

## Technical Bulletin

### Consultation on state pension provision and budget announcements on public service pensions

5 April 2011

#### A state pension for the 21st century

Yesterday the Department for Work and Pensions (DWP) issued a consultation paper 'A state pension for the 21<sup>st</sup> century', seeking views on options for reform of the state pension that better support saving for retirement, and also on the most appropriate mechanism for determining future changes to state pension age. The consultation period runs until 24 June. This GAD technical bulletin summarises key points from the consultation paper.

#### The context for reform

In the consultation paper the Government identifies a number of issues with the current state pension:

- High levels of means testing – for many, the incentives for saving are not clear.
- Significant inequality in the system – groups such as women and the low paid tend to have poorer state pensions.
- The complexity and uncertainty of outcomes – making it difficult for people to know what they can expect when they retire.
- Increasing pensioner life expectancy – impacting affordability and long-term sustainability.

In response to the issues that it has identified, the Government has set out four guiding principles, setting the context for state pension reform:

- personal responsibility;
- fairness;
- simplicity; and
- affordability and sustainability.

This framework has also informed the Government's reforms to date, including:

- for current pensioners, the introduction in April 2011 of a 'triple guarantee', providing increases to the basic state pension of the highest of earnings, prices or 2.5% a year;
- for future pensioners, the introduction from 2012 of automatic enrolment for workplace pensions; and
- adjusting the timetable for increasing state pension age to support sustainability.

The Government believes that further reform is necessary if it is to meet all of its principles.

### **Options for reform of state pensions**

The Government is seeking views on two broad options for state pension reform to provide a simple, flat-rate contributory state pension which lifts the majority of future pensioners above the standard means-test (the income level provided by the Pension Credit standard minimum income guarantee which currently tops-up pensioners' income to £132.60 a week).

**Option 1** involves accelerating existing reforms so that the basic state pension and the second state pension evolve into a fully flat-rate structure more quickly. Currently the basic state pension is a flat-rate payment of £97.65 a week and the state second pension is partly flat-rate and partly linked to earnings.

Under this option the pace of existing reforms would be accelerated so that the state second pension would become flat-rate by 2020 instead of, as currently planned, the early 2030's. At the end of transition, all those with a full contribution record, for example 30 qualifying years, would build up the same state pension from these two sources, currently estimated at around £140 a week. Under this option contracting-out of the state second pension would continue for defined benefit pension schemes.

**Option 2** is described as a more radical reform and would see a move to a single-tier flat-rate pension set above the level of the Pension Credit standard minimum income guarantee. The basic state pension and the state second pension would be combined into one single-tier state pension, set at a level currently estimated at £140 a week for future pensioners with at least 30 qualifying years under the new system. The self-employed, as well as the employed, would also be able to build up entitlement to the single tier pension.

Under this option, contracting-out of the state second pension for defined benefit schemes would end, but the complexities associated with contracting-out would continue during the transition to the single-tier pension. The end of contracting-out would mean that people who have been paying lower rates of national insurance, due to being contracted out, would start to pay the same amount of national insurance as other employees.

The Government recognises that under both these options transition to a simplified flat-rate pension will take time, and it will seek to address this in a way consistent with the guiding principles above. Transition to the single-tier pension under option 2 will require consideration of how individuals' pension records under the existing system, including periods spent contracted out of the state second pension, should be recognised.

### **Cost**

The Government is clear that any reform will not increase public spending dedicated to state pensions in any year. Final proposals on reform are subject to confirmation, including on affordability, and will reflect the projections set out in the Office for Budget Responsibility's forthcoming Fiscal Sustainability Report.

### **State pension age**

The consultation paper confirms that state pension age plays a key role in ensuring that the state pension remains sustainable and affordable. Accordingly, the Government is exploring a more automatic mechanism for ensuring that further revisions to life expectancy feed through to the determination of state pension age in a timely and transparent way. Two options explored in the consultation paper are:

- increasing state pension age by a formula linked to life expectancy;

- increasing state pension age through a formal review at regular, pre-determined intervals.

A copy of the Government's consultation paper can be found at the following link including, in section 5, a list of the consultation questions.

<http://www.dwp.gov.uk/consultations/2011/state-pension-21st-century.shtml>

## **Budget announcements on public service pensions**

The budget statement by the Chancellor on 23 March, and accompanying budget document included two important elements affecting public service pensions.

### **Response to the Independent Public Service Pensions Commission**

The Chancellor confirmed that "The Government accepts the recommendations of Lord Hutton's commission as a basis for consultation with public sector workers, trades unions and others, recognising that the position of the uniformed services will require particularly careful consideration. The Government will in the autumn set out proposals that are affordable, sustainable and fair to both the public sector workforce and taxpayers."

A copy of GAD's Technical Bulletin on Lord Hutton's final report can be found at:

[http://www.gad.gov.uk/Publications/Technical\\_Bulletins.html](http://www.gad.gov.uk/Publications/Technical_Bulletins.html)

### **Discount rate for public service pension schemes**

Following a full public consultation, the Government has decided that the appropriate discount rate for calculating unfunded public service pension contribution rates should be based on the long term expectation of Gross Domestic Product (GDP) growth. The stated rationale for this is that it will ensure that employment decisions made today take into account the costs passed to future taxpayers on a fair and sustainable basis.

The latest OBR forecast for long-term GDP growth is 2.2 per cent above the assumed GDP deflator, equivalent to a discount rate of 2.9 per cent above the Consumer Prices Index (CPI). Given the range of uncertainties inherent in these calculations, the Government believes that a rounded figure should be used. A discount rate of 3 per cent above CPI will therefore be adopted under this methodology for future actuarial valuations of public service pension schemes.

The Government proposes to review the level of discount rate every five years, and the methodology every ten years. The Government has confirmed that this change in the discount rate will not lead to an increase in member contribution rates beyond those already announced at Spending Review 2010.

Papers in relation to the Government's consultation on the discount rate can be found at:

[http://www.hm-treasury.gov.uk/consult\\_unfunded\\_pensions.htm](http://www.hm-treasury.gov.uk/consult_unfunded_pensions.htm)

If you would like to discuss any of these issues in more detail or have any other questions please get in touch with your usual GAD contact.

