**Single-tier transition – technical note**

## Introduction

1. Despite a number of reforms aimed at simplifying the state pension system substantial complexity remains. A key area of complexity is around the rules on entitlement to the earnings related part of the state pension, the additional State Pension. This is largely due to the fact that in the past changes to the rules for calculating entitlement have been incremental rather than wholesale replacements of the previous rules. Therefore a person reaching State Pension age in 2013/14 is likely to have their additional State Pension entitlement calculated under four different methods – more if they were contracted out.

2. The effect of past contracting out of additional State Pension entitlement is a particular barrier to providing clear information on future state pension entitlement. These complex rules have made calculating or forecasting a person's additional State Pension entitlement difficult. The practical effect has been that people have an incomplete picture of their potential state pension entitlement with attention centred on the flat-rate basic State Pension.

3. Following recommendations made by the Pensions Commission recent reforms focused on changing the structure of the state pension leading to a reduction in qualifying years and gradual erosion of earnings related accrual over the longer term which made it easier for a person to work out their potential entitlement. However, despite these changes the calculation will remain complicated until the middle of the century and the Government now considers that more radical reform is required to simplify the system. With the introduction of automatic enrolment into workplace pensions people will require a clear understanding of what they could get from the state pension in order to take informed decisions on further saving.

## The single-tier pension

4. The Government intends to introduce a new contributory state pension with more straightforward entitlement conditions. The start date for the single-tier pension has yet to be decided but for planning purposes we have assumed that it would be 6 April 2017, at the earliest. We have used this date for illustrative purposes in this note.

5. In future a person would be eligible for a single flat-rate pension of around £144[1] a week provided they had paid, been treated as having paid or been credited with National Insurance contributions for 35 years. This is an illustrative weekly rate that reflects the figure used in the White Paper, *The single-tier pension: a simple foundation for*

[1] The White Paper, *The single-tier pension: a simple foundation for saving*, provides an illustrative amount of £144 that would be increased annually by the triple lock.

*saving*, Cm 8528 published on 14 January 2013. As now, in any given tax year a person would need to have made contributions on earnings equal to the annual value of the Lower Earnings Limit (£5,564 in 2012/13) for that year to qualify for entitlement to the single-tier pension. People will also continue to be liable for National Insurance contributions on all earnings above the Primary Threshold (£146 a week in 2012/13) up to the Upper Earnings Limit (£817 a week in 2012/13) for each year through to State Pension age[2]. This single-tier pension would be based solely on a person's own National Insurance contribution record.

6. Additionally, a person would need to have built up a minimum number of qualifying years[3] in order to gain any entitlement to the single-tier pension. Where a person had met the minimum qualifying years test but had less than 35 years they would be entitled to a state pension based on the relevant proportion of qualifying years gained. For example, a person who had 19 qualifying years would be entitled to a weekly pension worth 19/35$^{th}$ of £144 i.e. £78.17.

7. A person could start to build single-tier qualifying years from 2017 onwards only. Therefore, on the basis of a 2017 start date a person entering National Insurance from that point would be awarded a full single-tier pension based on contributions made in the scheme in the late 2060s.

**Managing the transition**

8. There have been two tiers to the state pension system since 1961 when the first earnings related pension, the graduated retirement benefit, was introduced. This early scheme was subsequently replaced by the additional State Pension (also called the State Second Pension, formerly the State Earnings-Related Pension Scheme or SERPS) from 1978 and together with the basic State Pension this forms the scheme in place today.

9. The amount of additional State Pension to which a person can gain entitlement is based largely on the level of their earnings which makes it difficult to determine in advance what a person can expect to receive once they reach State Pension age. Restructuring in this area has further complicated the rules on how entitlement is calculated with different rules applying to past periods for which entitlement is established.

10. The change to a single-tier state pension will require a wholesale overhaul of the existing scheme. The current state pension scheme will

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[2] Employees currently pay National Insurance contributions at 12 per cent on earnings above the primary threshold up to the upper earnings limit and at 2 per cent on earnings above that level.
[3] In the White Paper modelling we have costed on the basis of a minimum of 10 years with the exact figure of between 7 and 10 years still to be confirmed.

be closed for people reaching State Pension age from single-tier implementation. However, people reaching State Pension age for a considerable number of years after single-tier implementation would have spent a significant part of their working lives making contributions prior to implementation of the new scheme. Therefore, it would be unfair if past contributions were not recognised.

