State Second Pension

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Section Business and Transport Section

The Category A State Pension is made up to two elements, the basic State Pension (£107.45 a week in 2012/13) and a second-tier, earnings-related, additional State Pension. There have been three different earnings-related state schemes since 1961: Graduated Retirement Benefit (GRB) which operated between 1961 and 1975; the State Earnings Related Pension Scheme (SERPS) which operated between 1978 and 2002; and the State Second Pension (S2P) which replaced SERPS in 2002. Unlike SERPS, S2P provides a second pension for some carers and disabled people. Its structure is more generous to low earners.

It was always the intention that S2P should become flat-rate at some point. The *Pensions Act 2007* introduced measures to accelerate this process, so that S2P would become flat-rate by around 2030. The rationale was that, in the face of an ageing population, "the State should move away from the direct provision of pensions related to individuals' earnings and concentrate on flat-rate provision in the future."

The current Government has announced its intention to introduce a single tier State Pension, combining the basic State Pension and State Second Pension, early in the next Parliament. It intends to publish a White Paper setting out its proposals in more detail.

This note provides an overview of how the State Second Pension works and how it is changing. Proposals for a single-tier State Pension are covered in more detail in Library Standard Note SN 5787 State Pension reform. Library Research Paper 99/109 provides a more detailed account of the background to the introduction of S2P.

Contents

1 Background

1.1 The State Pension

National Insurance state retirement pensions in the UK are composed of two main elements: a flat rate basic pension (currently £107.45 a week for a single pensioner) and an earnings-related Additional Pension (AP).

The first earnings-related pension provided by the state was the Graduated Retirement Benefit, which ran between 1961 and 1975. The additional State Pension was introduced in the form of the State Earnings Related Pension Scheme - in 1978 under the *Social Security Pensions Act 1975*. On 6 April 2002, the State Second Pension (S2P) replaced the State Earnings Related Pension Scheme (SERPS) as the state's additional pension provision.[1] Accrued rights to SERPS were preserved but new rights accrued on the basis of S2P rules.

[1] *Child Support, Pensions and Social Security Act 2000*

S2P is designed to produce a higher state pension for low earners and covers some carers and disabled people who were not covered by SERPS. An individual can build entitlement to S2P if either they are:

- An employee earning above the lower earnings limit (£5,565 in 2012/13) from any one job; or
- A carer or someone with a long-term illness or disability.

Payment of Class 2 National Insurance contributions by people who are self-employed do not count towards the State Second Pension. A decision to contract-out of S2P (see below) may affect the amount of additional State Pension an individual gets.

The Gov.uk website provides an overview of the scheme – additional State Pension.

1.2 Contracting-out

Since its introduction in 1978, it has been possible to contract out of the Additional Pension (SERPS/S2P) into either a private pension scheme which fulfils certain criteria. In return, the employee and employer pay reduced National Insurance Contributions (NICs) through the "contracted out rebate".

Originally, employers could only contract out of SERPS if they provided Defined Benefit (DB) schemes and a Guaranteed Minimum Pension (GMP) which at least equalled the SERPS they would have earned had they not been contracted out. *Pensions Act 1995* removed the requirement to provide a GMP for rights accrued from April 1997. From that date, a contracted-out DB scheme must satisfy a "Reference Scheme Test" (RST).[2] A scheme that passes the RST is "expected (but not guaranteed) to provide pensions broadly equivalent to or better than the benefits that the individual is giving up from contracting out of S2P".[3]

The *Social Security Act 1986* introduced the option of contracting-out into a DC (money purchase) scheme (i.e. a scheme in which the amount of contribution is set, but the eventual pension which that contribution will yield is unknown because it depends on factors such as the performance of the fund and annuity rates at the time the pension is taken).[4] The option of contracting out into a DC scheme was abolished under the *Pensions Act 2007* with effect from April 2012.[5]

Contracting out has the effect of reducing additional State Pension entitlement. The Pension Service explains:

> **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)*

[2] Section 12B *Pension Schemes Act 1993*

[3] DWP, *Pensions Bill – Impact Assessment*, footnote to para 2.34

[4] The legislation is now in Part III, Chapter 1 of the *Pension Schemes Act 1993*

[5] *Pensions Act 2007* , section 15; The Pensions Act 2007 (Abolition of Contracting-out for Defined Contribution Pension Schemes) (Consequential Amendments) Regulations 2011 (SI 2011/1245)

> 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.[6]

These issues are discussed in more detail in Library Standard Note SN 4822 *Contracting out of the State Second Pension* SN 2674 *Contracted-out deductions.*

1.3 How entitlement is calculated

Between April 1978 and April 2002, the Additional State Pension was built up under the State Earnings-Related Pension Scheme (SERPS). From April 2002, this was replaced by the State Second Pension (S2P).

