



DWP Department for
Work and Pensions

A state pension for the 21st century

Presented to Parliament by the Secretary of State
for Work and Pensions by Command of Her Majesty
April 2011

Cm 8053

£10.25



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This publication is also available on <http://www.official-documents.gov.uk/>

ISBN: 978-0-10-180532-2

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID: 2422218 04/11

Printed on paper containing 75% recycled fibre content minimum.

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Foreword

It is right that people are asked to take responsibility for their retirement by saving while they are working. But to do this we need a simple and fair state pension which acts as a foundation for building up retirement income and rewards people for taking responsibility.

We have delivered greater security for pensioners by restoring the earnings link and introducing a triple guarantee to protect the value of the basic State Pension. However, we need to think about the pensioners of the future, who will live and work for longer, and are much less likely to have generous final salary pensions. Automatic enrolment into workplace pensions with minimum employer contributions from next year will help future generations to build up private pension saving. But the state pension needs to do its bit by providing a basic income that people know they will be able to rely on – so they can make decisions about how much more they need to save for their retirement.

The complexity of the current state pension is a major barrier to saving. It means that few people have a clear idea of what their state pension will be worth when they retire. Not only that, the current system actually discourages saving, because the extent of reliance on means testing means that people cannot be sure they will benefit from the savings they put aside.

As life expectancy projections continue to be revised upwards, we also have a responsibility to ensure the pension system is sustainable and the costs of increasing longevity are shared fairly between generations. We have already brought forward provisions to increase the State Pension age to 66 and this paper seeks views on introducing a more automatic mechanism to consider changes in the future.

We want to support people to take more responsibility in saving for their retirement. We cannot realise that vision without making sure that the foundation of that saving is simple to understand, fair, and fiscally sustainable in the long term.

Through this consultation paper I seek views and contributions to the debate from anyone who has an interest: members of the public, employers and pension providers. Over the coming months I will be going out and talking to as many people as possible about what they think the state pensions system should look like in the future. I look forward to hearing from you.



Steve Webb MP
Minister of State for Pensions

Executive summary

This Government is taking forward radical reform to simplify the welfare system and ensure that work pays through the introduction of Universal Credit. We are now interested in looking at options for delivering a simpler and fairer state pension which rewards those who do the right thing and save for their retirement and is sustainable for future generations.

We are consulting on:

- two broad options for reform of the state pension that better support saving for retirement; and
- the most appropriate mechanism for determining future changes to State Pension age.

The context for reform

1. This Government is committed to the fundamental reform of the benefit system to ensure that it helps to support people to move into work and to save for their retirement, while supporting the most vulnerable in a fiscally sustainable way.
2. The Government has already announced plans to transform working-age benefits through Universal Credit that seeks to address the lack of work incentives in the system and hence to tackle the root causes of poverty and welfare dependency.
3. In terms of pension reform, we have four clear guiding principles:
 - **personal responsibility** – enabling individuals to take responsibility for meeting their retirement aspirations in the context of increased longevity;
 - **fairness** – ensuring an adequate level of support for the most vulnerable, ensuring everyone with a full contribution record should be entitled to a state pension above the standard level of means tested support¹, and ensuring all groups are treated fairly;

¹ This is defined as the level of income provided by the Pension Credit standard minimum income guarantee which in 2010-11 tops up pensioners' income to £132.60 a week.

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- **simplicity** – simplifying the state pension so that it is easier for people to plan and save for their retirement; and
 - **affordability and sustainability** – given longer-term pressures on the public finances, any state pension reform must be affordable. Any options for reform must be cost neutral in each and every year to avoid placing an unsustainable burden on future taxpayers. Any proposals will be subject to confirmation, including on affordability, and will reflect the projections set out in the Office for Budget Responsibility’s forthcoming Fiscal Sustainability Report. In addition, changes to State Pension age should ensure the system is sustainable for future generations.
4. We have already begun delivering against these principles. Our first priority was ensuring fair levels of support for current pensioners through the introduction of the triple guarantee and a commitment to retain measures such as free prescriptions and TV licences for the over 75s.
5. We have also begun the task of reforming the system for future pensioners, to support personal responsibility and fiscal sustainability. We have already:
- acted to ensure that more people will have the opportunity to save for their retirement by confirming that automatic enrolment, with an employer contribution, will be introduced for workplace pensions from 2012;
 - adjusted the timetable for increasing State Pension age to aid sustainability; and
 - established plans for removing the default retirement age to enable older people to continue to work where they wish to do so.
6. But automatic enrolment will only succeed if today’s workers feel confident that it will be worth their while saving and if they understand how much they need to save to fund their aspirations for retirement.
7. We believe that further reform is necessary if the Government is to meet all of its principles. In particular:
- Personal responsibility is only possible if working people feel they will be rewarded for doing the right thing. But the extent of reliance on means testing in the current system means that, for many, saving incentives are not clear. Currently, just under half of pensioners are eligible for means-tested Pension Credit to top up their state pension income.
 - There is still substantial complexity and uncertainty in the system. Many are unsure what their state pension will be worth when they retire. This makes it more difficult for people to plan and save for their retirement. In a Department for Work and Pensions survey 71 per cent of people agreed that ‘sometimes pensions seem so complicated that I cannot really understand the best thing to do’².
 - Significant fairness issues remain – in particular, groups such as women and the low paid tend to have poorer state pensions.
 - Sustainability is still a concern. Life expectancy in the UK has reached record levels and is projected to continue to increase. In 1981, an average 65-year-old man could expect to live for another 14 years, today it’s over 21 years. As longevity projections continue to increase, government has a responsibility to ensure the costs of increasing longevity are shared fairly between generations.

² Clery, E. Humphrey, A. and Bourne, T. (2010) *Attitudes to Pensions: the 2009 Survey*. DWP research report 701.

- While we are living longer fewer are saving for their retirement. Overall, between 1997 and 2010 the number of jobs in the private sector with any employer sponsored pension provision declined from 46 per cent to 36 per cent³. The Government is introducing automatic enrolment into workplace pension schemes from 2012 to tackle undersaving.
8. Chapter 1 considers the current pension system in greater detail including the key concerns that have been highlighted if it is left unreformed for future pensions.
 9. The Government believes, in light of these concerns, that it is necessary to consider further reforms to the pensions system. In particular we are consulting on:
 - Reforms to the state pension to better support people to save for their retirement; and
 - The most appropriate mechanism for determining future changes to State Pension age to support long-term sustainability.

Reform of the state pension: faster flat rating or a single tier pension

10. The Government believes it is necessary to reform the state pension for future pensioners so that it provides a better foundation for saving. This paper seeks views on two broad options for reform to deliver a simple, flat-rate contributory state pension that lifts the majority of future pensioners above the standard means-test:
 - **Option 1:** acceleration of existing reforms so that the state pension evolves into a two-tier flat-rate structure more quickly; or
 - **Option 2:** more radical reform to a single-tier flat-rate pension set above the level of the Pension Credit standard minimum guarantee.
11. Chapter 2 sets out these options in greater detail and assesses each option against the Government's principles for reform.

Option 1: Faster flat rating

12. Currently the basic State Pension is a flat-rate payment worth £97.65 a week and the State Second Pension is partly flat rate and partly linked to earnings, such that higher earners receive a higher state pension. Option one would accelerate the pace of existing reforms so that the State Second Pension would become flat rate by 2020 instead of the early 2030's. This would give people a clearer idea of the state pension they would get in retirement as they would receive a set amount of pension for each qualifying year. At the end of transition, all those with a full contribution record, for example 30 qualifying years, would build up the same state pension, currently estimated at around £140 a week, albeit through two tiers.

³ Office for National Statistics, (2010) *The Annual Survey of Hours and Earnings 2010*. ONS.

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13. It would be possible to go further by ensuring all earners built up the same pension, better aligning the detailed rules of entitlement between the basic State Pension and State Second Pension, and using the same uprating for the two pensions when in payment. This would further simplify the system and increase the number of people receiving the full pension. The precise value of this combined, flat-rate pension would need to be set at a level that met the affordability principle. Under Option 1 contracting out would continue for members of Defined Benefit schemes.

Option 2: Single tier

14. Option 2 would be a more radical approach to state pension reform, combining basic State Pension and State Second Pension into one single-tier state pension. Future pensioners with at least 30 qualifying years would receive the same flat-rate pension currently estimated at £140 a week – with this payment being set above the basic level of support provided by Pension Credit.
15. Under this option, contracting out for Defined Benefit schemes would end. In itself, this could ultimately bring simplification of the personal tax system. The complexity associated with contracting out would, however, continue during transition to the single-tier pension.
16. Each of these options can be designed to meet the principle of cost neutrality, and can be delivered within the currently forecast expenditure on the state pension. Option 1 is an evolution of the current system which brings forward changes which have already been legislated for. Under option 2, the payment currently estimated at around £140 to all future pensioners would be funded by ending the State Second Pension, Savings Credit and introducing a seven-year minimum qualifying rule. The Government is clear that any reform will not increase public spending dedicated to state pensions in any year. Final proposals 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.
17. We are seeking views on these two options: how well they address the problems with the current state pensions system for future pensioners, and the extent to which they meet the Government's principles – personal responsibility, fairness, simplicity, affordability and sustainability. The Government recognises that under both options transition to a new simplified flat rate pension would take time. We would be interested to discuss how this could be addressed in a way that would be consistent with our principles. We are also interested in any other options for state pension reform which meet the principles.
18. Under each of these proposals the Government will, in due course, give consideration to whether reforms are needed to the current system of means-tested support to ensure that this part of the system delivers on the principles for reform. Just as we have taken steps to rationalise the welfare system to ensure that work pays through introduction of the Universal Credit, we need to ensure that it pays to save for retirement and that complexities in the current system are reduced where possible. Further detail is set out in Chapter 3.

State Pension age mechanism

19. The State Pension age plays an important role in ensuring that the state pension remains sustainable and affordable – one of the key principles for future pension reform. The Government has acted quickly to take recent increases in life expectancy into account by setting out proposals to increase the State Pension age to 66 by April 2020.
20. But these increases in longevity will not end in 2020 and it is only fair that those generations who will benefit from these increases share in the costs. Not to do so would be unfair on the people of working age who would need to bear the burden of this increased longevity. In addition, there are important benefits to the economy and individuals from working longer.
21. The Government must continue to consider the State Pension age, and the question now is how to build into a future state pensions system a more automatic mechanism for ensuring further revisions in life expectancy are taken into account in a way that is timely and transparent.
22. The two options are:
 - Increasing the State Pension age through a formula linked to life expectancy.
 - Increasing the State Pension age through a review.
23. Further detail is set out in Chapter 4.

The current pension system

1

Life expectancy in the UK has reached record levels and is projected to continue to increase. Yet levels of pension saving, particularly in the private sector, are in decline. To address the challenge of undersaving, eligible workers will be automatically enrolled into workplace pensions from 2012 unless they decide to opt out.

The Government is concerned that the state pension, if left unchanged, would not provide the foundation that is needed to support people in taking greater personal responsibility for saving for their retirement.

Three main problems have been highlighted in the state pension:

- **The complexity and uncertainty of outcomes in the state pension** – makes it difficult for people to know what they will get when they retire, meaning it is more difficult to plan and save for retirement.
- **High levels of means testing** – can deter people from saving as the incentives are not sufficiently clear and too many pensioners are forced to rely on Pension Credit to top up their income. Around a third of pensioners do not claim the Pension Credit they are entitled to.
- **Significant inequality remains in the system** – groups such as women, the low paid and the self-employed tend to have lower state pensions.

