

Additional State Pension and Contracting out

1. The additional State Pension (State Earnings Related Pension Scheme - SERPS) was introduced in 1978 to provide an alternative for those workers who were not covered by an occupational pension. At the time millions of private and public sector workers were already in private schemes and rules were required to manage the relationship between these schemes and the new SERPS scheme - particularly to ensure that people were not worse off in their private occupational scheme than they would be in SERPS. The rules of contracting out were introduced to do this, but are the most complex arrangements in the entire social security system.¹
2. Contracting out introduced the Guaranteed Minimum Pension (GMP) to occupational pension schemes. In return for funding a GMP that would pay benefits broadly equivalent to the additional State Pension that the person would have received had they not been contracted out, employers and employees paid a lower rate of National Insurance contributions. Occupational pension schemes were not required to link GMPs built up to the 1987/88 tax year to price inflation once they were in payment but are required to increase GMPs built up from April 1988 to the 1996/97 tax year by price inflation up to a maximum of 3%.
3. To ensure that no-one was worse off for contracting out, people built up an entitlement to additional State Pension. However, to prevent the double provision through the occupational pension and through the State (and to reflect that National Insurance Contributions had been paid at a lower rate), an adjustment called the contracted out deduction is applied to the additional State Pension.
4. At State Pension age and thereafter, cost of living increases are paid by increasing any additional State Pension by inflation each year and then reducing it by the contracted out deduction (to represent the GMP). The contracted out deduction is increased in line with the GMP indexation rules (so no requirement to index pension built up from 1978-1988 and then up to 3% for pensions built up from 1988-1997). The effect on the recipient is virtually the same as if increases had been paid on their pre-88 GMP. However, **the Government does not pay increases on GMPs**. Occupational pensions are provided by employers as part of the remuneration package for their employees.
5. The position above covers everybody reaching State Pension age up to and including 5 April 2016
6. The State Pension is changing for people who reach State Pension age on or after 6 April 2016. It will be replaced by a simpler system. Under the reform the current retirement pension scheme consisting of a basic and additional State Pension will be replaced by a new State Pension. A direct consequence of the reform is that the additional State Pension will close. It will no longer be possible to contract out and also not possible to carry out the annual comparison between the additional State Pension and the contracted out deduction.

¹ To ease understanding this note concerns contracting out from Defined Benefit schemes for the period from 1978 to 1997 (the rules changed significantly from 1997). The note does not cover Defined Contribution schemes (it was possible to contract out of Defined Contributions schemes from 1988 to 2012 and similar rules to those described here were applied).

7. Most people reaching State Pension age after that date who have been contracted out in the past will be able to benefit from transitional arrangements which will outweigh the loss of price protection for the additional State Pension by allowing people to, in effect, work off part of their contracted-out deduction.

8. At the end of the 2015/16 tax year people's National Insurance record will be valued under the rules of the old and new scheme. A one off adjustment is made at that point (rather than State Pension age) to reflect people's contracted out employment. The higher of the new or old scheme amount becomes the person's starting amount. If the amount is less than the full rate of the new State Pension then people can build on this until they either reach the full amount or they reach State Pension age.

9. As an example, someone with a starting amount of £120, reaching State Pension age in March 2021 and who has worked or had National Insurance Credits over the four year period from 2016-2020 can increase their new State Pension by £16.96 a week. This is calculated by adding the value of 4 years' worth of the new State Pension to the £120 starting amount. In more detail, the illustrative 2014/15 value of the full new State Pension is £148.40. From the 2016/17 tax year 1/35th (the amount of years required to build the new State Pension in steady state) of this amount - £4.24 – is multiplied by the 4 National Insurance qualifying years (£16.96). This person would have a new State Pension of £136.96 a week.

10. In addition to being able to build further pension after the one off adjustment is made for contracting out, more of the new State Pension will be subject to at least earnings rather than price uprating. At the moment only the basic State Pension of £113.10 is uprated by at least earnings – with any additional State Pension paid on top of the basic State Pension being increased by prices. The full new State Pension of £148.40 will therefore be uprated by at least earnings.