11. The main challenge faced was in finding a fair and equitable way to bring people who had spent a significant proportion of their working lives contributing prior to implementation into the single-tier pension. The planned solution is to recognise the contributions people had made prior to implementation by converting them into an opening balance for single-tier, valued as at 2017. This would allow us to provide a more streamlined system for future pensioners by taking the value of contributions or credits held on their National Insurance (NI) record at the point of change and transforming them into a form relevant to the new scheme.

12. Further barriers to the immediate move to a reformed scheme that need to be resolved are that:
    - the NI contributions some people will have paid up to 2017 would under existing rules provide entitlement to a state pension of more than £144; and
    - because of contracting-out, not everyone is entitled to the same elements of State Pension.

13. In order to reconcile these factors[4] the following transition principles were established in the green paper *'A state pension for the 21st century'*, to:

    - find a way to recognise the NI contributions a person paid before 2017 in a way that is fair but allows for a speedy transition; and
    - take account of contracting-out in a fair and straightforward way.

### Valuing past contributions

14. To address the first point of providing a fair recognition of past NI contributions we intend to value those contributions as at 2017 under the single-tier rules to give a "foundation amount". A check will then be carried out to determine what the individual would have received under the old rules. If this amount would be higher than the single-tier valuation it will instead form the foundation amount. This will allow us to wrap up the old scheme whilst allowing potential state pension entitlement as assessed at the point of change to be carried forward into the new scheme. By carrying out the check the full value of a

[4] The intention being to bring everyone with 35 Qualifying Years up to £144 whilst recognising the potential value of contributions paid under the current scheme and the effect of contracting out

person's National Insurance contribution record at the point of single-tier's introduction could be taken into account.

15. In determining the value of contributions under the old rules we would consider whether those contributions would have provided entitlement to graduated retirement benefit, basic and additional State Pension. To assess a person's potential entitlement to a State Pension under existing rules we would use the rates of benefit in force in 2017 for graduated retirement benefit and the basic State Pension. For the additional State Pension we would calculate entitlement as if the person had reached State Pension age in 2017. Their earnings-related contributions would be revalued up to that point and averaged over their working life. Further detail can be found at paragraphs 18 to 26. This approach would maximise potential entitlement at 2017.

Basic State Pension

16. This will be calculated based on the number of qualifying years held on the contribution record at 6 April 2017 (therefore fully taking into account contributions up to the end of the 2016/17 tax year). We would use the full rate of the basic State Pension for 2017/18 tax year where a person has a minimum of 30 qualifying years. Where a person has less than 30 qualifying years the relevant fraction of the full rate would be used in the valuation.

Graduated retirement benefit

17. This will be assessed based on the number of units a person holds. Between 1961 and 1975 every £7.50 paid in graduated contributions provided 1 unit of graduated retirement benefit up to a maximum of 86 units. The intention is that the number of units would be multiplied by the unit value in force in 2017 to determine the cash amount to be used in the valuation.

Additional State Pension

18. Entitlement will be based on the earnings on which earnings-related contributions[5] are paid or treated as paid held for each tax year since 1978/79 or the tax year in which a person was aged 16, if after that date. The amount used in the valuation would be increased by earnings growth up to 2015 replicating the calculation that would be carried out if the person had reached State Pension age in 2017. We would need to work out the weekly value to be used for each tax year separately as multiple calculations would need to be done to determine the rate at which entitlement would have built up. Annex A contains an overview of the additional State Pension calculation.

19. We intend to value all past contributions from a common date to ensure that the rates used for individual records are consistent. However, using only the current system rules to obtain this valuation would mean

[5] These are contributions paid or treated as paid at or above the annual value of the lower earnings limit up to the upper accrual point in a tax year. The values for 2012/13 are £5,564 and £40,040 respectively.

that the current unequal outcomes between men and women would persist. Men, through higher earnings, gain under the current system compared to women and measures introduced to protect women, in particular credits in State Second Pension to cover caring responsibilities, take some time to work through in terms of outcomes.

