HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

Number 2674, 26 September 2019

State Pension - deductions for contracting-out

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Contents:

Contents

Summary

The old State Pension had two parts, the basic State Pension (paid at a flat rate, based on the individual's National Insurance record) and the additional State Pension (which was earnings-related). From its introduction in 1978, it was possible to contract-out of the additional State Pension into a workplace pension that met set requirements. Between 1978 and 1997, this was that the scheme provided a Guaranteed Minimum Pension (GMP) intended to provide at least what the individual would have got had they remained contracted in. From 1997, contracted-out defined benefit (DB) schemes had to satisfy a 'reference scheme test', intended to achieve broadly the same result.

The option to contract-out into a defined contribution (DC) scheme was introduced in 1988. In this case, the requirement was to make a minimum contribution. The benefits from this had to meet a 'protected rights' test but there was no guarantee to provide what the individual would have got had they remained contracted-in.

Individuals who were contracted-out paid a lower rate of National Insurance (NI), in recognition of the fact that they were forgoing additional State Pension rights for that period and building up rights to a workplace pension instead. Contracting-out therefore had the effect of reducing entitlement to the additional State Pension (*Pension Schemes Act 1993*, s46).

Whether the individual will always receive an amount from their pension scheme equivalent to reduction will depend on the type of scheme they were contracted-out into. For example, in the case of a defined contribution (DC) scheme (such as a personal pension), the "actual pension amount you get will depend on the performance of your investments […] and the choices you make when you decide how to take your fund"(DWP Guidance, April 2017).

The new State Pension (nSP) introduced in April 2016 is single-tier. There is no longer an additional State Pension and the option to contract-out has therefore ended. However, transitional arrangements to deal with past records include a deduction for people who were contracted-out during working life. This was intended to be broadly equivalent in value to the workplace pension the rebate funded and consistent with the rules of the old system. (DWP leaflet 2017, p3; factsheet 2013 p9). As a safeguard, a comparison was made in April 2016 of the amount an individual had built up under the old system and the amount they would have built up under the new system, had it been in place throughout. The higher of the two formed their starting amount for the new State Pension. People who continued to make NI contributions after April 2016 can increase their nSP above the starting amount - by £4.82 pw for each year worked, up to the maximum of £168.60 pw (2019/20 rates).

These arrangements mean that people who have been contracted-out are on average gainers from the new State Pension reforms, compared to the position if the old system continued (Evidence to W&P Committee, 1 Dec 2014, Q24). The National Audit Office found that impact of the reforms was particularly complex for people with Guaranteed Minimum Pension (GMP) entitlement, and varied widely depending on their circumstances.

This briefing paper looks at how the rules on contracting-out and the impact of State Pension entitlement have changed over time. Other relevant notes include Library Briefing Paper CBP 7414 The new State Pension – transitional issues (Feb 2019) and CBP 4956 GMP increases (Feb 2019).

1. The old State Pension

The State Pension for people who reached State Pension age before 6 April 2016 had two parts:

- a basic State Pension which depends on the number of "qualifying years" (years with a sufficient contribution record) in working life; and
- an additional State Pension – the State Earnings Related Pension Scheme from 1978, replaced by the State Second Pension in 2002 - which depends on the level of earnings between the Lower and Upper Earnings Limits (LEL and UEL) for National Insurance Contributions (NICs) on which you have paid contributions in your working life since April 1978.[1]

As discussed below, from the time SERPS was introduced in April 1978, under the *Pensions Act 1975,* it was possible to "contract out" into an occupational pension scheme, provided it met certain requirements (which have changed over time).

1.1 Contracting out into defined benefit (DB) schemes

Originally, employers were able to contract out of SERPS only if they provided an individually calculated defined benefit known as the Guaranteed Minimum Pension (GMP). Schemes providing GMPs were usually of the defined benefit (DB) type. However, defined contribution (DC) schemes could also contract out by providing a GMP.[2] The Department of Health and Social Security leaflet, *New Pensions: a more secure future,* (NP34), issued in January 1978, explained:

> The new state pension will operate in partnership with good occupational schemes … if your employer operates such a scheme he can apply to contract you out … of the state scheme's additional pension and you would then pay lower contributions to the state scheme … Your basic pension would then be provided by the state scheme and your additional pension by your employer's occupational scheme, with inflation-proofing after the pension is in payment provided by the state (…)
>
> **Guaranteed minimum pensions**
>
> A contracted-out occupational pension scheme must provide you with at least a guaranteed minimum pension, to match the additional pension you would have earned from the state scheme … Your occupational pension may, of course, be much higher than the guaranteed minimum pension, particularly if you are already a member of a scheme.

Although there were changes to the scheme over time, the basic principle held good: people who are contracted-out of the additional State Pension (ASP) paid lower NICs, and in return were expected to

1 *Social Security (Contributions and Benefits) Act 1992,* s44
2 IDS Pension Service, *Pension scheme design,* May 2009, para 8.43

receive the earnings-related element of their pension from private pension schemes rather than the state.