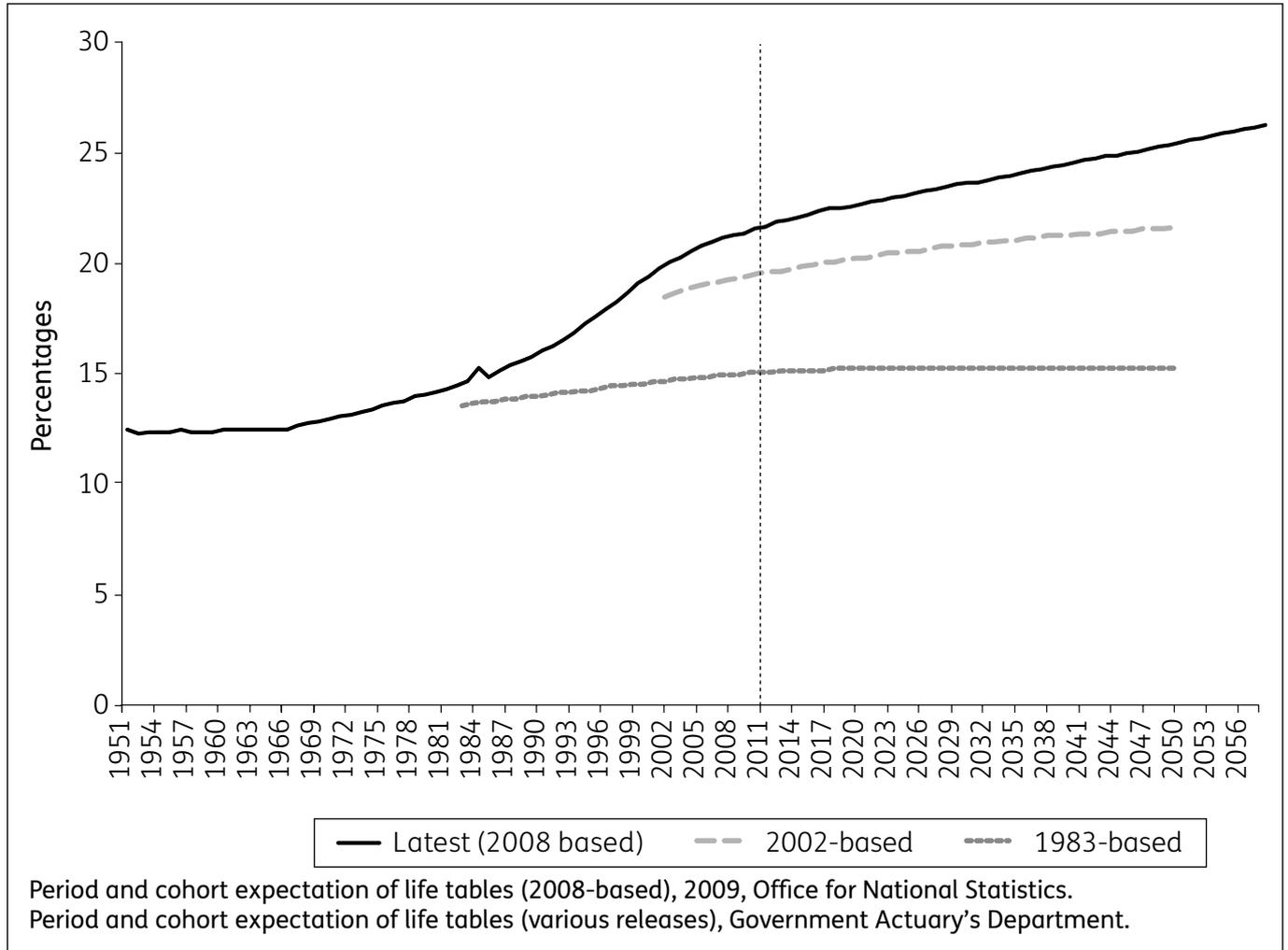
The changing pensions landscape

We are living longer

24. Life expectancy in the UK has reached its highest level on record for both men and women, and is projected to continue to increase. In 2007, for the first time, the number of pensioners exceeded the number of children in the UK⁴. Chart 1 shows that improvements in life expectancy have consistently outpaced projections.

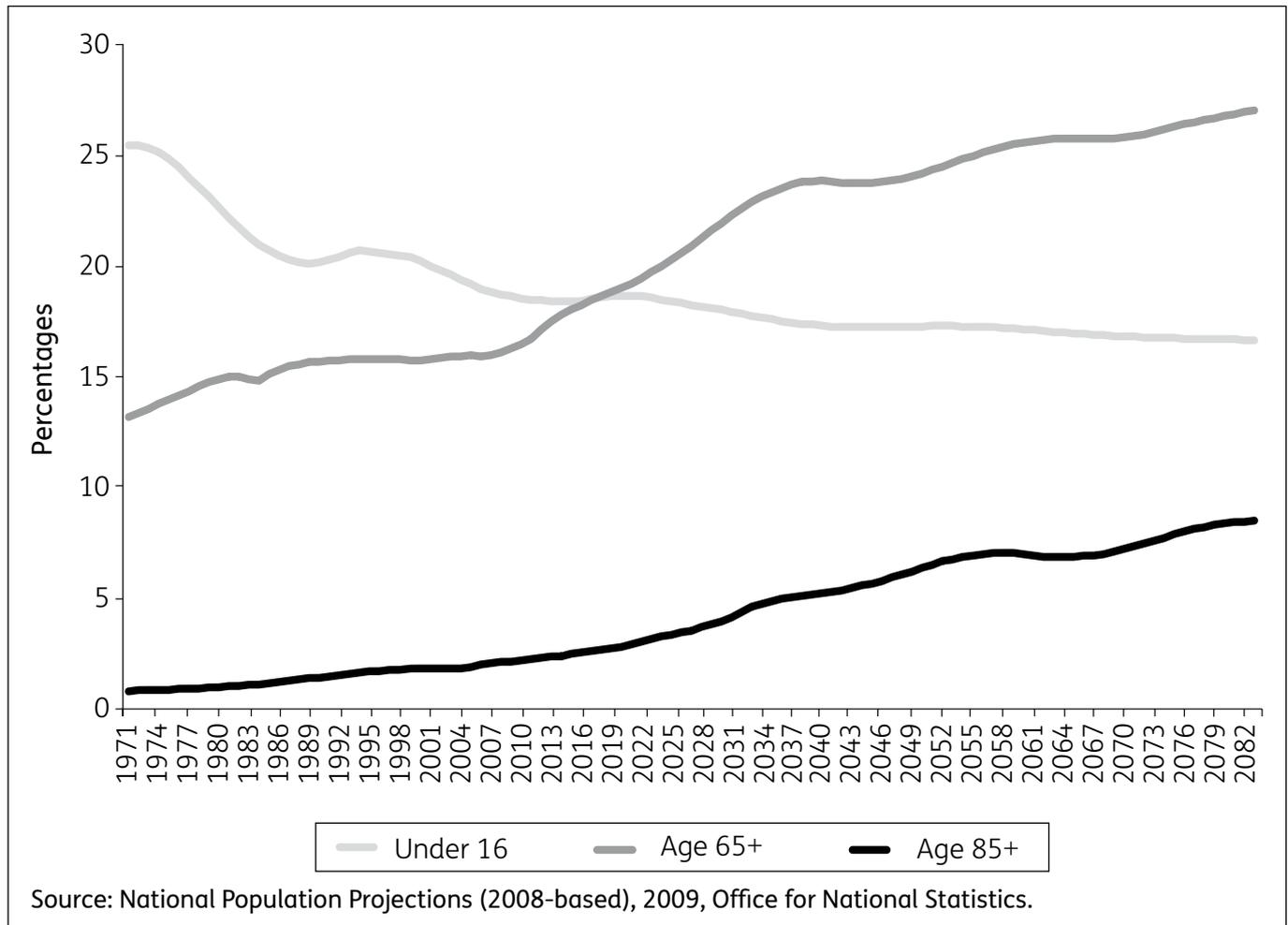
⁴ Office for National Statistics, (2009) *2008-based national population projections*. ONS.

Chart 1: Life expectancy for a 65-year-old male, 1951 to 2058



25. Office for National Statistics (2008) data shows that over the last 25 years the number of people aged 65 and over increased by just over 1.8 million and there will be further sharp increases, with more than 920,000 being added between 2011 and 2014 as baby boomers reach 65⁵.
26. Chart 2 shows that the proportions of the population aged 65 and over, and 85 and over, are projected to increase sharply over time, with the largest increases being among the oldest, while there will also be far lower proportions of people aged 16 and under. In 1971, just over 13 per cent of the population was over 65 with fewer than 1 per cent over 85. By the 2050's, the proportion aged 65 or over will have increased to around 25 per cent, and the 85s and over will have increased to around seven per cent. Over the same period, the proportion of the population aged 16 or under will have declined from 25 per cent to around 17 per cent.

⁵ Office for National Statistics, 2009, *2008-based national population projections*, ONS.

Chart 2: Proportion of population aged 16 or under, 65 or over and 85 or over, 1971–2082

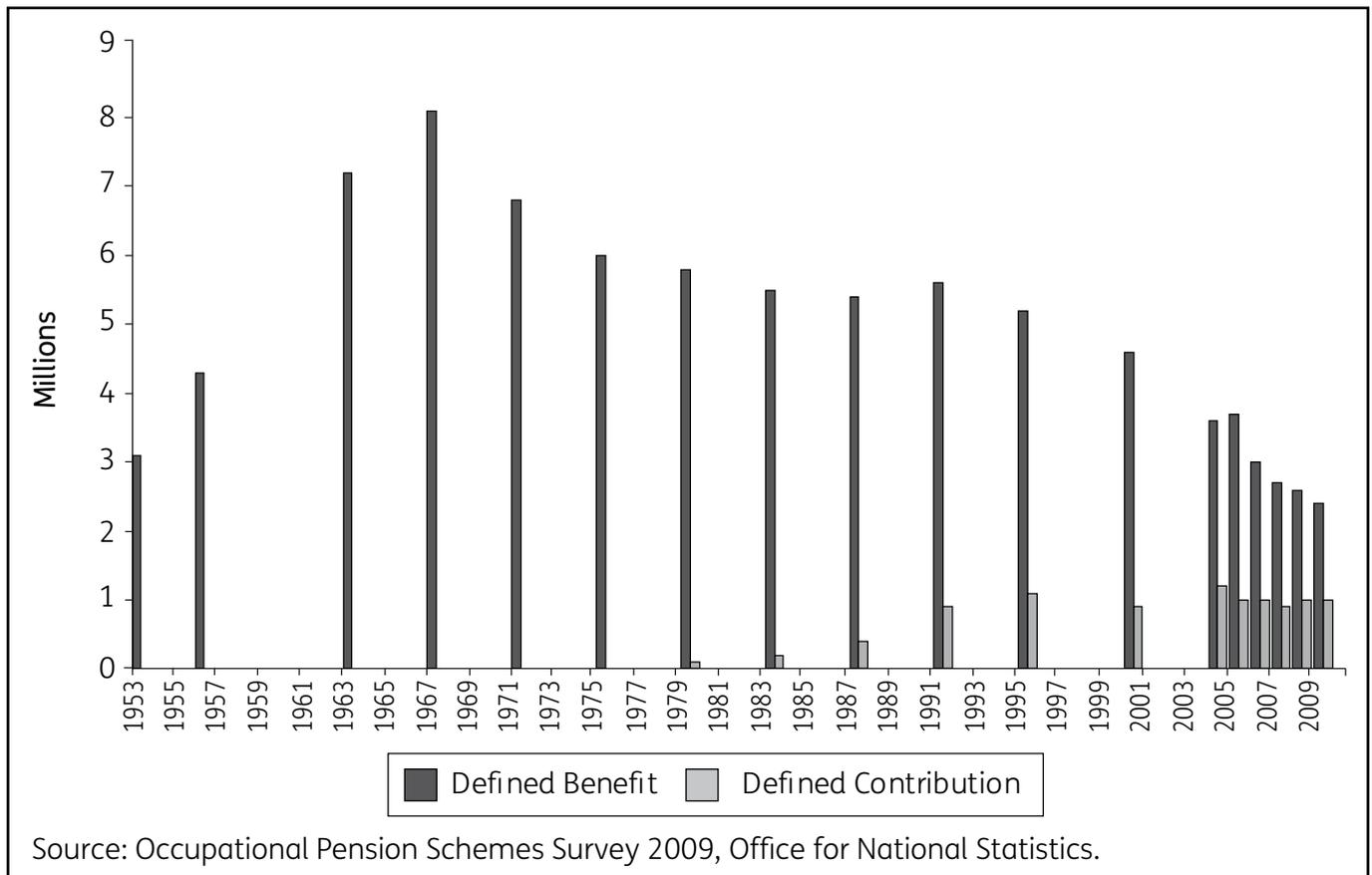
27. It is good news that life expectancy has improved. The relatively few men who reached the pension age of 65 in 1926, when the first contributory pension was introduced, could expect to live for just over a decade on average. Today, the much greater proportion of men who reach retirement age can expect to spend over two decades in retirement⁶.
28. In the face of rising longevity, the Government has taken steps to ensure the system remains fair and sustainable over the longer term. There are currently provisions before Parliament to bring forward the increase in State Pension age to 66 in 2020. But we also need to take steps to ensure that the state pension remains sustainable and affordable over the long term. So this paper examines our options for introducing a more automatic mechanism to ensure that further changes are made when appropriate. Further detail is set out in Chapter 4.