SERPS
The details of the SERPS calculation changed a number of times between 1978 and 2002. This means the amount a person gets will depend on the year they reach State Pension age (SPA). In its first report of 2004, the Pensions Commission provided an overview of the SERPS calculation:

> The amount of SERPS that an individual accrued in each year is calculated in two stages:
>
> 1. First calculate the value of a given percentage of earnings between the LEL and UEL in each year, revalued to take into account average earnings growth up to the point of retirement. The percentage is between 20% and 25% of earnings depending on when someone reaches SPA.
>
> 2. This amount is then divided by a number, which depends on when someone reaches SPA:
>
> a) If someone reached SPA prior to 1999 then it is divided by 20 years.
> b) If someone was 16 or older when SERPS was introduced, but did not reach SPA before 1999, the number of years is the number of years between 1978 and the year they reach SPA.
> c) If someone was younger than 16 when SERPS was introduced, the number of years is the number of years between 16 and SPA.[7]

HM Treasury's *Tax Benefit Reference Manual 2009/10* provided a more detailed account:

> 8.15 SERPS is based on earnings on which standard rate Class 1 national insurance contributions have been paid as an employee from the tax year beginning 6 April 1978-5 April 2002. The scheme provides for an additional State Pension, which depends on revalued earnings.
>
> 8.16 Main points:

6 Pension Service, *A detailed guide to State Pensions for advisers and others,* NP46 September 2008, p38

7 Pensions Commission, First Report, Appendix F, October 2004, http://tinyurl.com/6bewzf (UK Web Archiving Consortium, retrieved 18 August 2008)

- entitlement depends on the individual having earnings over the annual Lower Earnings Limit (LEL) on which he/she has paid standard rate Class 1 national insurance contributions in one or more tax years after 5 April 1978;

- it is a cash benefit consisting of an earnings-related weekly State Pension, usually paid on top of the basic State Pension, although the individual does not have to be entitled to a basic State Pension;

- it is reduced or extinguished by a 'contracted-out deduction' in respect of those tax years in which the claimant was 'contracted-out' up to 5 April 1997, and;

- it applies for the tax years 1978-79 to 2001-02 inclusive.

8.17 The amount payable is based on the total amount of earnings on which an individual paid contributions in each relevant tax year since 6 April 1978. The qualifying level of earnings for the basic State Pension for each year is deducted from the relevant annual earnings. The resulting surpluses are revalued in line with the increase in national average earnings. The amount of the additional State Pension earned in each year is divided by the number of years in the working life since 1978. For someone reaching State Pension age in 2008/09 this will be 30 years.

8.18 The amount accrued each year under SERPS is a fixed proportion of earnings in excess of the LEL. This figure is revalued in line with average earnings to the year before the person reaches State Pension age and is then added to similar amounts accrued from all the other years worked out.

8.19 For people reaching State Pension age on, or after, 6 April 2000, SERPS is worked out as follows:

8.20 For the period 1978/79 to 1987/88 the revalued surplus figure for those years is multiplied by 25 per cent. This figure is then divided by the total number of years between1978/79 (or the tax year in which they reached age 16, if this is later) and the tax year ending before the one in which the person reaches State Pension age.

8.21 For the period 1988/89 – 2001/02, the percentage used depends on when the person reaches State Pension age. For those reaching State Pension age between 1988/89 and 1999/2000, the percentage is 25 per cent.

8.22 For those reaching State Pension Age from 2000/01 onwards, the percentage is between 24.5 per cent and 20 per cent, as shown in the table below. This figure is then divided by the total number of years between 1978/79 (or the tax year in which they reached 16, if this is later) and the tax year ending before the one in which they reach State Pension age.