20. The single tier transition design specifically tackles this issue. By first carrying out the valuation under single-tier rules those with 35 qualifying years and no or little additional State Pension will receive immediate benefit from enhanced entitlement under the new scheme. We estimate that around 30 per cent of people reaching State Pension age in the first ten years after reform would have a valuation based on the single-tier rules in 2017 that would be higher than the current rules valuation.

For example

21. Mrs Bell was born in 1953. She is due to reach State Pension age in 2018 and has 39 qualifying years at 2017. Based on her contribution record she would have been entitled to a full basic State Pension and additional State Pension of £12 a week. We would carry out two comparative calculations at State Pension age based on her contribution position in 2017. The first would be a valuation under the single-tier and the second would consist of a valuation of her contributions based on the current scheme. Mrs Bell has more than 35 qualifying years at 2017 so she would be eligible for the full value of the single-tier state pension. The higher of the two amounts would be used to determine her foundation amount.

    <u>Single-tier valuation</u>
    £144

    <u>Current scheme valuation</u>
    £107 + £12 = £119

22. As the valuation under the single-tier rules would be greater this amount would be taken forward as her foundation amount and, because she would not have any further qualifying years, would represent her state pension award. Mrs Bell would gain £25 a week over her potential entitlement under the current scheme. By dealing with a contribution record in this way we are able to blend contributions made before and, where relevant, after 2017.

23. Where the valuation of a person's contributions as at 2017 produces a weekly amount of less than £144 it could be increased by further qualifying years up to the maximum amount. Each extra qualifying year would be worth 1/35$^{th}$ of £144 valued at around £4.11 a week[6].

[6] The exact value in 2012/13 price terms is £4.1142 to four decimal places.

24. Conversely, where the weekly amount would be more than £144 this extra amount would be paid as a 'protected payment'. A person would not be able to improve on this amount by having further qualifying years. We estimate that this would be the case for around 15 per cent of people reaching State Pension age in the first ten years of reform.

For example

25. Suppose the assessment of Mrs Bell's potential weekly additional State Pension entitlement produced a figure of £92 instead of £12. Her valuation would be calculated as follows:

    Single-tier valuation
    £144

    Current scheme valuation
    £107 + £92 = £199

26. As the valuation under the current scheme is now higher this would be taken forward as her single-tier pension award. However, the revaluation relevant to the protected payment would be different from that applicable to the full rate of the single-tier – see paragraphs 48 and 49.

    Single-tier Pension
    £144 + £55 = £199

**The effect of contracting-out**

27. A further complicating factor is that a person may have contracted out of the additional state pension during their working life by joining a private pension scheme. Under the contracting-out arrangements people pay lower National Insurance contributions on some of their earnings, or under defined contribution (DC) arrangements until 6 April 2012 could receive a rebate of National Insurance contributions which is paid into a private pension scheme. In return the person gives up some, or all, of their additional State Pension entitlement. We take account of contracting-out in different ways depending on when the person had been employed, the type of scheme membership and whether they remain a member through to scheme retirement age.

28. Between 1978 and 1996 inclusive salary-related contracted-out pension schemes had to provide their members with an alternative to the additional State Pension known as a Guaranteed Minimum Pension (GMP). The GMP rules broadly mirrored those for the additional State Pension. The National Insurance contributions paid on a contracted-out basis during this period would provide scheme members with entitlement to both additional State Pension and a GMP.

29. To avoid a person benefiting twice from the same contributions i.e. from both the additional State Pension and a GMP, and also from having paid reduced contributions, we make an adjustment to the additional State Pension at State Pension age. This adjustment takes the form of a contracted-out deduction (COD) that broadly reflects the total value of any GMPs to which the person is entitled and is offset against any additional State Pension entitlement covering the period up to 6 April 1997. GMPs from different periods of contracted-out employment are aggregated for this purpose. Where the combined GMP value is more than the additional State Pension entitlement for the period up to 1997 then the additional State Pension is effectively reduced to zero whether or not the person was employed on a contracted-out basis for the entire period.

30. From 6 April 1988 it became possible for members of money purchase DC occupational pension schemes to contract out of the additional State Pension. A person could be in this type of contracted-out employment if their employer made minimum payments to the scheme. The minimum payment represents the reduction in the employee's and employer's National Insurance contributions as a result of the employee being in contracted-out employment.