From 1997, the requirements applying to contracted-out DB schemes were simplified and no further rights to GMPs accrued from that date. Schemes were instead required to satisfy a reference scheme test. [3] A scheme that did so was expected (but not guaranteed) to provide pensions broadly equivalent to or better than the benefits that the individual is giving up from contracting out.[4]

1.2 Contracting out into defined contribution (DC) schemes

As the Money Advice Service explains:

> Defined contribution pensions build up a pension pot using your contributions and your employer's contributions (if applicable) plus investment returns and tax relief […] The size of your pension pot and amount of income you get when you retire will depend on:
>
> - How long you save for
> - How much you pay into your pot
> - The choices you make when you retire
> - How much you take as a cash lump sum
> - How well your investments have performed
> - How much your employer pays in (if a workplace pension)
> - Annuity rates at the time you retire – if you choose the annuity route
> - What charges have been taken out of your pot by your pension provider[5]

The *Social Security Act 1986* introduced legislation[6] which reduced the benefits which SERPS provided and enabled (indeed encouraged) – contracting-out into defined contribution (DC) pension schemes. For the first time, employers could use a defined contribution scheme for contracting-out and individuals could choose to contract-out into a personal pension.

The condition for this was payment of minimum contribution at least equal to the value of the contracted-out NI rebate. Financial incentives were provided to encourage more contracting-out.[7] The benefits secured by this were called "protected rights" and had to meet certain conditions, i.e:

> first, that protected rights are invested only in certain specified products; secondly, that they are only transferred to schemes that are contracted out; thirdly, that annuities purchased with the

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[3] Section 9 (2B) *Pension Schemes Act 1993*
[4] DWP, Pensions Bill – Impact Assessment, footnote to para 2.34
[5] Money Advice Service, Defined c
[6] The legislation is now in Part III, Chapter 1 of the *Pension Schemes Act 1993*
[7] See, for example, DSS White Paper, *Reform of Social Security: Programme for Action*, Cmnd 9691, December 1985, para 1.18

> protected rights must be calculated on a unisex basis, and fourthly, that the protected rights have to provide for a survivor benefit if a scheme member is married or a civil partner at the time that an annuity is purchased.[8]

Importantly, these rules did not ensure that an individual gets what they would have done had they been contracted in. IDS Pension Service explained that

> Protected rights are money purchase benefits and therefore if used to replace additional pension from SERPS/S2P may generate a capital sum that can create a larger pension than would have been delivered by either State scheme, or on the other hand may generate a capital sum that is insufficient to replace the additional pension that would have been available. This risk is borne by the employees. In practice, especially during the bear stock markets at the beginning of the century, many scheme members coming to crystallise their benefits from a [Contracted-out Money Purchase] scheme or [Additional Personal Pension] received less pension benefit than they would have received by not contracting out. In recent years, therefore, contracting out on a protected rights basis has become less popular and this is likely to have been an important factor in persuading the Government to include measures in the *Pensions Act 2007* and *Pensions Act 2008* to bring contracting out on a protected rights test to an end.[9]

In its 2010 leaflet on contracted-out pensions, the Pension Service said the decision to contract-out was one for individuals:

> **Should I contract out of the State Second Pension?**
>
> Only you can make this decision. There are different issues involved in contracting out using an appropriate personal pension or appropriate stakeholder pension and contracting out using an occupational pension scheme.
>
> **Contracted out appropriate personal pension or appropriate stakeholder pension schemes**
>
> As with all financial products where the benefits are linked to investments, there are risks involved with contracting out through an appropriate personal pension or an appropriate stakeholder pension. With this type of scheme, there is a risk that the pension you get from the minimum contributions (see page 24) will not be as much as the State Second Pension you have given up. However, it is also possible that your pension may be higher than the State Second Pension given up.
>
> There are also other things to consider, such as the flexibility a personal pension or stakeholder pension offers. For example, you can now take up to 25% of your contracted-out pension fund (known as the 'protected rights fund') as a tax-free lump sum when you take your pension.[10]

In 2005, the Financial Services Authority (FSA) launched an investigation into the position of people who had contracted-out using a personal or stakeholder pension. It found "no evidence of widespread mis-selling", although some people may have been "wrongly advised to contract

[8] Pensions Bill Deb, 1 February 2007, c235; DWP consultation document, *'Abolition of defined contribution (DC) contracting out: treatment of protected rights accrued in the past and proposed operational arrangements'*, Sept 2006, Annex A, para 6

[9] IDS Pensions Service, Pension scheme design, para 8.17

[10] Pension Service, Contracted-out pensions, September 2010, page 19

out."[11] It produced guidance on possible grounds for complaint for people who might be affected i.e, if they were:

1. an employee at any time between 1988 and 1997; and
2. advised to contract out of the State Earnings Related Pension Scheme (SERPS) using a personal pension between 1 July 1988 and 5 April 1997; and
3. above a certain age – roughly 45 for men and 40 for women – when you contracted out[12]