8.23 For example, for someone who reaches State Pension age in 2009/10 the percentage was 20.5 per cent. Additionally, the amount of SERPS that a surviving spouse or civil partner may inherit was changed from 6 October 2002[2]. There were differences in the computation of additional State Pension for people who reached State Pension age on or before 5 April 2000.[8]

The table below shows the accrual rates over the transitional period (2001-01 to 2009-10):[9]

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8 HM Treasury, *Tax Benefit Reference Manual 2009-10 edition,* section 8

9 Adapted from the Pension Service Pension Service, *A detailed guide to State Pensions for advisers and others,* NP46 September 2008, p33

Percentage rates of SERPS for those reaching state pension age on or after 6 April 1999

Tax year in which state pension age is reached	% of total surplus earnings from 1988/89
1999/2000	25
2000/2001	24 ½
2001/2002	24
2002/2003	23 ½
2003/2004	23
2004/2005	22 ½
2005/2006	22
2006/2007	21 ½
2007/2008	21
2008/2009	20 ½
2009/2010 or later	20

S2P

Initially, entitlement was based on three bands of earnings, divided by a Low Earnings Threshold and an Upper Earnings Threshold, with the accrual structure was weighted in favour of low and moderate earners. The Pensions Commission explained:

> S2P is based on this [SERPS] framework, but introduces different bands of accrual between the LEL and UEL. S2P introduces two important new thresholds into the calculations, the Lower Earnings Threshold (LET) and the Upper Earnings Threshold (UET), as illustrated in Figure F.8.
>
> - For earnings between the LEL and LET for the purposes of S2P employees are treated as if they are earning at the LET. The accrual rate at this point is 40%.
>
> - For earnings between the LET and the UET the accrual rate is 10% to compensate for the higher accrual rate on the first band on earnings, so that higher up the earnings distribution the benefits are more equivalent to what would have been accrued under SERPS.
>
> - For earnings between the UET and the UEL the accrual rate is 20%: that is the same as SERPS.
>
> In addition to treating individuals who have earnings below the level of the LET as if they had earnings at the LET. S2P, unlike SERPS, also gives credits to certain groups who do not have earnings. Credits mean that someone with no earnings above the LEL is treated as if they are earning at the LET. Credits are available for some groups of disabled people and carers, including those who are receiving Child Benefit for a child aged under six.[10]

From April 2009, the Upper Earnings Limit was replaced by a new upper accrual point as the cap on accruals.[11]

The *Pensions Act 2007* introduced measures with the aim of making S2P accrual flat-rate over time (see section 3.2 below):

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10 Pensions Commission, First Report, Appendix F, October 2004; HM Treasury, *Tax Benefit Reference Manual 2009-10 Edition,* p 192-3

11 *National Insurance Contributions Act 2008*

- From 2010/11, bands 2 and 3 were merged so that all earnings between the low earnings threshold and the upper earnings limit fall into band 2 and accrue additional pension at a rate of 10%;
- From a date to be determined by the Secretary of State, the accrual rate for band 1 (previously 40%) would be replaced with a weekly flat-rate accrual amount. An annual flat-rate accrual amount of £88.40 was introduced in 2012/13.[12]

The Labour Government's plan was for the earnings-related band 2 to remain in place for a time but to be withdrawn by around 2030, leaving a flat-rate benefit.[13]

2 State Earnings-Related Pension Scheme

2.1 Introduction

The Labour Government of 1974-79 introduced SERPS in April 1978 under the *Social Security (Pensions) Act 1975*. A White Paper published in September 1974 explained that the existing system had failed to prevent large numbers of pensioners having to claim means-tested benefits in retirement:

> 1. For 10 years successive Government have considered plans for pensions reform. One element of the problem to be tackled has always been clear. That is the failure of the present combination of a mainly flat-rate national insurance pension and of occupational pensions of sharply varying quality and limited coverage to guarantee all pensioners more than a low standard of living, or to prevent large numbers of them from having to rely on means-tested supplementary benefits. Occupational pensions have removed the threat of poverty in old age from a minority of pensioners and offer the promise of adequate pensions to great numbers in future, but they are still far from universal in coverage and they still leave gaps in the provision of adequate pensions for chronic ill-health and widowhood. [14]