31. In 1988, contracting-out was also extended to members of personal pension schemes. Where an individual was contracted out in this way, the individual and their employer paid full National Insurance contributions (did not receive any reduction). Instead, HMRC paid minimum contributions directly to the scheme.

32. Where an individual was contracted out in a DC arrangement between 1988 and 1997, like members of salary-related schemes, they also have a COD applied to their additional State Pension entitlement. The COD is calculated as if the individual was a member of a salary-related scheme in order that there is no discrimination between the different types of contracting-out. Although the DC arrangement will not provide a GMP as such the National Insurance contributions to the scheme should be sufficient to purchase a pension of broadly the same amount. Contracting-out for individuals in DC arrangements was abolished from 6 April 2012.

33. In 1997 the regime for salary-related schemes was restructured and GMPs were abolished. Salary-related contracted-out pension schemes were instead required to meet a test of scheme quality known as the Reference Scheme Test. As a consequence of the abolition of GMPs CODs no longer featured in the calculation of additional State Pension based on contributions paid after that date. National Insurance contributions that were paid on a contracted-out basis between 1997/98 and 2001/02 inclusive do not provide entitlement to the additional State Pension.

34. In 2002 the additional State Pension scheme was again changed with the introduction of the State Second Pension. Under this reform people earning up to around £33,000 a year (in 2012/13 prices) received more generous pension benefits than under SERPS. The rebate regime was partially changed which allowed personal pension schemes to broadly reflect the structure of the State Second Pension however rebates for occupational pension schemes continued to be based on contracting out of SERPS. Members of contracted-out pension schemes earning up to around £33,000 a year receive a 'top up' in the form of additional State Pension to reflect the extra benefits available under the State Second Pension compared to SERPS. There is no entitlement for those earning above £33,000.

35. The last major change to these rules was legislated for in the Pensions Act 2007 which brought in measures to cap the level of earnings on which entitlement builds up and convert the benefits provided on earnings of up to around £15,000 into a weekly cash amount. These two measures will lead to a gradual withdrawal of earnings-related entitlement so that the additional State Pension would provide completely flat-rate benefits by around 2040. However, under this timetable complex calculation rules to determine additional State Pension will be retained for several decades as those people with entitlement for periods before 2012, and their survivors, reach State Pension age. Also, contracting-out would continue albeit on an increasingly narrower band of earnings.

<u>Maintaining the value of pensions during the working life</u>

36. When working out a person's additional State Pension entitlement their past earnings need to be updated to reflect current earnings values. This is known as revaluation and is done by increasing the value of earnings in the years before the last complete tax year before the person reaches State Pension age in line with the growth in average earnings up to that year. A similar exercise is carried out to work out a person's GMP entitlement when they reach scheme retirement age.

37. However, where a person leaves their pension scheme before they reach retirement age, but elects to leave their accrued rights in the scheme the GMP, and consequently the COD, can increase at a greater rate than the additional State Pension. This is solely due to differences in the way in which the value of the additional State Pension and the GMP is maintained. When protecting the GMP, schemes have the choice of:
    - <u>Full rate revaluation</u> - increasing the GMP by increases in national average earnings, the same method is also used for additional State Pension and GMPs while in employment.

- Limited rate revaluation[7] - increasing the GMP by the lower of 5 per cent a year or average earnings.
- Fixed rate revaluation[8] – increasing the GMP by a rate set by Parliament every five years[9] based on assumptions about earnings growth. This rate is based solely on the date the member left service. Any changes to the rate after the member has left service are ignored.

38. This last preservation method, chosen by the majority of private sector pension schemes, can create discrepancies between the value of additional State Pension and GMPs. Where this happens the GMP can erode all of a person's additional State Pension entitlement covering the period up to 1997.

Maintaining the value of pensions in payment

39. The purchasing power of additional State Pension in payment is maintained by increasing the amount annually by prices, currently as measured by the Consumer Price Index (CPI)[10]. GMPs are increased differently. Schemes are required to increase the value of GMPs earned between 1988 and 1997 by prices up to a maximum of 3 per cent however there is no requirement to increase GMPs earned before 1988. The COD calculation is re-done every year to take account of these differences in the rules as the balance between the two amounts can change each year when in payment. Crucially, at State Pension age some people can have no entitlement to additional State Pension for periods before 1997 but gain entitlement in a subsequent year, as the difference is eroded by the full indexation applied to the additional State Pension.

