A SINGLE-TIER PENSION: WHAT DOES IT MEAN FOR INDIVIDUALS?

The government has proposed replacing the current state pension rules with a new single-tier pension for people reaching state pension age from April 2016. The effect this will have on people’s behaviour and wellbeing in retirement will depend, at least in part, on how it affects their future state pension income.

This study looks at the likely impact of the government’s proposed reform on individuals’ state pension incomes, using information from administrative data to look at the impact on those currently in their early sixties and simulating the potential effect on younger people.

Key points

- Some people who will reach state pension age in the first four years after implementation would receive a significantly higher state pension income under the single-tier system than they would get under the current system. In particular, this applies to those who had significant periods out of paid work to care for children or due to disability before 2002, and the long term self-employed.

- Across this group as a whole, 43% would get a higher state pension income at state pension age under the new system than under the current one. 26% would see an increase of at least £5 per week, while 13% would see an increase of at least £10 per week.

- Some of the increases in pension income seen by those who will reach state pension age in the first four years after implementation would, however, be offset by the loss of means-tested benefits.

- In the longer term, the new single-tier pension would be less generous than the current pension system for most people. People particularly worse off will be those who contribute to the system for longer, whether that contribution is through paid employment, caring responsibilities or receipt of disability-related benefits.

- The only groups who will get a significantly higher state pension income under the proposed system in the long-run are those who spend long periods in self-employment and those who will start to receive credits to the state pension for the first time under Universal Credit.

The research

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BACKGROUND

The Pensions Bill 2013–14 proposes combining the basic state pension (BSP) and state second pension (S2P) to create a new ‘single-tier’ pension for individuals reaching state pension age (SPA) from April 2016. This single-tier pension would be set at a level that was high enough to ensure that anyone with full entitlement would not qualify for the means-tested Pension Credit Guarantee. The Pensions Bill also proposes to abolish the Pension Credit Savings Credit. This study looks at the proposed reforms in detail using information from a household survey and administrative data, comparing the proposed system with the current one and examining how different groups of people would be affected.

The current pension system

The current state pension system consists of two (notionally contributory) elements – the BSP and the S2P. Each year people who work or take part in non-work activities (such as caring for children or sick or disabled adults, or receiving disability-related benefits) accrue entitlement towards both of these systems. In addition, a smaller group of people accrue entitlement to just the BSP – this includes the self-employed and those on short-term unemployment benefits.

For each year of qualifying activity, people accrue the right to an extra 1/30th of the BSP, provided they have not already achieved the maximum. A year of BSP accrual is, therefore, worth £3.63 of extra weekly pension income.

The amount of extra S2P entitlement that someone will earn for a year of ‘contribution’ depends on the level of their earnings. Anyone who is not working but is doing some other ‘creditable’ activity will get an extra £1.70 of weekly pension income. Higher earners can currently accrue more than this – up to a maximum of an extra £2.76 of extra weekly pension income. Additional entitlement to S2P can be earned for every year of activity up to the SPA – it is not capped at 30 years like the BSP.

The proposed pension system

The main proposal of the Pensions Bill 2013–14 is to combine the BSP and S2P into a single-tier pension. Anyone who would have earned entitlement to the BSP under the current system would instead accrue entitlement to this single-tier pension at a rate of 1/35th of the full amount per year of ‘contribution’. The government has not yet confirmed exactly what level the single-tier pension will be set at. But the Department for Work and Pensions’ impact assessment that accompanied the Bill was done on the basis of the single-tier pension being set at £146.30 per week and uprated each year at least in line with average earnings growth. On this basis, one year of accrual would be worth an extra £4.18 of weekly pension income.

The government plans to introduce the single-tier pension in 2016. There are a number of ways that this could have been done, each of which would have had a slightly different effect on the state pension income that different people would have received. However, one of the guiding principles underlying the change is a desire to move as quickly as possible to a situation where all new pensioners will receive the same, flat-rate amount of state pension.
In 2016 everyone will have their past contribution history assessed under the new pension system and, if that calculation would give them a greater pension income at retirement than the current system would, their accrued pension rights up to 2016 would be set at that amount. If instead they would have got more under the current rules, that entitlement will be protected. After 2016, each extra year of creditable activity would earn an extra £4.18 of weekly pension income, until someone reaches the maximum of £146.30.