The Government would therefore introduce a state earnings-related pension scheme, to work "in partnership" with occupational schemes:

> In return for wholly earnings-related contributions the scheme will provide earnings-related pensions fully protected against inflation at all times. This is one of the most precious assets of the scheme. Moreover, we have designed our proposals to protect the lower paid.
>
> The new scheme will operate in partnership with well-founded occupational schemes, whose members will gain considerable benefit from the new arrangements. Terms for contracting-out are as simple as they can be made and the pensions which members of contracted out schemes will receive will be at least as good as those of full members of the state scheme.[15]

SERPS was to be earnings-related to reflect "the fact that pensions are deferred pay".[16]

Employees started making contributions to SERPS in April 1978, and the DHSS paid the first additional pensions to people retiring in 1979. The design of the scheme meant it would build

12 *Pensions Act 2007. Explanatory Notes*, para 60-63; Social Security Pensions (Flat Rate Accrual Amount) Order 2012 SI 2012/189 – Explanatory Memorandum

13 *Pensions Act 2007. Explanatory Notes*, para 62

14 DHSS, *Better pensions fully protected against inflation: proposals for a new pensions scheme*, Cmnd 5713, September 1974

15 Cmnd 5713, September 1974; Foreword

16 Ibid, p 2

up slowly until the first full pensions would be paid in 1998/99. In its original form, SERPS offered a maximum earnings-related pension of 25% of earnings between the lower and upper earning limits for NICs, paid as an addition to the basic State Pension. A contributor would receive the revalued equivalent of 1¼% of his or her average earnings between the two limits until those who had contributed for 20 years qualified for the full 25% (that is, 20 multiplied by 1¼). The pension was to be based on the individual employee's earnings for the best 20 years of his or her working life from 1978 onwards. The White Paper anticipated that 40 years after the introduction of the scheme, pensioners receive benefits at the full rate would have incomes above half of the average income of the rest of the rest of the population.[17] There would be provision to contract-out of SERPS into an occupational scheme.[18]

2.2 Reforms

Although the 1975 Act was passed with all party support, in the mid 1980s the Conservative Government began to reassess SERPS during its review of the social security system. This review was part of that Government's general policy to reduce the level of social security expenditure. However, it was also a response to growing concern about the cost of the scheme into the next century when the rising proportion of elderly people in the population would add to the emerging cost of pensions as the scheme approached maturity. At the same time, reducing the level of benefits offered by the state scheme would make room for private alternatives favoured by the Government: occupational and personal pension schemes.[19]

In its initial Green Paper in 1985, the Government proposed abolishing SERPS.[20] The Labour Opposition of the time, and interest groups such as Age Concern, opposed the proposal and the Government decided against abolition. In the subsequent White Paper, the Government instead proposed making a number of changes to the scheme.[21] The *Social Security Act 1986* introduced these changes but many of them would not take effect until the end of the century. The legislation provided for the changes to be phased in over a long period. This was in order to provide some protection for pension rights based on contributions prior to the legislation, and to avoid dramatic differences in pension rights between people retiring on successive days. To briefly summarise, the *Social Security Act 1986* contained the following changes to SERPS:

- From 1999/2000, SERPS pensions to be based on a full working life rather than the best 20 years.
- SERPS pensions to be calculated on 20% of earnings rather than 25% (to be phased in from 2000/2001 at 24.5% in steps diminishing at 0.5% a year to 20% in 2009/2010).
- Widows to inherit half their spouse's SERPS rights rather than the full amount [22]

Additionally, the 1986 Act widened the scope for people to contract out of the state scheme and instead take out personal pensions. The 1986 changes were expected to considerably reduce the amount of SERPS accrued by those affected, compared to the previous scheme.[23]

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[17] Ibid, p 23

[18] This was extended to approved personal pension schemes by the *Social Security Act 1986*.