⁶ Government Actuary's Department, Period and cohort expectation of life tables (various releases). GAD.

Pension saving is in decline

29. Despite the fact we are living longer, fewer are saving for their retirement. In 1967, 12 million people were active members of occupational schemes. This has declined to just under nine million today. Within that overall decline there has been a move away from relatively generous Defined Benefit schemes within the private sector from a peak of 8.1 million active members in 1967 to 2.4 million active members today.

Chart 3: Active membership of private sector occupational pension schemes by benefit type, UK



30. Overall, between 1997 and 2010 the number of jobs in the private sector with any employer sponsored pension provision declined from 46 per cent to 36 per cent⁷.
31. Within the private sector we have also seen a shift from Defined Benefit to Defined Contribution pension schemes. Overall, Defined Contribution provision increased from 25 per cent of private sector employer-sponsored pension provision in 1997 to 61 per cent in 2010⁸. This means that the risk associated with ensuring that pensions deliver a particular level of income in retirement is being increasingly borne by individuals rather than employers.

⁷ Office for National Statistics, (2010) The Annual Survey of Hours and Earnings 2010. ONS.

⁸ Office for National Statistics, (2010) Occupational Pension Schemes Survey 2009. ONS.

32. Although many people are saving for their retirement in non-pension vehicles, such as property or ISAs (over 20 million people now hold an ISA), the Department for Work and Pensions estimates that around seven million people are not saving enough to meet their retirement aspirations⁹. This decline in saving, against a backdrop of increasing longevity, is a concern, especially as evidence suggests that on its own the state pension will not provide the retirement income that many people want in retirement. While retirement aspirations will vary considerably across individuals, the Pensions Commission concluded that a person on median earnings should be aiming for at least a 45 per cent replacement rate – that is, to retire on 45 per cent of what they earned during their working life.
33. As a result of the state pension reforms taken forward in the 2007 Pensions Act, a median earner retiring in 2055 can expect to retire on 32 per cent of what they earned during their working life – based solely on their state pension¹⁰. It is clear that relying on state provision alone will not provide sufficient retirement income to meet most people's expectations.
34. The Pensions Commission concluded, with a broad consensus across political parties and more widely, that most people would need to save more in private pensions – and this led to the introduction of automatic enrolment into workplace pensions and the establishment of the National Employment Savings Trust to encourage and enable more people to save for their retirement. As a result of these reforms, for the first time all employers will be required to automatically enrol eligible employees into a qualifying pension scheme and to make mandatory employer contributions on their behalf. The Government estimates this will result in between 5 and 8 million people newly participating, or saving more, in workplace pension schemes¹¹, with around £8 billion in additional pension savings each year¹².

The future landscape

35. Looking forward, the overall effect of these trends is that the current generation of savers will face a very different world from that experienced by today's pensioners. In particular they will:
- **live longer** – in 1981 an average 65 year old man could expect to live for another 14 years, today it's over 21 years, by 2050 it will be over 25 years;
 - **work longer** – younger generations face higher retirement ages than previous generations;
 - **be less likely to have the relative certainty of a Defined Benefit pension** – in 2010 61 per cent of employer-based pensions in the private sector were Defined Contribution¹³ schemes; and
 - **be the first generation to be automatically enrolled into workplace pensions.**
36. In light of the challenges facing the next generation, the Government believes it is important that the state pension is reformed to provide the right foundation to support people in taking greater personal responsibility for saving for their retirement.
37. The next section considers some of the key problems that commentators have highlighted in the current system. It then goes on to consider the extent to which the current system, if left unchanged, would meet the Government's principles for reform of personal responsibility, fairness, simplicity and affordability.

⁹ Department for Work and Pensions, (2006) *Security in retirement: towards a new pensions system*. Cm 6841, TSO.

¹⁰ Department for Work and Pensions, (2010) *Workplace Pension Reform Regulations Impact Assessment*. DWP.

¹¹ Department for Work and Pensions, (2011) *Pensions Bill – impacts – annex B: Workplace Pension Reform*. DWP.

¹² Department for Work and Pensions, (2010) *Workplace Pension Reform Regulations Impact Assessment*. DWP.

¹³ Office for National Statistics, (2010) *The Annual Survey of Hours and Earnings 2010*. ONS.

Complexity

38. The Pensions Commission described the UK pension system as one of the most complex in the world.

‘The state retirement benefit system has become arcanelly complex, with an enormous range of separate benefits, both entitlement based and means tested, having been built up over many years ... The system has become so complex that individuals and businesses find it almost impossible to understand.’

Roadmap for Retirement Reform 2009, Institute of Directors

‘... the behavioural barriers to savings ... have been made worse by the bewildering complexity of the UK pension system, state and private combined. This complexity reflects the impact of multiple decisions made over the last several decades, each of which appeared to make sense at the time, but the cumulative effect of which has been to create confusion and mistrust.’

Pensions: Challenges and Choices The First Report of the Pensions Commission, 2004

39. In a Department for Work and Pensions survey on attitudes to pensions, 71 per cent agreed that ‘sometimes pensions seem so complicated that I cannot really understand the best thing to do’ and only 23 per cent agreed that they knew ‘enough about pensions to decide with confidence how to save for retirement’¹⁴.
40. In an attempt to simplify the state pension and give people greater clarity over what they will get when they retire, the Pensions Act 2007 legislated to remove the earnings-related component of the State Second Pension so that the state pension will evolve into two separate flat-rate components by the 2030s.
41. One of the reasons for this change was that a flat-rate pension, in contrast to the complexity of the partly earnings-related State Second Pension we have today, would make the state pension more transparent and make it easier for people to work out what they will get from the state when they retire.
42. However, it takes time for the greater simplicity and clarity provided by a flat-rate pension to come into effect – the first person will not retire with a completely flat-rate pension until the 2080s.
43. The other main simplification was that the Pensions Act 2007 legislated to end the option to contract out of the State Second Pension in Defined Contribution schemes from 2012.
44. Beyond these changes much of the existing architecture of the state pensions system remained untouched and, as a result, a significant amount of complexity remains.

¹⁴ Cley, E. Humphrey, A. and Bourne, T. (2010) *Attitudes to Pensions: the 2009 Survey*. DWP Research Report 701.

'Successive Governments have changed the rules and requirements, making it extremely complex. As a result, many people do not have a clear idea of how much state pension they can expect to receive. The Bill would leave the pensions system very complex, although it would simplify some aspects.'

**PPI Briefing Note 36: Will the Pensions Bill solve the problems of state pensions?
January 2007**

45. This complexity makes it more difficult to provide simple straightforward communications on pensions and give people a clear idea of what they can expect to get in retirement. For example, pension forecasts issued by the Department for Work and Pensions include a raft of caveats and complex explanations. In some instances, these warn people against relying on the information they provide, as the extract below shows.

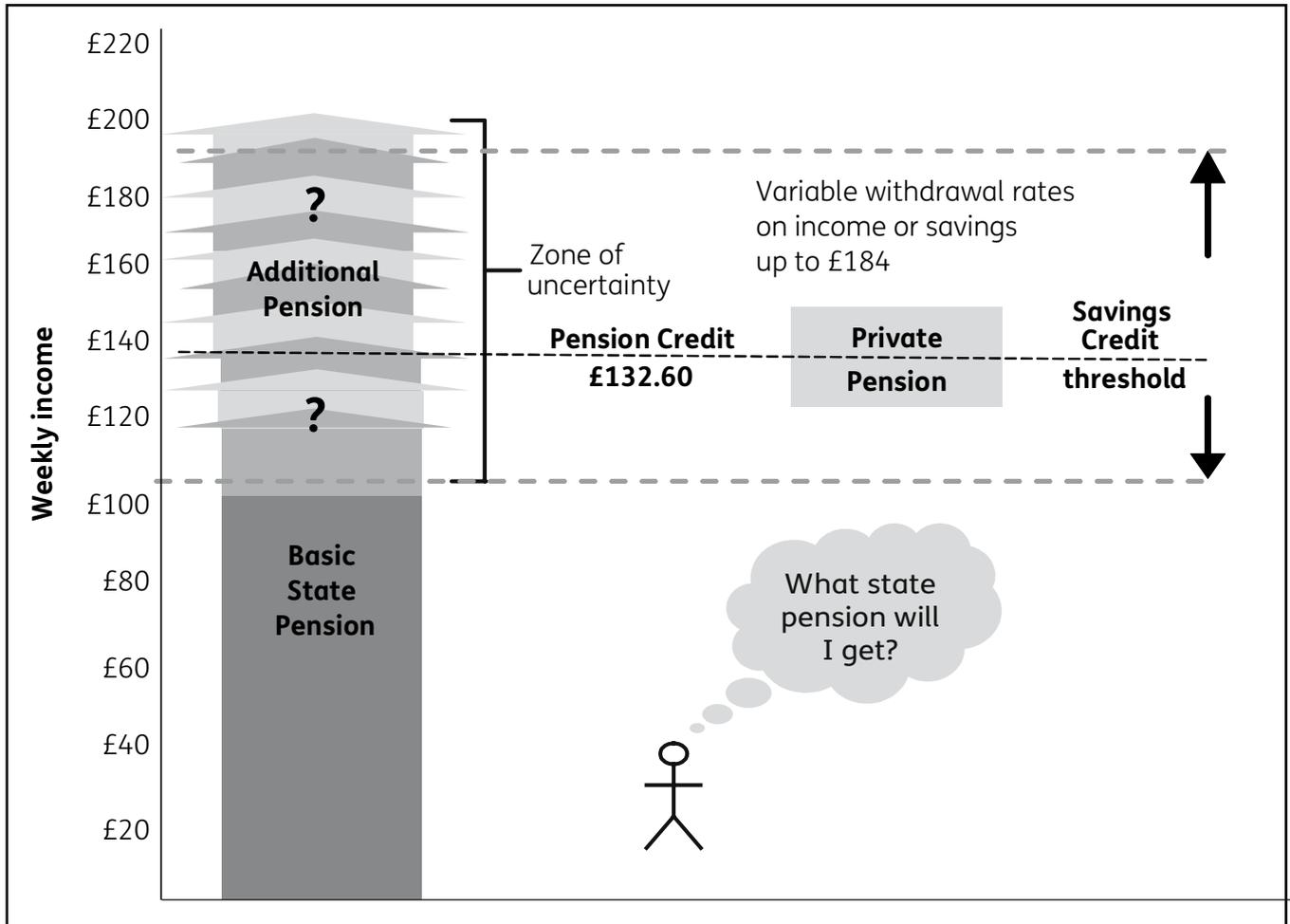
'At some time, you chose to 'contract out' of the additional State Pension by paying into an Occupational or Personal Pension. Because of this we make a contracted-out deduction (COD) from the maximum amount of additional State Pension that we would otherwise pay you. We make changes every year to the additional State Pension and the COD, but this may be at different rates. This means that your additional State Pension could be different from the amount we have estimated and could actually be reduced to nil.'