The option to contract out into a DC scheme was abolished with effect from April 2012.[13] This was because it had become "increasingly difficult to determine that a scheme member would be better off by contracting-out of the additional state pension."[14]

1.3 Effect on State Pension entitlement

Contracting-out had the effect of reducing additional State Pension entitlement. As the Pension Service explained, the way in which it did so changed over time:

> **Contracting out of the additional State Pension scheme**
>
> Since 1978 it has been possible for employees to opt out of the additional State Pension scheme. This is called 'contracting out' and means their additional State Pension will be reduced.
>
> The effect on the additional State Pension
>
> *From 6 April 1978 to 5 April 1997 (SERPS)*
>
> Any additional State Pension earned through SERPS from 6 April 1978 to 5 April 1997 is reduced (which could be to a nil amount) if the person was contracted out at any time during this period.
>
> *From 6 April 1997 until 5 April 2002 (SERPS)*
>
> SERPS is not paid for any week a person was contracted out.
>
> *From 6 April 2002 (State Second Pension)*
>
> The State Second Pension is reduced (which could be to a nil amount) if a person is contracted out.[15]

For periods of contracted-out employment between 1978 and 1997, a "contracted-out deduction" (COD) is applied. The amount of the COD is effectively worked out by treating the person as if they had built up rights to a Guaranteed Minimum Pension (GMP). If ASP is lower than the GMP, no ASP at all will be payable. *Tolley's Pensions Law* explains:

> For the periods of employment from 6 April 1978 to 5 April 1997 inclusive, any period of contracted-out employment, or any period in relation to which minimum contributions were being paid into

[11] FSA website, Results of the FSA's thematic work on contracting out of the additional State Pension

[12] FSA, State Second Pension – were you wrongly advised to contract-out?, June 2009

[13] *Pensions Act 2007* (s15)

[14] HC Deb 12 March 2010 36WS; For more on the background, see Library Briefing Paper 4822, Contracting out of the State Second Pension (2011)

[15] Pension Service, *A detailed guide to State Pensions for advisers and others*, NP46, August 2008, page 38

> an appropriate personal pension, will have the effect of reducing the individual's right to additional pension by means of a 'contracted-out deduction'.
>
> An employee who was contracted out at any time during this period will be treated as having built up rights to a guaranteed minimum pension (GMP). If the employee had been contracted out by the alternative protected rights test that came into effect on 6 April 1988, the pension to be provided by the protected rights is taken to be the same amount as the GMP which the employee would have accrued if he or she had been contracted out over the same period by means of the GMP test. A COD will be subtracted from the claimant's weekly additional pension entitlement equal to the claimant's GMP entitlement.[16]

People contracted-out into DC schemes were treated as though they had a GMP. *Tolley's Pensions Law* explains:

> If the employee had been contracted out by the alternative protected rights test that came into effect on 6 April 1988, the pension to be provided by the protected rights is taken to be the same amount as the GMP which the employee would have accrued if he or she had been contracted out over the same period by means of the GMP test. A COD will be subtracted from the claimant's weekly additional pension entitlement equal to the claimant's GMP entitlement.[17]

The relevant legislation is in the *Pension Schemes Act 1993.* Sections 46 to 48 provide for the effect of entitlement to GMP on social security benefits. The detail of the GMP calculation is in section 14. The way in which additional State Pension is calculated is provided for in section 45 of the *Social Security (Contributions and Benefits) Act 1992.*

Relationship between CODs and the State Pension

Because of the arrangements in force between April 1978 and April 1997, there is not a constant relationship between the COD and the additional State Pension (ASP). This is for two reasons:

> Any gross Additional Pension accrued during this period will be revalued by earnings until State Pension Age. However, the Contracted-out Deduction can be revalued by one of three different methods.
>
> After State Pension Age, gross Additional pension is uprated by prices, whereas the Contracted-out Deduction has different uprating rules applied to it.[18]

In more detail, if a person leaves a pension scheme early, becoming a deferred pensioner and retaining accrued rights to a GMP in the scheme, those rights must be revalued from the date of deferment to State Pension age. There have been three methods used to revalue the accrued GMP rights of early leavers, although only two remained open for newly deferred pensioners after 5 April 1997:

- The deferred pensioner's accrued GMP rights may be revalued in line with the rise in national average earnings, by reference orders

16 Para C 1.5
17 Para C 1.5
18 DWP factsheet, *Simplification of State Second Pension Schemes,* House of Commons Deposited Paper, Dep 2008-1955

under section 148 of the *Social Security Administration Act 1992.* This is the same method as is used to revalue ASP.