[19] DHSS, *Reform of social security: programme for actions*, Cmnd 9691 December 1985, para 1.8-1.15

[20] DHSS, *Reform of social security: programme for change, Volume 2*, Cmnd 9518 June 1985

[21] DHSS, *Reform of social security: programme for actions*, Cmnd 9691 December 1985

[22] For more on this policy and how it developed, see Library Standard Note SN 706 Inherited SERPS

[23] House of Commons Library, Reference Sheet No 86/3, Social Security Bill 1985/8 [Bill 59]

The net effect of changes introduced by the *Pensions Act 1995* further reduced the generosity of future accruals. At the time these were seen as somewhat technical and, in the context of a wider-ranging Bill, did not receive a great deal of discussion. However, the Government Actuary's Department estimated that they would roughly halve SERPS spending by 2050.[24]

3 State Second Pension

3.1 Introduction

In its 1998 Green Paper, *A new contract for welfare: partnership in pensions*, the Labour Government announced its intention to replace SERPS with a new State Second Pension. It had two aims – giving more help to people for whom private pensions were not an option and helping moderate earners to build up better second pensions through the introduction of stakeholder pensions. The intention was that S2P would become flat-rate over time:

> 3 Although SERPS is an efficient second pension, it is earnings-related. It does least for those on low incomes who have most difficulty in building up a good second pension. Many people on modest incomes will also receive limited benefits from SERPS or from the private provision they may make instead.
>
> 4 As a first stage, alongside our proposals for stakeholder pension schemes, we intend to replace SERPS with a new State Second Pension to meet two priorities. Our first priority is to give more help to those for whom private second pensions are not an option, either because they have low earnings or because they are, for a good reason, not working or seeking work. Our second priority is to help moderate earners to build up better second pensions, with as many as possible joining funded pension schemes. This will ensure that it is worthwhile for low and moderate earners to save for their retirement.
>
> 5. We expect most low earners to choose to remain in the new State Second Pension unless they can join an employer's scheme which offers a better deal. To begin with, moderate and higher earners will have the choice of remaining in the new State Second Pension or joining a funded scheme (those already in good occupational schemes, funded or unfunded, would be expected to remain in them).
>
> 6 In the second stage, when stakeholder pension schemes have established themselves as low-cost, value-for-money, funded second pensions, we expect the new State Second Pension to become a flat-rate scheme for those on lower earnings, with those on moderate and higher earnings joining a funded pension (with contracted-out rebates continuing to be earnings-related).
>
> 7. We do not believe it would be prudent to move to a new flat-rate State Second Pension in one step. It would cause significant disruption to existing provision, require millions of people to change their pension arrangements, and be costly. It would also be better to allow time for our new pension framework to become established.
>
> 8. We envisage that the move towards a new flat-rate State Second Pension might begin, for those with a significant part of their working lives still remaining (for example,

[24] For more detail, see Library Research Paper RP 95/47 *The Pensions Bill: Social Security Aspects*; *Government Actuary: Pensions Bill 1994: report by the Government Actuary on the Financial Provisions of the Bill on the National Insurance Fund*. Cm 2714

those aged under 45 at the point of change), five years after the introduction of stakeholder pension schemes.[25]

Improvements for low earners

Significant differences compared to SERPS would be the treatment of those on low earnings and carers and disabled people, who would be treated as thou they had earnings at the "low earnings threshold. The Explanatory Notes to legislation which introduced S2P said:

> 346. The State Second Pension regime will provide for a new Low Earnings Threshold, which will be uprated in line with increases in national average earnings. In 1999/00 terms this Low Earnings Threshold will be £9,500. Anyone earning less than £9,500 but at or above the annual Lower Earnings Limit (£3,432 in 1999/00) will be treated for State Second Pension purposes as if they had an earnings factor of £9,500.
>
> 347. Carers, who have no earnings or earnings below the annual LEL, will be treated for State Second Pension purposes as if they had earnings of £9,500 for any year throughout which:
>
> - they receive Child Benefit for a child under 6;
> - they are entitled to Invalid Care Allowance; or
> - they are given Home Responsibilities Protection because they are caring for a sick or disabled person.
>
> 348. Those entitled to long-term Incapacity Benefit or Severe Disablement Allowance throughout a tax year will also be treated for State Second Pension purposes as if they had an earnings factor of £9,500 in that year, provided they meet a simple labour market attachment condition when they reach state pension age. This condition requires that they have worked and paid (or are treated as having paid) Class 1 National Insurance contributions for at least one tenth of their working life since 1978, when Additional Pension was introduced.[26]