Extract from State Pension Forecast for those who have been contracted out of the State Second Pension

Uncertainty

46. It is very difficult for working people to know how much income they will get from the state in retirement. This uncertainty is a direct result of the structure of the current system.
47. The basic State Pension, worth £97.65 a week, is currently set below the safety net provided by the Pension Credit standard minimum income guarantee (worth £132.60). Whether someone has sufficient state pension income to lift them clear of the Pension Credit standard minimum income guarantee depends on, among other things, how much additional State Pension a person may be entitled to. This, in turn, is difficult to predict because how much additional pension people get will depend on a number of factors including their earnings and how long they work.

Chart 4: Structure of the current state pensions system



48. Concerns have been raised that the complexity and uncertainty of the current system act as a barrier to people being able to understand and engage with pensions, and make planning and saving for retirement more difficult.

‘It’s very confusing, for the average person it’s very confusing.’

‘It’s all hit-and-miss and airy fairy, and it really is a complicated thing. That’s why I think the government should provide a basic retirement pension for everyone.’

‘I think the thing that’s come out of all this is it’s overly complicated. The system is overly complicated.’

Pensions and retirement planning, Department for Work and Pensions Research Report No. 83, A Hedges

‘I don’t know why they can’t just keep things simple and plain, you know. It’s the person on the street that’s reading it, it’s not these government, lawyer-type people.’

How best to present State Pension information and support retirement planning, Department for Work and Pensions Research Report 690, J Hunt and J Phillips

49. The uncertainty in state pension outcomes in the current system feeds directly through to savings incentives. The amount of state pension that someone receives will determine both whether, and the extent to which, other sources of income are subject to withdrawal due to interaction with the means-tested system. For example, people receiving Pension Credit can have their private pension savings withdrawn at a rate of between 40 per cent and 100 per cent.

Dependency on means testing reduces savings incentives

50. One of the major criticisms of the current system is that the extent of reliance on means testing acts to reduce savings incentives.

‘We cannot safely ask people to save more for their old age including in NEST unless we reform the state pension platform underneath private provision and remove the means-testing trap.’

Baroness Hollis, A New State Pension, 2009

‘... one disadvantage of means-tested benefits is that they can be disincentives to save. This is because, if an individual makes private saving, the extra income received in retirement can mean lower entitlements to means-tested benefits. In extreme situations, individuals may be no better off from having saved.’

PPI, Increasing the value of saving in Personal Accounts: taking small pension pots, 2007

‘... Means-testing within the state system both increases complexity and reduces, and in some cases reverses, the incentives to save via pensions which the tax system creates.’

Pensions: Challenges and Choices, The First Report of the Pensions Commission

51. The Government believes that the general principle of having a safety net to protect the poorest pensioners is widely accepted. However, there is a question as to whether the extent of means testing in the current system strikes the right balance between protecting the poorest while ensuring people have clear incentives to save. The question of appropriate income support for pensioners in light of possible reforms is explored further in Chapter 3.
52. Currently, just under half of pensioners (45 per cent) are eligible for Pension Credit to top up their state pension. This is projected to fall to around a third by 2050 as more pensioners qualify for a full state pension in their own right and benefit from a more generous uprating of the basic State Pension¹⁵. While reliance on Pension Credit is projected to fall gradually the Government is concerned that, in light of the challenges facing current generations of savers outlined earlier, it does not fall fast or far enough.
53. It is also worth noting that Pension Credit is not claimed by around a third of pensioners who are entitled to it, a proportion which has proved fairly resilient despite efforts by successive governments to encourage pensioners to take up their entitlement. In 2008/09 between £1.6 billion and £2.9 billion Pension Credit was unclaimed by pensioners, with those who do not claim missing out on an average of around £34 a week¹⁶.

¹⁵ Department for Work and Pensions, (2008) *Projections of entitlement to Income Related Benefits to 2050*. DWP.

¹⁶ Department for Work and Pensions, (2010) *Income related benefits: Estimates of take-up in 2008-09*. DWP.

Inequalities in the system

54. The fact that women tend to have poorer outcomes than men in the current state pensions system is an issue that has been consistently highlighted. Recent figures confirm that, on average, women tend to get around £40 less state pension than men¹⁷. Women are also more likely than men to be in poverty as pensioners – around two-thirds of Pension Credit claimants are women¹⁸.

‘Eligibility for the basic State Pension has historically been complicated ... These rules meant that many people, mostly women, did not have enough credits for the full basic State Pension and accordingly receive a pro-rata pension.’

Fifth Report from the Work and Pensions Select Committee, Session 2008–09, Tackling Pensioner Poverty, HC 411-I, paragraphs 58–59

55. The comparatively poorer state pension outcomes for women can be seen to result from the fact that, historically, women have tended to have lower earnings and were less likely to have a sufficient number of qualifying years to get a full basic State Pension¹⁹. They were also less likely to become entitled to a comparable level of additional State Pension because periods spent outside the labour market caring for children were not recognised in the additional State Pension until 2002.
56. As part of the Pensions Act 2007, reforms were taken forward in an attempt to reduce inequalities for women in the state pensions system. Key measures included reducing to 30 the number of years needed to qualify for a full basic State Pension and introducing more generous credits for carers to ensure more people, particularly women, could become entitled to a higher level of State Second Pension.
57. However, it will take time for these measures to translate into improved pension entitlement. The proportion of women qualifying for a full basic State Pension will not catch up with men until around 2020²⁰. It will take a further 30 years, until 2050, before women reach comparable outcomes with men in the State Second Pension²¹.
58. In addition, it is worth noting that the self employed are not entitled to the State Second Pension because they pay a lower level of contributions than those in employment. The main rate of Class 4 National Insurance Contributions payable by the self employed on their profits will be 9 per cent in 2011–12 compared to a 12 per cent Class 1 main rate for employees. There is of course no employer contribution for the self-employed.
59. This chapter has set out some of the key challenges facing the current generation of savers. The Government is concerned that the state pension, if left unchanged, would not meet the principles of simplicity, personal responsibility fairness or affordability and sustainability.

¹⁷ Department for Work and Pensions, (2011) *Gross State Pension Entitlement*. DWP.

¹⁸ Department for Work and Pensions, (2011) *Work and Pensions Longitudinal Study*, August 2010. DWP.

¹⁹ Department for Work and Pensions, (2010) *National Insurance Contributions & Qualifying Years and Second Tier Pension Provision, 2008/9*. DWP.

²⁰ Department for Work and Pensions, (2007) *The Gender Impact of Pension Reform*. DWP.

²¹ Department for Work and Pensions, (2011) *Gross State Pension Entitlement*. DWP.

60. The complexity and uncertainty of outcomes means the state pension is unlikely to provide the foundation that is needed to help current generations in taking greater personal responsibility for saving for their retirement. Without further simplification, the state pension would remain difficult for people to understand. The fact that the contributory state pension is set to improve only gradually over time means that many would continue to rely on means-tested support to top up their income. As a result savings incentives would remain unclear.

Question 1

Would the current state pension, if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?

61. In view of the concerns raised about the current system, the next chapter considers two options for reform to deliver a simpler state pension that provides a better foundation for saving.

Options for state pension reform

2

The Government is clear that any options for reform must cost no more than if the current system continued. This chapter sets out two potential options which seek to deliver a simple, flat-rate contributory state pension that lifts the majority of future pensioners above the standard level of means-tested support:

- **Option 1** – accelerate the pace of existing reforms so that the state pension evolves into a flat-rate two-tier structure more quickly; or
- **Option 2** – more radical reform to a single-tier pension set above the level of the Pension Credit standard minimum guarantee.

This chapter assesses each option against the Government's principles for reform – personal responsibility, fairness, simplicity, affordability and sustainability.

The two options presented share a common set of underlying objectives – to simplify the system, reduce reliance on means testing and provide people with clearer incentives to save.

Building on recent reform

62. The key priority for this Government on coming to office was to address issues facing current pensioners by introducing the triple guarantee for the basic State Pension, and protecting additional support for pensioners. Given the challenges confronting the next generation of savers, the priority is now to ensure that the state pension provides a clear platform to support private pension saving.
63. But, as set out in the previous chapter, the existing state pension is extremely complex, making it difficult for individuals to plan and save for their retirement. The extent of means testing within the system means that saving incentives are often unclear and significant inequalities remain for women. The Government believes that the current system, if left unchanged, would not meet the principles of personal responsibility, fairness, simplicity and affordability and sustainability.

64. The next section sets out two broad options for reform of the state pension for future pensioners which aim to deliver a simple, flat-rate contributory state pension that lifts the majority of future pensioners above the level of the standard means-test²²:
- **Option 1** – accelerate the pace of change of existing reforms by speeding up the transition towards a simpler, flat-rate two-tier state pension; or
 - **Option 2** – more radical reform introducing a single-tier pension set at a level above the Pension Credit minimum guarantee.

Option 1: speed up the transition to a flat-rate two-tier pension

65. Currently, the basic State Pension is a flat-rate payment worth £97.65 a week and the State Second Pension is partly flat rate and partly linked to earnings. Under reforms legislated in the Pensions Act 2007, the earnings-related part of the State Second Pension is set to be phased out in the early 2030s, at which point the State Second Pension will be valued at £1.60 a week for each qualifying year.
66. One of the reasons for this change is that a flat-rate State Second Pension will provide people with a clearer idea of the state pension they can look forward to when they retire. This is because people would know that they would receive a set amount of pension in return for each qualifying year.
67. The transition to a flat-rate State Second Pension could be speeded up by phasing out the earnings-related component of the State Second Pension more quickly – by 2020 instead of the mid-2030s. Currently, people can build up earnings-related State Second Pension on earnings between around £14,000 and £40,000. Under current legislation this band is being reduced gradually. Under option 1, the upper band of £40,000 would be brought down to £14,000 over seven years. At the end of this period, people would only build up the flat-rate amount of £1.60 for each qualifying year.
68. Under this option, in the longer term people with 30 years of contributions in both the basic State Pension and State Second Pension could expect to retire on a state pension of around £145 a week. This would consist of around £97 in basic State Pension and £48 in State Second Pension. People who contract out of the State Second Pension will, as now, receive part of that pension payment from their private pension rather than delivered through the state (see box on page 32).
69. On the most incremental version of this option, the qualification criteria for both elements of the state pension would remain broadly unchanged. People would have to have 30 qualifying years to qualify for the full basic State Pension, but could pay contributions that count towards the State Second Pension for the whole of a working life, from age 16 to State Pension age.
70. The entitlement rules would continue as now: people receiving Jobseeker's Allowance would be credited with contributions for the basic State Pension, but not the State Second Pension; and people who are self-employed would not be able to pay contributions for the State Second Pension. The method of uprating the two pensions would also continue as now. The basic State Pension would continue to be uprated in line with the triple guarantee and the State Second Pension in line with the Consumer Prices Index (CPI).

