benefit for pensioners, rather than a non-contributory pension, to avoid confusion with Category D (see **Reference 4** above).
- 7 At least one member of the couple must be aged 60 or over for a couple to receive guarantee credit; at least one member of the couple must be 65 or over for a couple to receive savings credit.
- 8 When introduced in 2003, guarantee credit was to be earnings-uprated at least until 2008. The Pensions Act 2007 confirmed that it would continue to be uprated in line with earnings after 2008.
- 9 The 2009 Budget added another category: grandparents of working age who are caring for their grandchildren for at least 20 hours a week. This category should be included from 2011.
- 10 In previous versions of Table 5.8, weekly full BSP was forecast to remain exactly the same in price terms between 2012 and 2050 in the 'without reform' scenario, as it would be uprated in line with inflation in the absence of reform. However, in the latest version of the table, owing to projected deflation during the uprating period for 2010 and the commitment to uprate by the 2.5 per cent underpin instead, slight increases are forecast.
- 11 DWP Pension Reform Fact Sheet – see **Sources and further reading**.
- 12 Second Report of the Pensions Commission, 2005 – see **Sources and further reading**.

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