In fact, the previous Conservative government had intended that Home Responsibilities Protection for the additional pension should be introduced to compensate carers for the removal of the "best 20 years rule" for SERPS in 1999. The White Paper *Equality in State Pension Age* had said:

> The *Social Security Act 1986* contained powers to enable regulations to be made to extend HRP to SERPS entitlements and allowing those with caring responsibilities – predominately women – to obtain a full SERPS pension on the basis of as little as 20 years' earnings. Since SERPS began in 1987, this would effectively mean that new awards of SERPS could be enhanced from 1999 onwards, significantly improving women's retirement incomes. Regulations will be made at the appropriate time.[27]

In the event, the 1997 General Election intervened and the new Labour government undertook its own review of pensions, so these regulations were not laid. Its manifesto for the 1997 election had included a commitment to "develop the administrative structure of SERPS so as to create a 'citizenship pension' for those who assume responsibility as carers [...]".[28]

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[25] DSS, *A new contract for welfare: partnership in pensions,* Cm 4179, December 1998, p5 and p49

[26] *Child Support, Pensions and Social Security Act 2000*

[27] DSS *Equality in State Pension Age Cm 2420* December 1993; HC Deb 14 February 1997 c 342W

[28] Labour Party Manifesto for the 1997 General Election, *New Labour: because Britain deserves better*, p 27

Interaction with contracted-out schemes

The intention was for S2P to cease to be earnings-related in the long-term and would be focused on low earners. Those on "middle incomes" (would be encouraged to join private, funded schemes.

In order to encourage private saving, the Government proposed to introduce Stakeholder Pensions. These would combine:

> Low overheads and high security of occupational pension schemes with the flexibility of the best personal pensions, and will be available to all. They are particularly designed to help those on middle incomes (between roughly £9,000 and £18,500 a year) to start their own pension but will benefit those on higher incomes too.[29]

The Government recognised when people contracted out, they did so "on the basis that their pension arrangements would give them, broadly speaking, what it would have received from the state had they not been contracted out." In order to ensure that the new 40% accrual rates for S2P did not mean that moderate earners would be better-off contracted-in, the Government would enhance contracted-out rebates and provide S2P "top-ups". The then Social Security Minister, Jeff Rooker, explained:

> The extra help for members of personal pension schemes, including stakeholder schemes, will be delivered through a combination of extra rebates and a state scheme top-up. Rebates from national insurance contributions for the scheme will be enhanced to reflect the new three-part accrual in the state second pension. Everyone on earnings up to £21,600 will therefore benefit from higher rebates. People earning less than £9,500 will receive more than twice the help that they are currently given, as applies under the state second pension. Their rebate will double from a pension accrual rate of 20 per cent to 40 per cent. In addition, low earners will receive a state second pension top-up payment to match the earnings boost to £9,500 that low earners in the state scheme will receive, payable from the state pension age. The rebates will be paid directly into people's pension arrangements, providing an immediate boost to savings.
>
> Equal support is provided for people in occupational schemes, but in a slightly different way. For low and moderate earners in such schemes, the extra help will be delivered entirely through an extended state second pension top-up, payable at pension age. We are committed to supporting occupational pension provision, which is nearly always the best choice for employees. Generally speaking, if employees have the opportunity to join an occupational pension scheme, they will be well advised to do so. That is general advice; one cannot be specific, because there will always be odd individuals for whom such schemes are not appropriate, but the majority of people should get into an occupational pension scheme if they have the chance to do so. We do not want people to think that the state second pension is a better option, so, to protect them, a top-up will apply to earnings of up to £21,600.
>
> The state second pension top-up payment will do two things for low earners in occupational schemes. First, because their rebate will remain unchanged, it will deliver the difference between the 20 per cent. rebate on their actual earnings and the 40 per cent. accrual rate in the state second pension. Secondly, it will pay the full 40 per cent. accrual on the boost between their actual earnings of, say, £6,000, and £9,500-so £3,500 would be the boost in such a case. For moderate earners, the top-up payment will reflect the extra help given in the state second pension, with the payment tapering away on earnings of between £9,500 and £21,600. That approach minimises disruption

[29] Ibid, p47

to employers, who would otherwise have to redesign their occupational schemes. It also means that employees will not have to make difficult decisions on whether they are better off in the state or occupational schemes.