- Alternatively, schemes may use the fixed rate revaluation. The Government laid down the fixed rate to be applied in periodic orders amending the *Occupational Pension Schemes (Contracting-out) Regulations 1996*, SI 1996/1172. The rate applying at the time the member leaves the scheme must be applied every year until he reaches pension age. The rates are:[19]

Date of termination	**Fixed-rate revaluation**
before 6 April 1988	8.5% p.a. compound
6 April 1988 to 5 April 1993 inclusive	7.5% p.a. compound;
6 April 1993 to 5 April 1997 inclusive	7.0% p.a. compound
6 April 1997 to 5 April 2002 inclusive	6.25% p.a. compound
6 April 2002 to 5 April 2007 inclusive	4.5% p.a. compound
6 April 2007 onwards	4.0% p.a. compound

A further complicating factor is the indexation arrangements. GMPs, once in payment, are increased each April by the increase in the retail prices index (RPI) announced for the previous September. For GMPs accrued between April 1978 and 1988, this increase is paid by the state, through an increase to the pensioner's SERPS entitlement. Indexation of GMP rights accrued between 6 April 1988 and 5 April 1997 (up to a ceiling of three per cent) is the responsibility of the pension scheme. The state pays the balance of any annual increase to match any rise in the RPI above three per cent.[20]

One outcome was a change in the number of people entitled to ASP over time:

> Mr. Frank Field: To ask the Secretary of State for Work and Pensions pursuant to the answer to the hon. Member for Arundel and South Downs of 17 March 2003, Official Report, column 606W, on pensions, what the reasons were for the fall in the percentage of men aged 65 receiving both basic and additional State Pension.
>
> Maria Eagle: The fall in the percentage of men aged 65 receiving both the basic State Pension and additional State Pension between September 1995 and September 2002 is due to the reduction in the number of men aged 65 in receipt of net additional State Pension over that period.
>
> Gross additional State Pension entitlement for men aged 65 has been steady in recent years. 92 per cent of men aged 65 who were receiving a State Pension, received gross additional State Pension in September 1999, compared with 91 per cent. in September 2002.
>
> However, the percentage of men aged 65 in receipt of net additional State Pension is falling because of the increase in excess

[19] SI 1996/1172 regulation 62 as amended

[20] *Pension Schemes Act 1993*, s109; HC Deb, 21 November 2004, c1741W; IDS Pension Service, *Pension Scheme Design,* May 2009, para 8.51

> Contracted Out Deduction cases due to the interaction between the gross additional State Pension and Contracted Out Deduction calculations. There are two reasons for this. The first reason is that there are more early leavers with fixed revaluations coming into retirement. These revaluations were in the past far higher than the current revaluations meaning that more people have excess Contracted Out Deductions than in the past and these excess Contracted Out Deductions themselves are larger. The second reason is that there are relatively low post award upratings experienced in the last few years, which means that it takes longer to reduce the excess Contracted Out Deductions and for the gross additional State Pension to exceed the Contracted Out Deductions.
>
> Notes: 1. Gross additional State Pension figures on a consistent basis are not available before September 1999.
>
> 2. 5 per cent. sample from the Pension Strategy Computer System (PSCS) as at the date of extraction. Source: The source data used to extract the figures are subject to change if further relevant earnings are posted to the National Insurance account.[21]

The Government has acknowledged that the shifting relationship between CODs and the ASP has made it very difficult to give people meaningful information about their future State Pension entitlement:

> The result of these complex arrangements is that the relationship between the gross Additional Pension and the Contracted-out Deduction can change constantly. This makes it extremely difficult to offer the 11 million contributors who have accrued contracted-out rights between 1978 and 1997 meaningful information about their future pension entitlement. The extract below from the letter issues to people requiring a forecast of their state pension notes the difficulty with this issue [...] 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 go up or down.

The *Pensions Act 2008* (s103) included measures to effectively fix the relationship between CODs and the ASP.[22] DWP produced a factsheet to explain how this would work.[23] The Government intended this to apply to those reaching State Pension age after 5 April 2020.[24] However, the introduction of the new State Pension in 2016 meant these were no longer required and the provisions were repealed.[25]

People who have been contracted-in and out

Pensioners are sometimes dismayed to see that they are "entitled" to an additional pension of a certain amount, but that a contracted-out deduction (equal to the lower of their GMP or their theoretical SERPS entitlement) has been taken away from it, so that they may receive no, or only a very small amount of SERPS. For people in a defined benefit

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21 HC Deb, 14 Deb 2003, c635W
22 HL Deb, 14 July 2008, c1030-31; *Pensions Bill 2007-08,* HL Bill 79, clause 100
23 Dep 2008-1955
24 Ibid
25 Pensions Act 2014, s23 and Sch 12. Explanatory Notes, para 107

scheme who have never been in contracted-in employment, this can be seen as the quid pro quo for having paid lower NICs. IDS Pension service notes that they should not be worse off:

> Through the system of [contracted-out deductions]…the total revalued GMP plus SERPS entitlement payable to any particular individual from State pension age, assuming adequate scheme funding, will not be less than if the employee had never been contracted out and had relied on SERPS alone, irrespective of the revaluation method adopted.[26]

They may in fact be considerably better off because occupational pensions may well be calculated on higher earnings and with better accrual rates than SERPS.