40. In April 2011 the method for increasing the basic State Pension was changed from prices to average earnings[11]. At that time the Government introduced the 'triple lock' under which the basic State Pension is increased by the higher of average earnings, prices (as measured by the CPI) or 2.5 per cent.

[7] This method can only be used where contracted-out employment ended before 6 April 1997 and required payment of a premium by the pension scheme to the National Insurance Fund to compensate for the lower increases the scheme would be required to pay.
[8] This method allowed contracted-out schemes to achieve certainty in respect of the deferred GMP liability.
[9] The rate is revised with every review of national insurance rebates. The maximum period that rates can stand before being reviewed is 5 years.
[10] The Retail Price Index was used prior to April 2011
[11] The basic State Pension was increased by more than price inflation between 2001/02 and 2003/04 and in 2010/11. In 2001 the Government promised to increase the basic State Pension in future by a minimum of £100 a year or 2.5 per cent.

### Current scheme valuation

41. The current scheme valuation includes graduated retirement benefit, basic State Pension and additional State Pension referable to the years up to 1997, less any contracted-out deduction for this period (this is the same as the valuation performed when someone reaches State Pension age under the current scheme). Typically, no additional State Pension or COD is considered for post 1996/97 years contracted-out, since National Insurance contributions paid on a contracted-out basis from that point on do not provide entitlement to additional State Pension. The reasoning behind this is that the benefit accrued from the rebate is assumed to match the additional State Pension given up by contracting out. Therefore, it is *as if* the periods spent contracted-out from 1996/97 onwards are automatically calculated in a person's current scheme valuation. However, in certain circumstances contracted-out contributions made from 2002/03 onwards can provide entitlement to the additional State Pension – see paragraph 34 for more information.

### Rebate derived amount

42. Where a person who reaches State Pension age after the introduction of the single-tier has had periods of contracting out, we need to factor the National Insurance rebate received or reduced contributions paid into their valuations. The **rebate derived amount** is a new feature that is intended to represent the total benefits a person could gain in a private pension as a result of funding from the rebate. This amount would include the value of any rebate earned from 1997/98 onwards, when contributions paid on a contracted-out basis in general[12] do not provide entitlement to the additional State Pension. Therefore, it would be broadly equivalent to the value of additional State Pension a person would have been entitled to had they not made contributions on a contracted-out basis after 1996/97.

### Single-tier valuation

43. However, there is no such equivalent means for automatically factoring in the value of the rebate for years in which the person was contracted out from 1997/98 onwards in a person's single-tier valuation, as there is in the current scheme valuation. We will need to determine the value of the rebate for the entire period from 1978 – 2017. This will include their COD (for years between 1978 and 1997) and also their assumed additional State Pension, which is assumed to match the benefit accrued as a result of contracting out, for years between 1997 and 2017. The total of this – the rebate derived amount – will be subtracted

[12] See paragraph 34 for information on the position after 2002/03 when contracted out earning can provide additional State Pension entitlement in certain circumstances.

from their single-tier valuation. This approach will ensure that people with periods of contracting out are not able to benefit at a disproportionate rate to others.

For example,

44. Mr Clark was born in 1952. He is due to reach State Pension age in May 2017 and has built up 40 qualifying years. Based on his contribution record he would have been entitled to an additional State Pension of £45 a week. As Mr Clark has been a member of a contracted-out pension scheme during his working life, we need to take account of this time spent contracted out to reflect the National Insurance rebate he received.