**How would individuals be affected?**

Some people would see an immediate significant boost to the state pension income they are entitled to. In particular, this would include those who have undertaken activities that were only creditable for BSP and not S2P, for example the self-employed, or those who undertook other non-work creditable activities (such as childcare or receiving disability benefits) before the introduction of S2P in 2002.

On the other hand, for the vast majority of people, further years of activity beyond 2016 would result in lower additional accrual to the state pension under the proposed single-tier system than under the current system. Annual accrual of flat rate pension, at £4.18 of weekly pension income for each year of contribution, is lower than the sum of accrual to the BSP and S2P (£5.33 for a low earner = £3.63+£1.70, and £6.39 for a high earner). One exception to this is the self-employed: under the current system, they would only accrue entitlement to the BSP, which is worth less than the single-tier pension. The other main exception is those who will have a state pension entitlement after assessment in 2016 of less than £146.30 but who already have 30 years of BSP accrual: for these people, an additional year of accrual under the current system would be worth a maximum of £2.76 of extra weekly pension income, compared to £4.18 under the single-tier system. This group is essentially those who have in the past opted not to accrue S2P but to accrue higher private pension savings instead (known as ‘contracting out’).

The study found that, of those reaching SPA between April 2016 and March 2020, 43% (including 35% of men and 61% of women) would see an increase in their state pension income at SPA under the proposed system. It found 26% would see an increase of at least £5 per week, while 13% would see an increase of £10 per week or more.

In contrast, almost all of those who entered the labour market after – or not too long before – 2002 will get a lower state pension income under the proposed system than they could get from the current system. This includes everyone born since 1986 and could include people born as early as 1966. This is because, since 2002, almost all activities that will be credited under the new system have also been credited towards BSP and S2P, and the combined accrual of BSP and S2P is worth more each year than accrual of the single-tier. Those who will be particularly worse off include those who contribute for longer, whether that ‘contribution’ is through paid employment, caring responsibilities or the receipt of disability-related benefits. The only significant exceptions to this are the long-term self-employed and those who will start to receive credits to the state pension for the first time under Universal Credit. However, some of this gain to the self-employed would be offset if the government decided to increase the level of National Insurance contributions made by self-employed people.

The proposed new system is likely to be clearer and easier to understand than the current system. This clarity, coupled with the lower state pension income it will provide to most younger people, may encourage people to save more privately for their retirement.
Conclusion

The single-tier pension proposals mark the latest step on a rather circular journey over the last 40 years. This journey began with the 1975 Social Security Act, which introduced the first significant earnings-related state pension (SERPS) and also introduced crediting for periods of childcare into the state pension system. Subsequent reforms have gradually dismantled the earnings-related element and significantly strengthened crediting for unpaid activities.

With its lower generosity for later cohorts, the single-tier proposals also go some way to addressing the long-term pressures on the UK’s public finances posed by our ageing population. By sweeping away many of the complexities of the current system and addressing some of the long-term funding pressures, the latest set of proposals may prove to be more long-standing than those that have gone before. This would be welcome news to people for whom constant changes to the state pension system make planning for retirement difficult.

About the project

The study used detailed micro data from the English Longitudinal Study of Ageing (ELSA), linked to lifetime National Insurance contribution records, to simulate how the first generations reaching SPA after 2016 would be affected by the proposed pension reform. This data provided complete information on National Insurance contributions up to March 2004 and a variety of information on behaviour and circumstances from 2002–03 to 2010–11 for those born up to the end of February 1952. However, the analysis had to make a number of assumptions about behaviour beyond 2011. Specifically, the analysis assumed that individuals continued to behave and contribute to the National Insurance system in the same way as they were in 2010 until they reached SPA. The study examined the impact of the policy on those born between 1952 and 1954. These individuals were assumed to have essentially the same contribution history as those born slightly earlier, but occurring a few years later. For the analysis of later cohorts, the study calculated state pension income under the current and proposed systems for example contribution histories.

FOR FURTHER INFORMATION

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