However, for some people who have moved in and out of contracted out employment, and who have paid contracted in contributions at some period of their lives, it can mean that – in effect – they have no or reduced SERPS in return for these contributions. This can also apply to people who have been employed in two jobs at the same time – one in contracted in and one in contracted out employment. The reason is that pension entitlement is only calculated at the end of one's working life when one retires. All the GMP one has accrued throughout that working life (revalued, in some cases, by the fixed rate) is compared with SERPS entitlement. If the GMP is bigger there will be no SERPS payable – even for periods when one was contracted in and paying full NICs.

There have been several cases before the Social Security Commissioners on this issue, but they have ruled that it "simply has to be accepted as part of the structure of the scheme". Commissioner J Mesher, in Case CP/1318/2001, described one claimant's challenge:

> 5. The basis of the claimant's challenge was this. He had been in contracted-out employment with one employer in tax years 1978/79 to 1983/84 and then with another employer from tax years 1984/85 to 1988/89. The second employment ceased to be contracted-out after 30 September 1988 and he was then contracted-in from 1 October 1988 to 30 September 1990. The terms contracted-out and contracted-in refer to the state earnings-related pension scheme (SERPS) originally introduced with effect from 6 April 1978 under the Social Security Pensions Act 1975. Employment was contracted out from SERPS when an employee was a member of an occupational pension scheme which met a number of conditions, in particular down to 5 April 1997 that the scheme would provide a guaranteed minimum pension. One consequence was that employer and employee then paid a lower rate of national insurance contribution. A further consequence, to which I shall have to return in detail, was that the amount of retirement pension including the SERPS additional component (later the additional pension) would be adjusted to take account of the amount of GMP entitlement. The Secretary of State's calculation set off the claimant's GMP entitlement against the additional pension earned by contributions both contracted-out and contracted-in over the whole period from 4 April 1978 to 30 September 1998. The claimant argued that that was wrong and that there should be an offset only against the additional

[26] IDS Pension Service, *Pension scheme design,* May 2009, para 8.49

> pension earned by contributions in the years of contracted-out employment. He argued that the additional pension earned by contributions in his period of contracted-out employment should be paid in full, without any adjustment for a GMP. The claimant calculated that he should have been paid about £9.46 per week extra,[27]

The Commissioner rejected this claim, arguing that the Department had made the correct deduction, as laid down in the legislation:

> 15. That rests on the plain words of section 46(1) of the *Pension Schemes Act*. They require one to look first at the category A retirement pension to which a person has become entitled by contributions made throughout the person's working life. Then one must look at the part of the additional pension attributable to earnings factors for all the tax years in the period when GMP entitlements could be built up and at the total actual GMP entitlement for those years. The offset effectively required is of an amount equal to the total GMP entitlement (subject to the limit of the amount of the additional pension attributable to those tax years). The operation is to be carried out looking at overall entitlements as they exist after the ending of the person's working life and the taking of a state retirement pension. The operation in the claimant's case, there being no challenge to the Inland Revenue figures, requires as at 12 April 1999 the deduction from his entitlement to category A retirement pension (basic pension, £66.75, + additional pension, £60.29, = £127.04) of £56.91, the amount of his GMP entitlement. That leaves £70.13 payable. The appeal tribunal was wrong in law to impose any different result.
>
> 16. There is no scope within the legislation for there to be a separation of periods in which a person was not contracted out of SERPS and for additional pension earned in those periods to be taken out of the operation of section 46 and paid without any deduction. If, because of differences in the ways in which the real values of GMP entitlements and of earnings factors are protected, that involves some eating into additional pension earned in contracted-in years, that simply has to be accepted as part of the structure of the scheme.

27 Tribunal Service/search for decisions

2. The new State Pension

A new State Pension (nSP) was introduced from 6 April 2016 for people reaching State Pension age (SPA) from that date. People who had already reached SPA continue to get their pension under the 'old rules.'[28] The nSP is different in several ways. For example:

- It is set above the basic means-tested guarantee - at £168.60 pw in 2019/20;
- People with no NI record before April 2016 need 35 qualifying years for the full amount. (Transitional arrangements mean that not everyone with 35 qualifying years in April 2016 will receive this amount);
- It is single-tier, so the option to 'contract-out' has ended.

2.1 The end of contracting-out

With the introduction of the nSP, the additional State Pension closed and, by extension, the option to contract-out of it. For individuals, the loss of the 'contracted-out rebate' meant an increase in their rate of National Insurance contributions (equal to 1.4 per cent of their earnings between the LEL and the UAP), up to the standard rate for employees.[29] In return, they started to build up State Pension rights on the same basis as other employees. The Government estimated that:

> […] approximately 90% of people who start to pay higher National Insurance contributions (NICs) and reach State Pension age over the first two decades after implementation will receive enough extra State Pension over their retirement to offset the increase in NICs, and any potential adjustments to their occupational pension schemes.[30]

There were also implications for employers who sponsor contracted-out schemes, as the loss of the contracted-out rebate would mean they needed to start paying the standard rate of NICs (an increase for each contracted-out employee of 3.4 per cent of relevant earnings).[31] For employers in the private sector, the Government legislated to allow employers a limited 'statutory override', to enable them to make changes to scheme rules without the consent of the trustees to adjust for the additional NI cost resulting from the loss of the rebate. It thought this was necessary to safeguard the ongoing viability of Defined Benefit pension schemes in the private sector.[32] After consultation, it decided to exclude from the operation of the override "protected persons" (i.e. employees with pension rights protected under arrangements put in place when some formerly nationalised industries