    Current scheme valuation
    £107 + £45 - £45 = £107
    equals basic State Pension plus additional State Pension minus COD

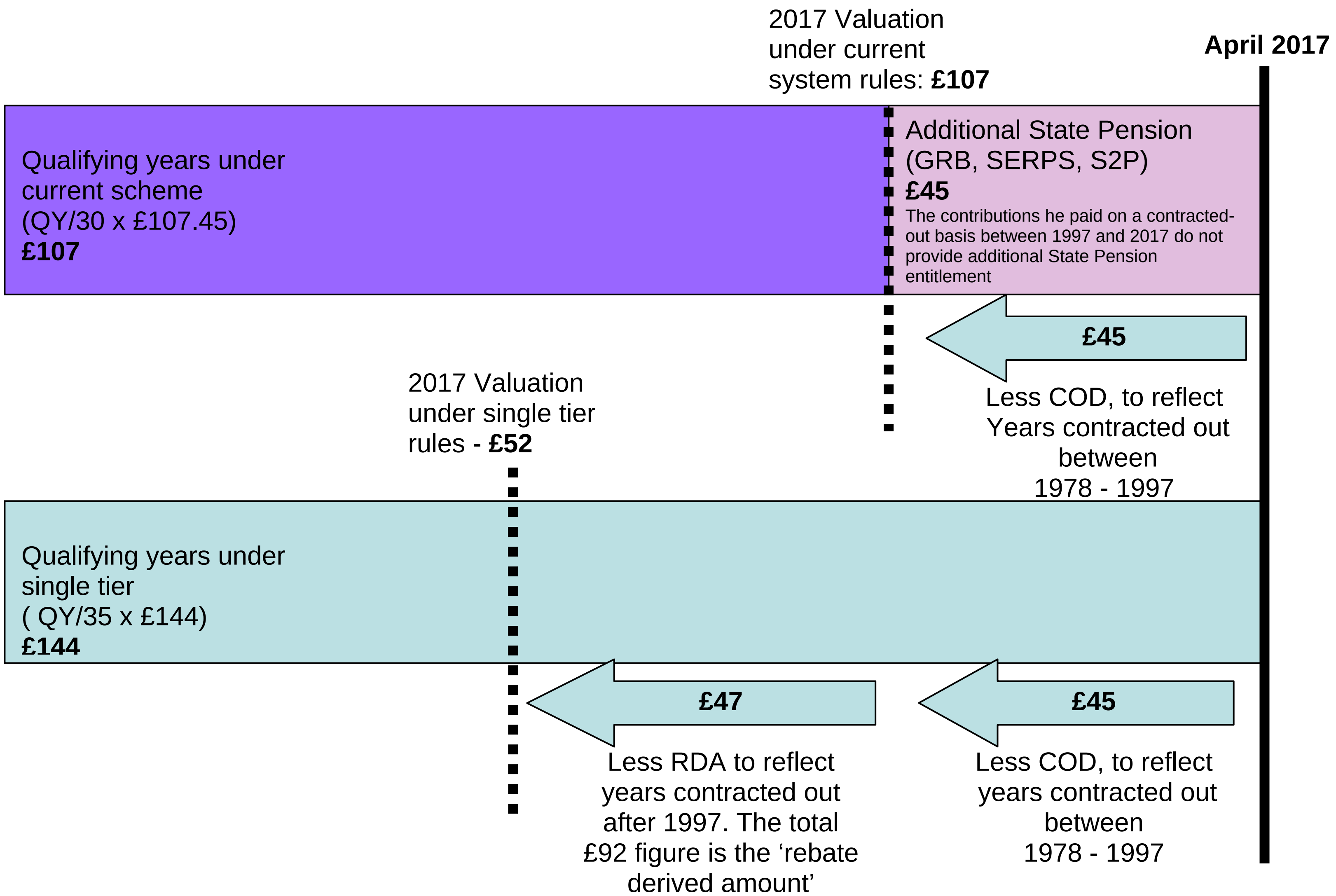
    Single-tier valuation
    144 – £92 (£45 + £47[13]) = £52
    equals qualifying years valued under single-tier minus rebate derived amount

45. The valuation under the current scheme rules is greater so that valuation would form Mr Clark's state pension award. Mr Clark is unable to build further qualifying years as he is due to reach State Pension age in 2017.

[13] Includes the £45 from before 1997, and £47 to cover the period 1997 to 2017 for which there is no corresponding additional State Pension entitlement as he was contracted out.