²² This is defined as the level of income provided by the Pension Credit standard minimum income guarantee which currently tops up pensioners' income to £132.60 a week.

71. Our initial view is that under this option the Savings Credit would need to be retained for future pensioners.
72. There would be scope to simplify the system as part of this option by consolidating the calculations of the different pensions used to determine the additional State Pension²³. This has already been legislated for under the Pensions Act 2008. Consolidating past calculations would give people a clearer idea of their future pension and provide a more transparent basis for a flat-rate pension going forward.

Possible further change

73. If the decision is taken to introduce the changes outlined under option 1, the differences between the two elements of the state pension could be reduced. This could be done by aligning the crediting arrangements for the basic State Pension and State Second Pension more closely, bringing the self-employed into the State Second Pension and uprating both elements of the state pension by the same amount. Other elements of the design could also be considered, such as introducing a minimum qualification period.
74. If changes are made which increase the coverage of the state pension, savings would need to be found from elsewhere to ensure this option remained cost neutral. For example, funding more generous crediting arrangements and more generous uprating of the state pension would mean reducing the value of the State Second Pension. This might mean that an individual with 30 years of qualifying contributions would build up a state pension of between £135 and £145 depending on the design of the overall system.

Summary of option 1 – speed up transition to flat-rate two-tier pension

- Thirty qualifying years for full entitlement to basic State Pension.
- For State Second Pension 49/50 qualifying years maximum (from 16 to 65/66).
- Basic State Pension value as now, uprated by triple guarantee.
- State Second Pension £1.60 a week for each qualifying year, revalued by earnings until State Pension age and uprated by CPI in payment (as now).
- Earnings-related component to be withdrawn more quickly than under Pensions Act 2007, over period from 2013 to 2020.

Options for further change

In order to address inequalities and ensure more people receive a state pension above the level of the standard means test, it would be possible to:

- a) bring the self-employed and job seekers into eligibility for the State Second Pension.
- b) apply the same indexation rate to increase the basic State Pension and State Second Pension in payment.

However, the level of a two-tier system would need to be set so as to achieve cost neutrality.

²³ This would include earnings-related pension built up under the Graduated Retirement Benefit, State Earnings Related Pension Scheme and State Second Pension.

Assessment against principles for reform

75. This option would make the State Second Pension more transparent and provide people with a clearer indication of the overall state pension they could receive. It would also ensure that each year of work and credits would be recognised in the state pension and could be designed to be cost neutral over the long term.
76. However, the State Second Pension, which is one of key causes of variability and uncertainty in state pensions, would be retained, meaning people would not have absolute clarity as to the amount of state pension they would receive when they retire (as set out in Chart 4 in Chapter 1).
77. The nature of pension reform is that full transition can take a long time. At its most incremental, option 1 would be relatively slow to deliver improved state pension entitlement. Under this option, the large majority of people could expect to receive a state pension that lifted them above the standard level of means-tested support only by around the middle of this century. This raises questions about whether this option would clarify savings incentives in time for the roll-out of automatic enrolment from 2012 and go far enough in delivering the platform that is needed to support current generations in saving for their retirement.
78. Fairer support for women and others who traditionally have lower pension entitlement would take many years to be delivered in full under option one.
79. Under this option, the State Second Pension would be retained, but in a form that delivers clearer, flat-rate state pension provision. Consequently, the system of contracting out for members of Defined Benefit schemes would also remain. However, the value of the rebate would be adjusted so that it continued to reflect the cost of benefits given up.
80. Moving from the current system to faster flat rating would not be difficult operationally as this option brings forward changes which have already been legislated, and planned for. However, it would take a significant amount of time – until around 2070 – for earnings-related State Second Pension to fully work its way out of the system for newly retired pensioners and, without further simplification, much of the complexity of the current system would remain.
81. The Government recognises that this transition to a two tier flat rate pension would take time. We would be interested to discuss how this could be addressed in a way that would be consistent with our principles for reform.

Impact on individuals

82. A flat-rate pension would make the state pension more transparent, but the amount of state pension that people get would continue to be uncertain and vary between individuals. Those with longer working lives would continue to build up more state pension.

Question 2

To what extent would faster flat rating meet the principles for reform and improve savings incentives?

Question 3

What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?

Faster flat rating – assessment against principles for reform**Simplicity**

- Consolidating past calculation and flat rating make the state pension more transparent.
- Greater simplicity through flat-rate support, but complexity through the maintenance of a two-tier system.

Fairness

- Ensures each year is recognised in the state pension.
- It would take until around 2050 before 90 per cent of people get a state pension of £145.
- Improved crediting, introduced in 2002, will deliver fairer outcomes for women in the longer term.

Affordability and sustainability

- Cost neutral.

Personal responsibility

- Flat-rate amount would provide greater clarity for people needing to save, and ultimately deliver flat-rate support.
- Uncertainty linked to two-tiered pension may not give a clear foundation for saving.

Option 2: A single-tier flat-rate pension above the Pension Credit standard minimum guarantee

83. An alternative, more radical approach would be to combine the basic State Pension and State Second Pension to create a single-tier state pension for future generations of pensioners set at a level above the Pension Credit standard minimum guarantee.
84. To qualify for the full amount of the single-tier pension people would, as now, have to build up 30 years of National Insurance contributions or credits.
85. People would qualify for the single-tier pension individually, irrespective of whether they were married, divorced or widowed, reflecting the fact that most people working today can expect to build up sufficient state pension in their own right. Rules around state pension entitlement would be simplified so that there would be no special rules for bereavement, marriage or divorce.

86. The self-employed, as well as employees, would be able to build up entitlement to the single-tier pension.
87. There would be a minimum level of seven years of contributions or credits to qualify for the single-tier pension. This would ensure that state pension expenditure is targeted at those who make a contribution to this country over their working lives.
88. The full amount of the single-tier pension would be uprated in line with the triple guarantee (the higher of earnings, prices or 2.5 per cent) ensuring that it maintained its value over time. The Savings Credit element of Pension Credit would be abolished for future pensioners because the vast majority of people could expect to retire with a State Pension above the level of the Pension Credit standard minimum guarantee.
89. Under this option the State Second Pension would end and with it the ability to contract out of the State Second Pension. While this would be a significant simplification of the personal tax system, it would also have significant implications for employees, employers and schemes. We provide further detail of this later in this chapter.
90. Our assessment indicates that a state pension currently estimated at around £140 would be cost neutral. The model set out here could be funded within the overall spending on state pensions. This would be achieved through the abolition of the Savings Credit, closure of the State Second Pension and the introduction of a seven year minimum qualifying rule for future pensioners. The revenue from ending contracting out (the National Insurance rebate) has been excluded from this assessment of costs. Final proposals 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.

Summary of option 2 – a single-tier pension above the Pension Credit standard minimum guarantee

- Everyone with 30 years of contributions or credits reaching State Pension age would receive a weekly flat-rate payment currently estimated at around £140, which would be above the Pension Credit standard minimum guarantee.
- Everyone would qualify individually – whether single, married, divorced or widowed and no special rules for marriage, bereavement or divorce.
- For self-employed as well as employees (subject to National Insurance considerations).
- Uprated by the higher of earnings, prices or 2.5 per cent.
- Minimum qualification of seven years of National Insurance contributions or credits.

The following components of the existing system would end for future pensioners:

- The State Second Pension, and with it the ability to contract out of the State Second Pension.
- Savings Credit, as most people could expect to retire on a state pension that lifted them clear of the Pension Credit standard minimum income guarantee.

91. This option would provide people with clear saving incentives, ensuring around 90 per cent of people retiring in the new system would qualify for a state pension which lifts them above the threshold for the Pension Credit standard minimum income guarantee by around 2020²⁴. This would mean the state pension would provide a strong platform to enable people to take greater personal responsibility for saving for their retirement. However, for a significant proportion (e.g. around a half of pensioners by around 2050), this pension would consist in part of private provision built up using the contracted-out National Insurance rebate. This is because, as now, the state pension people receive takes account of periods spent contracted out of the State Second Pension. Further detail is provided in the box on page 32.
92. This option would deliver improved pensions for women, low-paid workers and the self-employed, providing the basis for a fairer system. The whole pension would be uprated by the triple guarantee so people could be confident their State Pension would maintain its value over time.
93. However, the trade-off for the greater simplicity and clarity provided by giving everyone with a full contribution record a set flat-rate amount is that the amount of State Pension would be capped at 30 qualifying years. In practice, this means that people who build up National Insurance contributions or credits for additional years would not receive more than the flat-rate payment. In addition, the end of contracting out would mean that people who have paid lower rates of National Insurance, due to being contracted out, would start to pay the same amounts as other employees (for further details see the final section of this chapter).
94. Introducing the single-tier would be a radical reform of the state pension. Major change such as this could not be introduced without taking into account the contributions people have made under the current system. Recognising these contributions would inevitably mean that some of the complexity of the current system, particularly related to contracting out, would continue during the transition to the single-tier pension.

Transition to the single-tier pension

95. In managing the transition from the current system to single tier there would be two main issues to address:
1. **Recognising people's pension records under the existing system in a way that is fair, but facilitates transition to the new system as quickly as possible:** This could be achieved by calculating pension records under the existing system and then, during transition to the new system, recognising amounts in excess of the currently estimated single-tier pension of £140. This would mean people with higher amounts of additional State Pension before the introduction of single tier would receive correspondingly higher weekly payments than the current estimate of £140.
 2. **Calculating entitlement to the new pension taking account of periods spent contracted out of the State Second Pension in a way that is fair, but delivers simplicity and clarity as quickly as possible:** This would mean that during the transition many would receive their single-tier pension from a combination of their state and contracted out scheme, as happens now. This means they would receive less than the currently estimated £140 directly from their state pension. We estimate that around half of pensioners could have an offset applied to their single tier pension by around 2050. Further detail is provided in the box on page 32.

²⁴ Department for Work and Pensions, (2007) *The Gender Impact of Pension Reform*. DWP.

The contracting-out offset

Under the current system, people who have spent periods in schemes contracted out of additional State Pension (State Second Pension and its predecessor State Earnings-Related Pension Scheme (SERPS)) have an amount deducted from the state pension they receive when they retire. This reflects the fact that people in contracted-out schemes do not contribute to the additional State Pension and thus pay a lower rate of National Insurance (the National Insurance rebate). The rationale for the rebate is that people receive an amount of pension from their contracted-out scheme at least as good as the state pension given up. In Defined Benefit schemes, the scheme provides members with a minimum level of benefit and Defined Contribution schemes invest the rebate on members' behalf. The purpose of the contracting-out offset is to ensure that all provision funded by the taxpayer, including that funded by the National Insurance rebate, is taken into account when calculating people's entitlement to the state pension.

As an example, consider someone who reaches State Pension age retiring with a state pension worth £177.60 a week. If this person was contracted out of SERPS between 1978 and 1997 and accrued a Guaranteed Minimum Pension of £40 a week – which their scheme will pay – they will receive £137.60 a week directly from their state pension.

Under single-tier, contracting out would end with the closure of the State Second Pension. However, it could take a significant amount of time for members of contracted-out schemes to work through the system. This means that the need to apply an offset to take account of periods spent contracted out of the State Second Pension would continue under single tier. Many pensioners would receive their single-tier pension through a combination of their state pension and contracted-out pension scheme, as happens now. We estimate that around half of pensioners could have an offset applied to their single-tier pension by around 2050.

The Government recognises that transition to a single tier flat rate pension would take time. We would be interested to discuss how this could be addressed in a way that would be consistent with our principles for reform.