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28 *Pensions Act 2014*, s1

29 DWP, *Single-tier Impact Assessment*, October 2013, section 5.2

30 DWP, Impact of New State Pension (nSP) on an individual's Pension Entitlement – Longer Term Effects of NSP, January 2016, p13

31 Ibid, para 140

32 *Pensions Act 2014*, s24 and Sch14; DWP, *The single-tier pension: a simple foundation for saving*, Cm 8528, January 2013

were privatised).[33] In addition, public sector employers were not be able to pass on the increase in cost to their employees, reflecting commitments made on public service pension reform in 2011/12.[34]

Being a member of a private sector scheme that was contracted-out (and where the employer used the statutory override) made it less likely that the individual would recoup the full cost of additional contributions by working additional years.[35]

2.2 Deductions for periods of contracting-out during working life

When presenting the Coalition Government's proposals for the new State Pension to Parliament in 2013, the then Pensions Minister Steve Webb said contributions already made would be recognised:

> Of course, national insurance contributions paid and that would, under the current system, have led to entitlement to a second state pension will be recognised. For example, when we introduce single tier, someone who retires in 2018 who has £160 in the current system will still get a pension of £160.[36]

Although the nSP is single tier, and there is no longer an option to contract out, the transition to the new system needs to take account of past periods of contracting out. Had it not done so, people who had been contracted-out would effectively have been provided for twice - with their contracted-out private pension *and* the additional State Pension they had contracted-out of. The then Pensions Minister, Steve Webb explained:

> Millions of people, including all of us who have ever been in the Parliamentary Pension Scheme, have paid less NI than our neighbours. We have been contracted out. Our employer paid less; we paid less, and a deal was done that the scheme would replace part of the state benefit. That was the deal. The question is: we get to 2016 and there is no contracting out, there is just one pension, one bit of the system, so what do you do with the past contractors-out? There are two extremes. One is you forget contracting out ever happened, which would be beautiful, simple and clear; I would have loved it. But it would have cost billions because all of us would have suddenly got full State Pensions, not reduced ones, and it would have been grossly unfair on our next-door neighbours, who never contracted out, who paid more NI than we did and still got the same pension. So we could not afford to do it and it would not have been fair. [37]

The mechanism for doing this, as explained in the January 2013 White Paper, was to apply a deduction to the nSP:

> 84. For those who have been contracted out, a deduction – the 'rebate-derived amount' – will be applied to the single-tier

For more information, see

DWP, Your State Pension explained, April 2019, section 7

DWP, Contracting out and why we may have used a Contracted-out Pension Equivalent (COPE) amount when you used the online service (April 2017)

DWP, The New State Pension transition and contracting-out factsheet, July 2015

33 HL Deb 24 February 2014 c805; See also DEP 2014-0210; See HC Library Briefing Paper SN06725 *Pensions: possible statutory override for protected persons,* 8 April 2014

34 CM 8528; chapter 3, para 71; For more detail, see Library Briefing Paper CBP 5768 Public service pensions – the 2015 reforms (Feb 2019)

35 Ibid

36 HC Deb, 14 January 2013, c606

37 Oral evidence to the Work and Pensions Select Committee, 25 November 2015, Q4

> valuation, as of the date of the implementation of single tier, to reflect the lower rate of National Insurance contributions paid when contracted out.
>
> 85. This calculation will be as follows:
>
> **Single-tier valuation for people who have contracted out**

Single-tier valuation for people who have contracted out:

$$\left(\frac{\text{Number of pre-implementation qualifying years}}{35} \times £144\right) - \text{‘rebate derived amount’}$$

The Government argued that the deduction was intended to be:

> […] broadly equivalent in value to the workplace pension the rebate funded. This is consistent with the rules of the existing system.[38]

As a safeguard, a check was made in April 2016, comparing the amount individuals had built up under the old system, with what they would have built up under the new system had it been in place throughout. The higher of the two amounts was their 'starting amount' for the new State Pension. A DWP leaflet explains how this works:

> If you qualify for the new State Pension, we have used your NI record to 6 April 2016 to work out a Starting Amount for you. This Starting Amount calculation compared the amount of State Pension you would have received under the old State Pension rules with that under the new State Pension rules, based on your NI record as of 6 April 2016. The higher of these amounts is your Starting Amount for the new State Pension system.
>
> […]
>
> **Did you contract out?**
>
> Most people were contracted out at some time during their working life.
>
> Many workplace pension schemes where the pension you get is linked to your earnings (for example – defined benefit, final salary or career-average salary schemes) contracted-out all their scheme members as part of their scheme rules. If you were a member of a defined contribution workplace scheme (sometimes called a money purchase scheme) or bought a personal or stakeholder pension from a pension provider, you may also have been contracted out of the additional State Pension.
>
> **How does this affect the amount of State Pension you get?**
>
> Your Starting Amount for the new State Pension may be lower than that for people with similar circumstances who were not contracted out.
>
> However, you should bear in mind that you may be able to increase your State Pension by adding further NI qualifying years before you reach your State Pension age.