## Case Study T.1: Consideration of time spent contracted out of the additional State Pension

*Figures are illustrative, based on the case study of Mr. Clark on page 10*



46. If Mr Clark had been born in 1956 and had built up 36 qualifying years he would be awarded the £107 as his foundation amount. He would reach State Pension age in 2022 aged 66 and, on that basis; he would be able to add further single tier qualifying years at £4.11 a week up to the maximum weekly entitlement of £144. He could get a further 5 single-tier qualifying years before reaching State Pension age thereby increasing his potential state pension award to £127.55 a week. This approach would enable people who start to pay increased contributions following the end of contracting-out to gain extra pension entitlement as a result.

47. On top of this £127.55 a week from the state, Mr Clark would have built up pension benefit in his private pension scheme as a direct result of his having contracted out in the past: part of his overall retirement income funded will have been through National Insurance contributions.

Revaluation of 2017 amounts

48. The method used to maintain the value of the 2017 amount through to a person's State Pension age will differ depending on whether or not the valuation includes a protected payment. The intention is to increase all amounts of £144 or less at least in line with earnings but the assumption here is that they would be increased by the 'triple lock', (the higher of increase in earnings, growth in prices as measured by CPI or 2.5 per cent). This would reflect the current approach taken with the basic State Pension so that awards made to those newly retired under the single-tier rules would mirror the payments that would be made to pensioners with full single-tier entitlement. New awards would therefore be made at the prevailing rate, or the relevant fraction of that rate, of the single-tier pension.

49. Where the valuation includes a protected payment the intention is that a different method would be used to maintain the purchasing power of this extra amount through to State Pension age. These amounts would track changes in price inflation as measured by CPI.

## Annex A – calculation of additional State Pension

1. The additional State Pension calculation will differ depending on when and at what level contributions were made. Under current rules a person's additional State Pension would be based on revalued earnings[14] in each tax year between 1978 (or age 16) and the full tax year before State Pension age. The rate at which entitlement builds up will differ depending on the year and level of earnings on which it was based. As an illustration the entitlement for a person reaching State Pension age in 2013/14 would be based on the following calculations:

**1978/79 to 1987/88 – State Earnings-Related Pension (SERPS)**

2. the total revalued earnings multiplied by 25/N per cent.

**1988/89 to 2001/02 – (SERPS)**

3. the total revalued earnings multiplied by 20/N per cent

N = the number of years between 1978/79 and the last complete tax year before State Pension age is reached – in this example 35

**2002/03 to 2009/10 – State Second Pension (S2P)**

4. the total revalued earnings would be split into three separate earnings bands with each band building up at a different rate based on the underlying SERPS rate for accruals after 1988. The three bands are:

- Band 1 - revalued earnings up to the low earnings threshold (LET);
- Band 2 - revalued earnings between the LET and an upper earnings threshold (UET); and
- Band 3 - revalued earnings between the UET and the annual upper earnings limit. From April 2009 the upper threshold for additional State Pension accruals was changed from the annual upper earnings limit to the annual upper accrual point which is fixed at £40,040.

5. The accrual rate for each band would be twice the SERPS accrual rate (40 per cent), half the SERPS accrual rate (10 per cent) and the SERPS accrual rate (20 per cent) respectively.

**2010/11 to 2011/12 – S2P**

6. the total revalued earnings would be split into two separate earnings bands. The two bands are:

- Band 1 - revalued earnings up to the low earnings threshold (LET);
- Band 2 - revalued earnings between the LET and the annual upper accrual point.

7. The accrual rate for each band would be 40 per cent and 10 per cent respectively.

[14] Additional State Pension entitlement is based on earnings above the annual lower earnings limit in any given year – earnings in years before the last complete tax year the person reaches State Pension age would be revalued.

**From April 2012 – S2P**

8. the total revalued earnings would be split into two separate earnings bands. The two bands are:

- Band 1 – an annual cash amount of £88.40 in 2012/13 (£1.70 a week); and
- Band 2 - revalued earnings between the LET and the annual upper accrual point.

9. The accrual rate for band 2 would be 10 per cent.

10. The revalued totals for each tax year from 2002/03 to 2011/12 would be added together and divided by the number of years between 1978 and the tax year before State Pension age – so again 35. From 2012 the band 2 revalued amounts would be divided by 44 and then added to the cash amount in band 1.

11. The additional State Pension payable would be the totals of all the amounts from 1978. This figure would be divided by 52 to provide a weekly figure.