Impact on individuals

96. In broad terms, people on low incomes and people who have been excluded from additional State Pension, such as women and the self-employed, would gain under this option, although loss of Savings Credit and reform of inherited rights would be expected to affect some people in these groups. Groups who would expect to build up more significant amounts of State Second Pension, such as those with longer working lives and higher earners, would not be able to do so under this option. The introduction of a seven year minimum qualifying rule would also affect the entitlement of older people who are either late migrants to this country or who have had very little contact with the National Insurance system.

Single tier – assessment against principles for reform

Simplicity

- Flat-rate payment easy to understand and gives people clarity and certainty.
- Complexity of contracting out would remain during transition – with many pensioners not receiving the full single-tier pension directly from the state until transition is complete.

Fairness

- Large majority get a state pension which lifts them above the standard level of means-tested support.
- Triple guarantee ensures single tier retains its value over the long term.
- Improved pensions for women, self-employed and other groups more quickly than current system.
- No ability to build up additional state pension entitlement beyond 30 qualifying years.

Affordability and sustainability

- Cost neutral.

Personal responsibility

- Certainty of a pension above the level of means testing provides a clear and simple platform for private pension saving.
- It would take until around 2050 for a majority of pensioners to receive their full single-tier pension directly from the state.

Question 4

To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?

Question 5

Which of these two options would act as the best complement for automatic enrolment?

Question 6

Government would be interested in hearing views on other reform options that would meet the Government's principles for reform.

Ending contracting out for Defined Benefit schemes

97. Where individuals are contracted out of the State Second Pension they and their employers receive a rebate on their National Insurance contributions to reflect the fact they are building up less state pension entitlement. Schemes are obliged to either invest the rebate directly into the scheme on members' behalf (in Defined Contribution schemes²⁵) or provide members with a minimum level of benefits as set out in legislation for Defined Benefit schemes. The purpose of the contracting-out rebate is, in effect, to compensate members for the additional state pension they have given up.
98. This chapter has set out two options for state pension reform. Under option 1 (faster flat-rating), contracting out would continue, although the value of the rebate would fall over time. Under option 2 (single tier) contracting out for Defined Benefit schemes would end completely. The Government is interested in hearing views and receiving evidence on the impact of ending contracting out completely on employees, employers and schemes in the public and private sector. We would also be interested in hearing views on how best to manage the process to remove contracting out, if the decision is taken to end this aspect of the current system.
99. If, following consultation on the proposals set out in this paper, a decision is taken to close the State Second Pension to new accruals and end contracting out, sponsors and members of Defined Benefit schemes contracted out of the state second pension would face an increase in National Insurance contributions, so that they would pay the same rate of National Insurance as other employers and employees. Based on the value of the rebate in 2012 the increase for employers would be 3.4 per cent of National Insurance contributions on earnings between £5,044 and up to £40,040²⁶. Employees would face an increase in National Insurance contributions of 1.4 percentage points to the same upper limit. So while this would be a significant simplification of the personal tax system, it would also have significant implications for employees, employers and schemes.
100. While sponsors of contracted-out schemes would lose the rebate, the legislative requirement for schemes to provide a certain level of benefits would no longer apply. In theory, scheme rules could be changed to reduce the benefits payable and hence reduce the contributions that employers are required to make, so that there is no impact on employers from the loss of the National Insurance rebate. However, it may be difficult for some schemes to do this in practice and the Government would wish to support a balance being struck between the need to ensure provision is sustainable and that it provides good value for members.
101. This Government is committed to reinvigorating private pension provision and creating the right conditions for higher household savings. In support of this objective, the Government has already taken action to improve the environment for employers, for example, by adapting automatic enrolment to ensure the regulations are more targeted and less burdensome.

²⁵ Under Pensions Act 2007, contracting out for Defined Contribution schemes end in 2012.

²⁶ £5,044 is the Lower Earnings Limit in 2010/11 and £40,040 is the Upper Accrual Point, the upper limit of earnings for a State Second Pension.

Question 7

What would be the impact of ending contracting out, as implied by any single-tier model?

Question 8

If the decision is taken to end contracting out how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

102. This chapter has set out two possible options for reform of the state pension. The next chapter considers the future role and structure of the safety net currently provided by Pension Credit.

Means-tested safety net for pensioners

3

As Chapter 1 stated, the Government believes that a safety net will continue to be needed to protect the poorest. However, there is widespread concern that the current prevalence of means testing undermines savings incentives for future pensioners. Currently, almost half of pensioners (45 per cent) are eligible for Pension Credit.

Chapter 2 outlined options for delivering a simpler state pension that provides a firmer foundation for saving. Option 1, which accelerates the pace of existing reforms, would result in reduced reliance on means-tested support gradually over time. Option 2, involving radical reform to deliver a single-tier pension above the Pension Credit standard minimum guarantee, would reduce reliance much more quickly.

In view of potential reforms to the state pension, the Government is consulting on whether the current system of means-tested support would best meet the needs of future pensioners and whether the current system of means-tested support should be reformed in line with the Government's principles for reform.

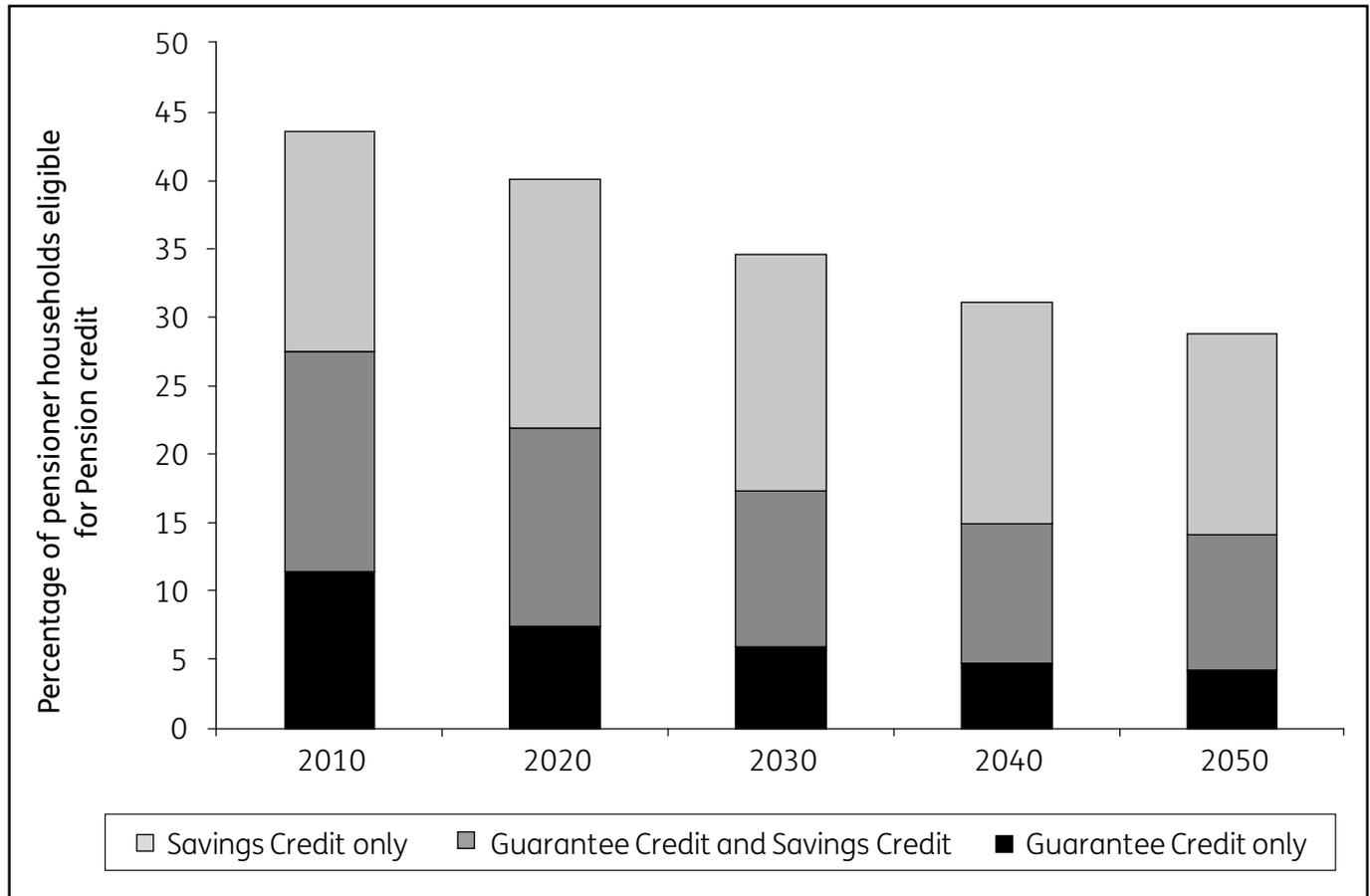
Means-tested support today

103. Whatever the shape of the state pension, the Government recognises that there will always need to be a safety net benefit to help those pensioners who do not have sufficient resources to meet their basic needs in retirement.
104. Pension Credit currently fulfils this support for pensioners' basic needs, and will continue to support today's pensioners who have insufficient resources for their basic needs in retirement.

105. Pension Credit currently has two elements – the Guarantee Credit that ensures people have a minimum income (£132.60 a week for single people and £202.40 a week for couples), and the Savings Credit that ensures those with small amounts of savings see some reward (they keep 60 pence for every additional pound of income above £98.40 for a single pensioner). In addition, Pension Credit provides additional support for disability, care and pensioners with mortgages. Many of those on Pension Credit may also get additional support through Housing Benefit and Council Tax Benefit.
106. The Savings Credit element was introduced to ensure that those who had made some modest provision for their retirement above the level of the basic State Pension were rewarded for saving. However, due to under-saving for retirement, Pension Credit has effectively evolved from being a safety net to protect the poorest pensioners to being a more general top up for basic retirement income for those who have had low and moderate incomes during their working lives. A quarter of pensioner households – some 3.3 million individuals (2.7 million households) – now receive Pension Credit to supplement their retirement income. Those saving for their retirement may have justifiable concerns that for every additional pound they save the gains will be offset by a reduction in the means-tested support they could receive.

The need for change

107. Means-tested support raises two issues for a person saving for their retirement. First, there is the possibility that they will be subject to means-testing when they retire; and second, if they do end up on means-tested support there is uncertainty about the extent of withdrawal of benefits for every pound of income. We believe both of these areas mean there is scope to improve a person's savings incentives by reforming means-tested support.
108. Pension Credit has been – and will remain – an effective means of delivering additional support for many of those who retire on existing state pensions. But the situation in the future will be different. As more people get a decent pension in their own right, the proportion of people needing means-tested help will fall gradually. Chart 5 shows how the proportion of pensioners eligible for Pension Credit is expected to fall over time under the current system. The proposals outlined in Chapter 3 would potentially reduce reliance far more sharply than shown in Chart 5, so future pensioners are likely to be far less reliant on means testing.

Chart 5: Proportion of pensioners entitled to Pension Credit

109. Of course there will always be a need for a safety net for those people who, for whatever reason, have insufficient resources when they retire.
110. However, when looking to the future, it is not clear that the current system can deliver on the principles for pension reform, particularly simplicity and promoting personal responsibility.

The future safety net

111. As Chapter 2 outlined, there are two potential options for reform of state pension. Under Option 1 Savings Credit would be retained. Option 2 on the other hand would see the abolition of Savings Credit for future pensioners as the vast majority of future pensioners would have a single-tier pension which lifted them above the basic level of support provided by Pension Credit.