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[38] See also, a 2017 factsheet and DWP, Single-tier State Pension Factsheet, 2013 p9

> Find out more about how the new State Pension is calculated[39]

It goes on to explain that in most instances, your workplace or personal pension will include an amount equivalent to the contracted-out pension equivalent (COPE) deduction. However, this will depend on the type of arrangement:

> **The Contracted-Out Pension Equivalent (COPE)**
>
> The pension you get from your workplace or personal pension scheme for the periods you were contracted out, should include an amount that, in most cases, will be the equivalent of the additional State Pension you would have got if you had not been contracted out. This is your Contracted-Out Pension Equivalent (COPE) amount. […]
>
> **Will I always get an amount equivalent to the COPE amount from my workplace or personal pension?**
>
> That depends on your scheme.
>
> **(a) If you were part of an earnings-based private pension scheme**
>
> Schemes that pay an amount of pension based on your earnings (often called defined benefit, final salary or career-average salary schemes) are required to provide benefits to replace the State Pension you were opted out of, in return for allowing members and employers to pay lower NI. The private pension you built up during the years 1978 to 1997 as a result of being contracted out is called your Guaranteed Minimum Pension (GMP). If you are no longer contributing to this earnings-based private pension scheme, your scheme is required to revalue your GMP each year either by a fixed rate or by the rate of increase in average national earnings. If your scheme uses a fixed rate, your GMP amount should be higher than the additional State Pension you otherwise may have got.
>
> In some cases, it is possible that your schemes may not pay you an amount equivalent to the COPE if:
>
> - your scheme got into financial trouble and wound up underfunded
> - your rights were transferred to a scheme that was not linked to your earnings and investments in that scheme did not perform well
>
> You should know if this applies to you, but if you are in doubt and think you may be affected you can contact your scheme.
>
> **(b) If you were a member of a defined contribution, personal or stakeholder pension scheme**
>
> These types of scheme pay you according to the investment returns on the contributions you (and where appropriate your employer) have paid in.
>
> This means that the actual pension amount you get will depend on the performance of your investments (for example, where your pension pot is invested, the fees you are charged and how much

39 DWP guidance, Contracting-out and why we may have included a Contracted-Out Pension Equivalent (COPE) amount when you used the online service, 6 April 2017; See also DWP,-Single-tier transition and contracting out, 2013, paras 6-9

> these investments increase), and the choices you make when you decide how to take your fund.
>
> For instance, under the pension flexibility reform that was introduced in April 2015, you may take some or all of your pension pot as a cash payment. The amount you take will affect your private pension income amount – and if you decide to take all your pension pot as a cash payment, you may not get any private pension income.
>
> If you use your private pension investment to buy an annuity that provides a regular pension income, the type of annuity you buy will also determine your private pension income.[40]

This is in the *Pensions Act 2014* - s5 and Sch 1, Part 2, para 5.

As a result of these arrangements, people who were contracted-out will have had a 'starting amount' in April 2016 that was less than the full amount of nSP even if they had 35 qualifying years or more. However, from April 2016, they started to be liable for the standard rate of NI and to build up State Pension rights on the same terms as other individuals. This enabled them to effectively 'work off' the deduction for contracting at the rate of 1/35th of the full nSP amount for each additional qualifying year accrued before State Pension age.[41]

2.3 Impact of the reforms

People who have been contracted-out can be among the gainers from the introduction of the nSP.[42] The Pensions Policy Institute (PPI) noted that this was more likely to apply to younger workers who had many years to go to retirement.[43]

The Government estimated that of people paying more NI in the first 20 years of the nSP, around 90% would gain enough State Pension over and above what they would have got under the old system to offset the extra NI and any loss of GMP indexation.[44]

Steve Webb recently explained that although people who had been contracted-out are often gainers from the reforms, they did not see it that way:

> They don't perceive it because they say, "He is getting a flat rate and I am not," but I am getting the lower rate plus my teacher's pension, and now I will get a better State Pension plus my teacher's pension.[45]

From 2018, over 70 per cent of people who were contracted-out are notional gainers from the reforms.[46] The Government estimated that

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40 Ibid

41 DWP, *The single-tier pension: a simple foundation for saving*, Cm 8528, January 2013, p11, para 24

42 IFS, *A single-tier pension: what does it really mean?*, July 2013; see also *PPI, Single-tier series paper 4: the impact of the abolition of contracting-out*, 19 February 2014

43 PPI, *Single-tier series paper 1: The impact of the Government's single-tier state pension reform*, June 2013

44 Evidence to the Work and Pensions Committee, USP0143, January 2016; DWP, *Single-tier impact assessment*, October 2013 paragraph 88, para 135