11. Some people reaching State Pension age in the first year of the new State Pension (and who therefore cannot build a further £4.24 a week pension) will not have sufficient pension over £113.10 to benefit from the wider band of earnings uprating mentioned above. However, they will benefit from a higher start amount than they could have expected when they were building their GMP. This is because the triple lock² method for uprating means the full basic State Pension will be around £560 a year higher in 2015/16 than had it been uprated just by earnings since the start of this Parliament. It means the full basic State Pension is the highest relative to average earnings that it has been for over two decades

12. Parliament has been informed of the changes through Parliamentary Questions [181794] [181795] [181860] from Teresa Pearce, MP for Erith and Thamesmead (see Hansard 6 Jan 2014: Column 50W). The details are attached.

² The higher of price or earnings inflation or 2.5%

Guaranteed Minimum Pensions

Teresa Pearce: To ask the Secretary of State for Work and Pensions (1) what estimate his Department has made of the number of people affected by ending the payment of guaranteed minimum pension increases; [181793]

(2) what impact assessment his Department has conducted of ending the payment of guaranteed minimum pension increases; [181794]

(3) what estimate he has made of the average loss to persons affected by ending the payment of guaranteed minimum pension increases; [181795]

(4) what estimate his Department has made of the total saving to the public purse as a result of ending the payment of guaranteed minimum pension increases. [181860]

Steve Webb: The Department for Work and Pensions does not pay increases on guaranteed minimum pensions (GMPs). GMPs are occupational pension scheme benefits which were accrued between 1978 and 1997. Pension schemes are liable for any statutory indexation of GMPs, and this liability will not change as a result of the single tier reforms. The Department for Work and Pensions pays state pension benefits and their indexation, including additional state pension (SERPS and S2P) and basic state pension.

Additional state pension and GMPs are linked in that when a person reaches pensionable age, the total amount of GMP is subtracted from the total amount of additional state pension built up between 1978 and 1997, and any net amount is paid. This subtraction of the total GMP amount is called a ‘contracted-out deduction’, and reflects that reduced national insurance was paid during the period of contracting out in return for meeting legislative requirements. This calculation is performed each year that the pension is payable.

There is no statutory obligation on schemes to pay increases on GMPs accrued between 1978 and 1988. However, additional state pension built up during that period is subject to increases. When the contracted-out deduction is subtracted from the additional state pension, the remaining additional state pension includes an increase linked to prices. In this way, an amount broadly equivalent to the GMP, but which is in fact additional state pension, is subject to an increase. Schemes are under an obligation to pay increases on GMPs accrued between 1988 and 1997, subject to a cap of 3%.

With the introduction of single tier, the additional state pension will close, as will the facility to contract out. For those reaching state pension age from April 2016, we will value their national insurance record to that point. We will compare what state pension the single-tier rules would give them with what they have built up as at April 2016 under the current system. The higher of these two valuations will become the individual’s ‘foundation amount’.

As set out in the White Paper, the design of the transition will benefit many people with a history of contracting out. In effect, these individuals may be able to offset their contracted-out deduction with further qualifying years until they reach the full amount of single tier. This means that many individuals who have previously been contracted-out may receive more state pension than they would have under the current system.

The Department estimates that over 2 million people will reach state pension age in the five years after the introduction of single tier, of whom around 40% to 45% will have been contracted out of private and public sector defined benefit schemes between 1978 and 1988. From 1988 onwards, the facility to contract out was extended to people in defined contribution schemes. By the mid 2030s over 80% of people reaching state pension age will have had a deduction for being contracted out factored into their transitional calculations and many will be able to benefit from the transition described above, as well as from the indexation arrangements for single tier compared to the current arrangements for additional pension and basic state pension.

The single tier reforms will cost no more than the existing system, and expenditure is projected to be within 1% of current spending until the late 2030s. The impacts of the single tier reforms have been captured in the impact assessment for single tier, which is published online. We estimate that those who hold GMPs are no more likely to have a lower outcome as a result of the reforms overall than the rest of the population.