112. Pension Credit is an effective safety net in helping to keep today's pensioners out of poverty. However, we are interested in views as to whether a continuation of the current system of Pension Credit for future pensioners would help achieve the Government's principles of a state pensions system that is simple, fair, promotes personal responsibility, and is affordable and sustainable. Any reforms would need to be delivered without increasing public spending in any year.

Question 9

In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-testing system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

State Pension age

4

The State Pension age plays an essential role in ensuring that the state pension remains sustainable and affordable – one of the key principles for future pension reform. The Government has acted quickly to take recent increases in life expectancy into account by setting out proposals to increase the State Pension age to 66 by April 2020. This will help keep the state pension sustainable.

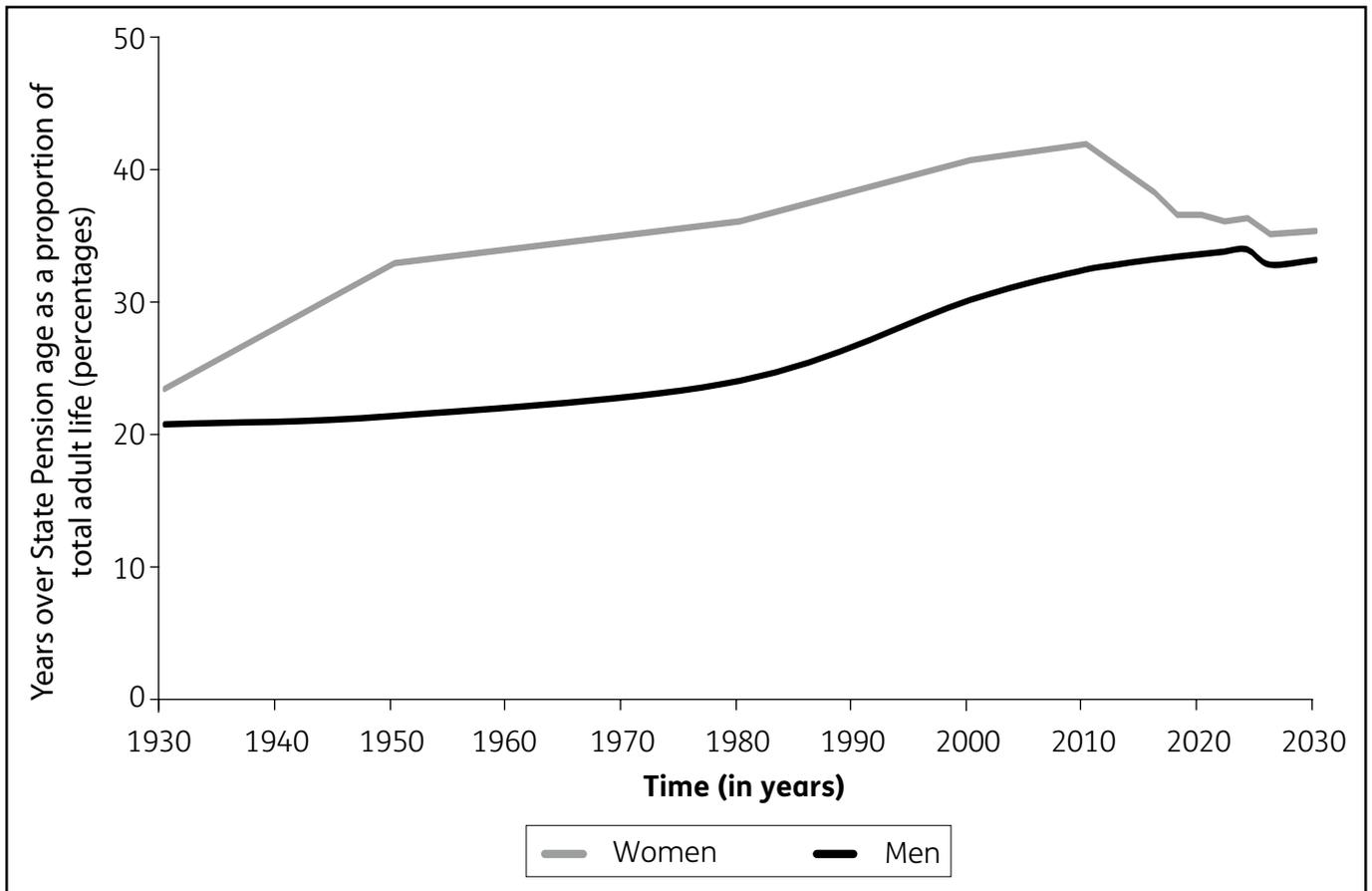
But these increases in longevity do not end in 2020 and it is only fair that those generations who will benefit from these increases share in the costs. Not to do so would be unfair on the people of working age who would need to bear the cost of this increased longevity. In addition, there are significant benefits to the economy and individuals from working longer.

So the Government must continue to consider the State Pension age and believes that an objective process is the best way of making these decisions. We are therefore inviting views on how to build into a new state pensions system a more automatic mechanism for ensuring that further revisions in life expectancy are taken into account in a way that is timely and transparent. The Government recognises that this may have implications for the current timetable for increasing the State Pension age beyond 66.

113. One of the key principles underpinning pension reform must be that the state pensions system is one that future generations can afford. The age at which the state pension is available plays a significant role in ensuring the sustainability of the state pensions system as a whole. No reform to the state pension would be complete without considering how the State Pension age should change in the future, and in a more automatic way than is currently the case.
114. We are, on average, living longer, and an increasing proportion of us are surviving to older age. It is unrealistic to expect the state pension to continue to provide a solid foundation income for our retirement if the age at which we can start receiving it remains unchanged.

Increasing life expectancy

115. The Government is acting on its commitment to review the timetable for increasing the State Pension age to 66. While this has generated much discussion, there is general agreement that increasing average life expectancy means that the increase to age 66 must be brought forward from the current 2026 date.
116. There are good reasons for this view. As discussed in Chapter 1, average life expectancy at age 65 has increased significantly since the first contributory pension was introduced in 1926. More people survive to age 65 now than ever before. Despite a reduction in pension age from 70 to 65 in 1926, only around 34 per cent of men and 40 per cent of women born in 1861 lived long enough to draw a pension. Of the generation born in 1945, 78 per cent of men and 85 per cent of women were expected to live to age 65 in 2010.
117. The 'baby boom' generations are now also beginning to reach 65, increasing the number of people in retirement. By 2030 there will be one and a half times as many people aged over 65 as there were in 2010.
118. But perhaps the most striking aspect of the increase in longevity is the speed of this increase over the recent past. It took 70 years – between 1920 to 1990 – for average life expectancy at age 65 to rise by five years. The next five year increase took just 20 years, between 1990 and 2010.
119. These rapid life expectancy increases in later life, combined with the first of the 'baby boom' generations reaching 65 in 2010, mean that more people will spend longer in retirement. When considered as a proportion of an individual's total adult life, the amount of time in retirement and receiving state pension has increased significantly over the years.

Chart 6: Time spent in retirement as percentage of total adult life²⁷

The consequences of a longer later life

120. The consequence of this longer later life is profound. Chapter 2 showed that the proportion of the population aged between 65 and 85 is projected to increase sharply. Such significant demographic change presents both challenges, particularly in terms of the fiscal consequences of an ageing population, and opportunities, to harness the social and economic contributions of people in later life.
121. An ageing population will create significant pressures on the public finances. This is partly a consequence of the nature of the state pensions system, with the state pensions of today's pensioners mainly paid for by the current working-age population. The change in the age structure of our society means that a proportionately smaller number of working-age people will be required to support an increasing number of pensioners. In addition, the significant increase in people over retirement age will also act to drive a large rise in age-related public spending in areas other than the state pension, particularly health and social care. The independent Commission on Funding Care and Support is considering how to best meet the costs of social care as a partnership between individuals and the state.

²⁷ For data up to 1980, DWP analysis is based on ONS Cohort Life Tables for England and Wales (2008), principal projections. For data after 1980, DWP analysis is based on ONS Cohort Life Tables for the UK (2008), principal projections. Note: State Pension age for women was reduced from 65 to 60 in 1940.

122. So further pressure to spend more on the state pension arising as a result of increased longevity will need to be considered alongside other spending demands which will inevitably arise from an ageing population.
123. In 2009–10, age-related public spending (health, education, pensions and social care) accounted for 22.5 per cent of Gross Domestic Product (GDP). With unchanged policies, this total is projected by the Office for Budget Responsibility to rise to 25.1 per cent of GDP in 2029/30 and 26.6 per cent of GDP by 2039–40, purely as a consequence of demographic change.²⁸ At current prices, this would correspond to extra public spending of almost £60 billion by 2040.
124. The more rapid than expected increases in longevity witnessed in recent years have had significant implications for projections of future state pension spending. For example, projected spending on state pensions by the middle of this century has increased by around 0.5 per cent of GDP in the space of only two years, between 2008 and 2010.²⁹
125. These longer term fiscal pressures need to be tackled, as without policy change increasing demand for age-related public services will necessitate a larger share of GDP being devoted to the provision of these services. This would require higher taxes or increased borrowing – both of which would be potentially economically damaging – or cuts in public spending in other areas.
126. So the case for taking action to constrain future spending pressures from our ageing society and managing these challenges more automatically through the state pensions system is strong. It is only right that those people who benefit from increases in longevity, and so receive a state pension for longer, share in the costs.
127. Older people can and do make a significant contribution to both society and the economy. The National Institute of Economic and Social Research³⁰ has estimated that extending working life by one year would increase GDP by around 1 per cent (around £14 billion).
128. Employers can also see financial gains from older employees. Many companies have found that encouraging and enabling older employees to remain in work has allowed them to retain skilled staff, reduce recruitment costs, and have staff who can mentor less experienced employees.
129. Individuals also benefit financially from working longer. As well as the additional income from earnings, working longer allows people more time to contribute to their private pensions and generally results in a larger pension when it is drawn.
130. The benefits of increasing older people's participation in the labour market are wider than simply financial. Evidence has shown that remaining in high quality work has health benefits to the individual. Harnessing these benefits will become increasingly important as the population ages. Many older people also find that working provides an opportunity to broaden their social contacts, or gives them a sense of purpose and achievement.
131. Changes in life expectancy, and the consequences that flow from this, mean that the current timetable for increases in the State Pension age – despite being passed into law only in 2007 – no longer matches current projections of life expectancy.

²⁸ Office for Budget Responsibility, *Economic and fiscal outlook*. November 2010, page 145.

²⁹ Comparing projections for spending on State Pensions in HM Treasury's 2008 *Long-term public finance report* and the Office for Budget Responsibility's October 2010 *Economic and fiscal outlook*.

³⁰ Barrell, Kirby and Orazgani, *The Macroeconomic Impact of Extending Working Lives*, DWP Working Paper 95. January 2011.

132. This is because increases in State Pension age to 66, 67 and 68 were set using life expectancy projections published in 2004. Revised projections available in 2006 and 2008 meant this Government had to act quickly to bring forward the increase to 66.