45 Oral evidence to the Work and Pensions Committee 25 November 2015, Q24

46 DWP, Impact of the New State Pension (nSP) on an Individual's Pension Entitlement – Longer Term Effects of nSP, January 2016, p13-4; Table 4.a

some 37% of people reaching SPA in 2016/17 would receive the full amount of the new State Pension "directly from the state." The proportion rose to 90% if the additional State Pension they would have built up had they not been contracted-out was included:

> Nearly 90% of people reaching State Pension age in 2016/17 would have the full rate of the new State Pension, or more, if we include the amount of additional State Pension they opted out of or were opted out of when contracted out of SERPS or State Second Pension (S2P) (additional pension).
>
> The percentage of pensioners reaching State Pension age in 2016/17 estimated to receive the full amount of the new State Pension directly from the state is around 37%. By 2020 this percentage will reach around 50% and by 2035 around 84%. Most people who contracted out of SERPS or S2P were required, as a condition of contracting out, to accrue an alternative private pension. This replaced the additional State Pension, which they were contracted-out of.[47]

In a 2016 report, the Work and Pensions Committee said that the fact that many people with periods of contracting-out believed wrongly that they were disadvantaged was "in part a failure of Government communication."[48]

GMP increases

Determining the impact of the reforms is particularly complex for people with Guaranteed Minimum Pension (GMP) entitlement. A GMP is a defined benefit that occupational pension schemes were required to provide as a condition of contract-out of the additional State Pension between 1978 and 1997.[49]

Under the 'old system', responsibility for index-linking GMPs was divided. Occupational pension schemes had a statutory responsibility for uprating GMP rights accrued between 1988 and 1997 subject to a 3% cap.[50] Increases over and above this (i.e; on rights accrued between 1978 and 1988 and in excess of 3% on rights accrued between 1988 and 1997) were effectively provided via the additional State Pension.[51]

The requirement on schemes to index-link GMPs accrued between 1988 and 1997, subject to a 3% cap did not change in April 2016.[52] However, the Government does not take account of inflation increases to GMP when uprating the nSP. The impact of this in individual cases can be offset by two factors - the more generous uprating arrangements (with the nSP uprated according to the triple lock) and the ability to build up more qualifying years from April 2016 for people who were contracted-out.[53]

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47 HL 903 State Retirement Pensions 29 June 2015; DWP, Impact of the New State Pension (nSP) on an Individual's Pension Entitlement – Longer Term Effects of nSP, January 2016, figure 5

48 Work and Pensions Select Committee, Communication of the new State Pension, HC 926, March 2016

49 *Pension Schemes Act 1993*, s13-8

50 Ibid s15

51 HC Deb 6 January 2014 c51W

52 See Library Briefing Paper CBP 4956 GMP increases (Feb 2019)

53 DWP, Impact of New State Pension (nSP) on an Individual's Pension Entitlement – Longer Term Effects of nSP, January 2016

The Work and Pensions Select Committee identified some people with GMPs (those who had built up large GMPs during the period from 1978 to 1988 and would reach State Pension age during the early years of the new State Pension) as one of the groups that would stand to receive less in the early years of the new State Pension than they would have done had the current system continued. It recommended direct communication with those affected:

> 48.**The losses are largely products of the simplification of an outdated and extraordinarily complex system. It is those complexities, however, that make explaining the consequences to those affected imperative. People who understand their individual circumstances are better placed to adapt their plans in their best interest. Government should not rely on general awareness campaigns or happenchance in promoting that understanding. It should focus on identifying the individuals affected, assessing their potential losses, and communicating with them.**[54]

In response, the Government said it would direct people to information on Gov.UK and the Check your State Pension Service:

> 24.**Guaranteed Minimum Pensions (GMPs)**. The majority of those who built up a GMP during the period 1978 to 1988 will not be disadvantaged by the changes, because of the interaction with other parts of the pension reforms. Evidence from our latest impact assessment is that by 2020, 75% of people with a pre-1988 GMP will gain from the new State Pension (with an average gain of £4 a week) and around 25% of people will lose (with an average loss of £2 a week).
>
> 25.Given the current evidence on the ineffectiveness of direct mail as a communications tool, we believe that our strategy should continue to direct people to the detailed information on GOV.UK and the Check your State Pension service. The Check your State Pension service allows people to see a forecast of their new State Pension at State Pension age – assuming future qualifying years count towards the individual's new State Pension. The service also shows information on any gap years, where the individual may be able to pay voluntary National Insurance contributions to improve their new State Pension position.[55]

The National Audit Office found that the impact of the nSP on people with GMPs would vary widely depending on their circumstances.[56]

For more on the background, see Library Briefing Paper CBP 4956 Guaranteed Minimum Pension (GMP) increases (Feb 2019).

[54] Work and Pensions Select Committee, Communication of the new State Pension, HC 926, March 2016
[55] Communication of the new State Pension: The Government's response, June 2016
[56] NAO, The impact of the state pension reforms on people with GMPs, HC 907, 24 March 2016

BRIEFING PAPER
Number 2674
26 September 2019