A mechanism for future increases

133. In the period between 1926 and 2010 the only change to the State Pension age was to reduce it from 65 to 60 for women in 1940. In 2005, the Turner Commission addressed the need to reflect improvements in longevity in the State Pension age. At the time, the report recommended that ‘the latest trends in life expectancy and implications for the long-term public expenditure/State Pension age trade-off’ should be considered on a regular basis.
134. As well as ensuring that the state pension provides a firm foundation, developing a state pensions system fit for the 21st century means accepting that the era of a static State Pension age, set long into the future, must end. The State Pension age must ensure that the state pension remains sustainable and fair between the generations.
135. So the question is how to build into a future state pensions system a more automatic mechanism for ensuring that further changes in life expectancy are taken into account in a way that is timely and transparent.
136. Such a system would need to balance the needs of individuals to have some certainty about when to expect their state pension with the need to protect against the fiscal consequences of greater than expected increases in life expectancy. It could consider the timing of the move to 67 and 68 and any potential further increases well into the future.
137. The Government believes the principles for pension reform are also relevant to the design of a mechanism for regularly considering the State Pension age in a structured way:
- **Personal responsibility:** any mechanism must support individuals in taking responsibility for their retirement provision.
 - **Fairness:** any mechanism needs to ensure that the State Pension age is fair to individuals from different generations by sharing the increased cost of longevity between those who will benefit from the increases in longevity and those who will bear the cost. It also needs to be fair to individuals whose State Pension age will be changed by a new system.
 - **Simplicity:** just as people need to understand what their state pension will be worth when they retire, they need to know when they will be entitled to it.
 - **Affordability and sustainability:** the State Pension age needs to ensure that demographic changes are reflected in the age at which people can receive the state pension, taking account of the economy, labour market and other factors.
138. It would be important for any mechanism to command widespread confidence, and so the extent to which any decision is informed by evidence independent from Government is of critical importance in designing a mechanism, particularly around the life expectancy projections which will form the basis of any decision.
139. There are a number of different ways that a future mechanism could be implemented, and the Government is interested in views about the best system. Two possibilities are set out below.

Increasing the State Pension age through a formula linked to life expectancy

140. One way of adjusting the State Pension age could be through the use of a formula. Through this approach any increases in life expectancy would automatically adjust the State Pension age to reflect revisions in projected longevity.
141. This approach could provide a greater degree of certainty over how future increases in life expectancy would be reflected in the timing of increases in the State Pension age. It could also provide a more objective means of setting the State Pension age if the formula had widespread support.
142. However, reliance on a legislated formula in its simplest form could also mean that the State Pension age would not be a fixed age for any period, but would rise on a continual basis as soon as revised life expectancy projections were available.
143. A more complicated formula that captured wider factors in some way might not meet the simplicity test, as it would be more complicated for individuals to be certain about their State Pension age.
144. In the face of the sort of rapid gains in longevity witnessed over the past 20 years, there may be difficulties in balancing the need to maintain parity with a formula with the need to provide some period of notice for those affected by any increases.
145. Finally, a formula set out in primary legislation might not provide an appropriate level of Parliamentary oversight if the State Pension age was automatically increased without Parliament being able to bring wider factors into the decision. But to put in place this kind of 'safety valve' would negate the value of a clear link between the formula and the extent of any State Pension age increase.

Increasing the State Pension age through a review

146. An alternative approach would be to put in place a review at regular, pre-determined intervals. This would give greater certainty about when the State Pension age would be considered again in the future.
147. A review would enable the latest life expectancy projections to be taken into account. This review could be informed by an independent report covering some of the key factors around longevity, and could include a principle (such as the proportion of adult life in retirement) against which a recommendation or decision could be made on the timing of further increases.
148. A review-based approach would also enable wider factors to be taken into account by Government in making any final decisions such as variations in life expectancy for those in lower socio-economic groups, healthy life expectancy and the fiscal position.

149. Potentially, a review mechanism could be more complex than a formula to determine what the State Pension age should be because of the range of different, possibly conflicting, evidence and the relevant weighting that should be applied to each.
150. It would, of course, be possible to combine the two approaches. The Government could, for example, set a formula based on average life expectancy, but only make changes to the timetable through a periodic review, considering the latest information on longevity.

Question 10

What mechanism should be used to determine future increases in State Pension age?

151. In setting a mechanism to consider future State Pension age rises, the Government must take into account that a longer notice period increases the risk that the timetable is out of date by the time the increase in State Pension age is reached. This is because of the increases in life expectancy between the timetable being set and the increases in State Pension age actually taking place.
152. This issue needs to be balanced against the time required for individuals to prepare for an increase in their State Pension age.
153. The Government would be interested in views on how this balance might best be achieved, and whether a minimum notice period should be included in a future mechanism.

Question 11

How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

Summary of consultation questions and process

5

154. This paper seeks views and tests our thinking on reforming the state pensions system. We would like to hear from all who are interested. Throughout this paper we have asked a number of questions and sought your views on a number of issues:

Chapter 1 – The current pension system

Question 1

Would the current state pension, if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?

Chapter 2 – Options for state pension reform

Question 2

To what extent would faster flat rating meet the principles for reform and improve savings incentives?

Question 3

What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?

Question 4

To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?

Question 5

Which of these two options would act as the best complement for automatic enrolment?

Question 6

Government would be interested in hearing views on other reform options that would meet the Government's principles for reform.

Question 7

What would be the impact of ending contracting out, as implied by any single-tier model?

Question 8

If the decision is taken to end contracting out, how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

Chapter 3 – Means-tested safety net for pensioners

Question 9

In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-testing system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

Chapter 4 – State Pension age

Question 10

What mechanism should be used to determine future increases in State Pension age?

Question 11

How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

How to respond

155. The consultation period begins on 4 April and you should ensure your response reaches us by 24 June 2011. Please send your response to:
- State Pensions reform consultation team
Pensions Analysis and Incomes Division
Department for Work and Pensions
5th Floor
Caxton House
Tothill Street
London SW1H 9NA
Email: statepension.reformconsultation@dwp.gsi.gov.uk
Telephone for queries on the consultation: **0207 449 7732**
156. An online version of this consultation will be available shortly after the publication. You can access this from the website: www.dwp.gov.uk/state-pension-21st-century
157. Please say whether you are responding as an individual, or on behalf of an organisation. If on behalf of an organisation, please make clear who the organisation represents, and how the views of members were obtained.
158. Copies of this publication can be made available in alternative formats if required.
159. We will publish a summary of responses to the consultation on the consultations section of the Department for Work and Pensions website: www.dwp.gov.uk/consultations

Freedom of information

160. The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.
161. All information contained in your response may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

The consultation criteria

162. This consultation is being conducted in line with the Government Code of Practice on Consultation www.berr.gov.uk/whatwedo/bre/consultation-guidance/page44420.html
The seven consultation criteria are:
- **When to consult.** Formal consultation should take place at a stage when there is scope to influence the outcome.
 - **Duration of consultation exercise.** The Government Code of Practice on Consultation recommends a minimum 12-week consultation period for public consultations, unless there are good reasons for a limited consultation period.
 - **Clarity of scope and impact.** Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence, and the expected costs and benefits of the proposals.
 - **Accessibility of consultation exercises.** Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is designed to reach.
 - **The burden of consultation.** Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
 - **Responsiveness of consultation exercises.** Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
 - **Capacity to consult.** Officials running consultation exercises should seek guidance in how to run an effective consultation exercise, and share what they have learned from the experience.

Feedback on this consultation

163. We value your feedback on how well we consult. If you have any comments on the process of this consultation, for example, how it could be improved, but not about the issues raised, please contact our Consultation Coordinator:

Roger Pugh
DWP Consultation Coordinator
1st Floor
Crown House
2 Ferensway
Hull HU2 8NF
Email: roger.pugh@dwp.gsi.gov.uk

Glossary of terms

All benefit rates quoted in this document are in 2010–11 cash terms.

Additional State Pension	The earnings-related state pension. From 1978-2002 the State Earnings Related Pension Scheme (SERPS) and, from 2002, the State Second Pension (S2P).
Automatic enrolment	Where an individual is made a member of a private pension scheme unless they actively opt out. To be introduced in 2012.
Basic State Pension	The state pension based on the amount of National Insurance contributions a person has paid, has been treated as having paid or has been credited with during a working life.
Consumer Prices Index	The general index of consumer prices published by the Office for National Statistics. To be used as the benchmark for prices growth for the purposes of uprating most state benefits from April 2011.
Contracting out	The system by which individuals opt out of the additional State Pension and use a proportion of their National Insurance contributions to build up a private pension.
Contracted-out deduction (COD)	The amount deducted from the additional State Pension to account for any Guaranteed Minimum Pension payable by an individual's contracted-out private pension scheme (or schemes).
Contributory benefits	The national system of contributory benefits paid in specific situations, such as retirement, and based on paid or credited National Insurance contributions.
Council Tax Benefit	Income-related benefit to assist with the costs of Council Tax.

Defined Benefit schemes	A private pension scheme where the pension is related to the member's salary or some other value fixed in advance. Sometimes called a salary-related scheme.
Defined Contribution schemes	A private pension scheme where the individual receives a pension based on the contributions made and the investment return that they have produced. Sometimes referred to as money-purchase schemes.
Graduated Retirement Benefit	An increase in state pension based on graduated National Insurance contributions paid between 1961 and 1975.
Guarantee Credit	An element of Pension Credit available to men and women who have reached the qualifying age (which is linked to women's State Pension age). It tops up income to a 'standard minimum guarantee'. This level may be increased for people with caring responsibilities, severe disabilities or certain housing costs, such as mortgage interest.
Guaranteed Minimum Pension	The minimum pension a contracted-out salary-related scheme must provide as one of the conditions of contracting out before 6 April 1997.
Housing Benefit	Income-related benefit to assist with the costs of rent (to a private landlord or in respect of a council dwelling).
Income-related benefits	Benefits calculated by reference to a person's income that provide a minimum weekly amount, and allow targeted support for savers, carers and disabled people and to help with housing costs and Council Tax. Also referred to as 'means-tested benefits'.
Life expectancy	At a given age, life expectancy 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.
Lower Earnings Limit	The limit where earnings start to count for benefit purposes. The limit is below that of the Primary Threshold, the start point for employees to pay NICs.
Means-tested benefits	See 'Income-related benefits'.
National Employment Savings Trust	The National Employment Savings Trust is a scheme designed to support automatic enrolment. It will be progressively rolled out during 2011.
National Insurance contributions	Paid or credited contributions to the National Insurance Fund. Class 1 National Insurance contributions are compulsory for employees and employers. Class 2 and 4 National Insurance contributions are compulsory for self-employed earners. Class 3 National Insurance contributions are voluntary. National Insurance contributions provide entitlement to specific benefits, including pensions from the state.

National Insurance Credits	Credits of earnings awarded by the Government in certain circumstances (for instance when someone has caring responsibilities). They cover periods when a person is not paying National Insurance contributions.
Occupational pensions	A pension provided by an employer, where the pension scheme takes the form of a trust arrangement and is legally separate from the employer.
Pension Credit	The main income-related benefit for pensioners. A non-contributory, non-taxable, means-tested benefit, made up of two elements: the Guarantee Credit and the Savings Credit (see respective terms). The qualifying age for men and women is linked to women's State Pension age.
Qualifying year for state pension	A tax year in which someone has qualifying earnings, or credits of earnings, of at least 52 times the Lower Earnings Limit.
Savings Credit	A component of Pension Credit which provides additional support for those aged 65 and over with income above the Savings Credit Threshold.
Standard level of means tested support	This is defined as the level of income provided by the Pension Credit standard minimum income guarantee which in 2010–11 tops up pensioners' income to £132.60 a week.
State Earnings-Related Pension Scheme	An earnings-related additional State Pension based on National Insurance contributions paid as an employee, which was in place between 1978 to 2002 before being replaced by the State Second Pension.
State Pension age	The earliest age at which a person can get their state pension. A claim is required to get a state pension.
State Second Pension	The current earnings-related additional State Pension. This replaced the State Earnings Related Pension Scheme in 2002. It is based on contributions paid as an employee or credits for caring or ill-health.
Triple Guarantee	Introduced in April 2011, the Government's indexation method to be used to provide an annual increase to basic State Pension – the higher of the growth in average earnings, price increases or 2.5 per cent.



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Department for Work and Pensions

4 April 2011

www.dwp.gov.uk

ISBN 978-0-10-180532-2



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