Such help will continue to be given even when the state second pension becomes flat rate in stage 2. It will avoid the creation of perverse incentives for low earners to rejoin the state scheme, and ensure that moderate earners have an earnings-related incentive to save for their retirement in funded pensions. As well as providing a boost to individual savings, it ensures that there is no disruption for employers. That was a particular concern of the pensions industry, and we have responded positively to it.

Overall, we are investing an additional £400 million in extra rebates from the outset of the reforms. That will rise to an extra £4.5 billion in 2010. The long-term state second pension benefit costs, including the top-up, will increase by a net figure of some £6.2 billion a year in 2050, which is radically increased help for people on below average earnings. We have discussed some of the net costs in previous debates.

Part III of new schedule I sets out how the top-up provisions will work, and refers to three separate amounts: A, B and C. As I said, if the theory is simple, it is a question of putting it into practical legislation. Amount A is the amount of earnings related state second pension an individual would receive if they had not contracted out. Amount B is the amount of the pension represented by the contracted out rebate. The difference between the two is amount C, which is the state second pension top up for the year. That is added to the other amounts for each year of the working life, whether contracted in or out, and divided first by the number of years between 1978 - the start of SERPS - and the year before the state pension age and then by 52 to find the weekly amount.

That is an integral part of a computerised state second pension calculation and does not require employers to provide any additional information in order to calculate the amount due. The whole calculation is made by a computer, automatically, at the press of a button. [Laughter] I said that with a straight face. It would not be possible to do these calculations manually because of the numbers involved. It is dependent on IT - or on the legacy of the previous Government buying NIRS2. [HON. MEMBERS: “Oh.”] I apologise for that, it was below the belt. [30]

A note provided by the DSS to Committee Members in February 2000 included a detailed explanation of how this would work and an example calculation.

The Explanatory Notes on the *Child Support, Pensions and Social Security Act 2000* said:

353. As the State Second Pension is designed to boost the pension of low and moderate earners, the Government intends to change the contracting-out arrangements to ensure that members of contracted-out pension schemes are not better off contracting back in. Proposals on how the future contracting-out regime could be structured were the subject of a consultation exercise which ended on 14 January 2000. After giving careful consideration to all the responses, the Government has decided to introduce measures which provide for:

- all rebates for contracting-out into a personal pension, including a personal pension based stakeholder pension, to be calculated to reflect the enhanced 3 part accrual rate in the State Second Pension;

[30] SC Deb (F), 7 March 2000, 24th sitting

- rebates to continue to be calculated as they are now for all occupational pension schemes, which will not be required to change their benefits;

- people in all contracted-out pension arrangements on low earnings (up to £9,500) to get a top-up from the State Second Pension; and

- the top-up to be extended to people on moderate earnings (up to £21,600) in contracted-out occupational pension schemes.

354. The combination of these measures will ensure that low and moderate earners in contracted-out provision will also benefit from the extra help that the State Second Pension will give. This will simplify the choice of alternative pension vehicles available to them, without their having to contract back in to the state scheme to access that help.

355. These proposals will also apply when State Second Pension becomes a flat-rate scheme for those who are contracted-in to the State scheme. Rebates and any state scheme top-up will continue to be earnings-related. This will prevent disruption to schemes at that stage, as well as providing an incentive for moderate earners to contract-out of the state scheme into a funded arrangement and ensuring that they will continue to be better off under State Second Pension.

Impact

When S2P was introduced, the Government estimated that it would benefit 18 million people:

> 18 million people will benefit through State Second Pension:
>
> - 4.5 million low earners (earning between £3,900 and £10,800 in 2002/03 terms)
> - 9.5 million moderate earners (earning up to £24,600)
> - 2 million carers (those that look after children under the age of 6 or disabled people)
> - 2 million disabled people with broken work records.[31]

The redistributive effect of S2P was illustrated by the answer to a Parliamentary Question in March 2001, which showed how much more additional pension low earners could expect to receive under S2P than under SERPS.

> **Mr. Field:** To ask the Secretary of State for Social Security what weekly state second pension a person can expect to receive having worked for 40 years and with annual earnings of *(a)* £4,000, *(b)* £5,000, *(c)* £6,000, *(d)* £7,000, *(e)* £8,000, *(f)* £9,000, *(g)* £9,500, *(h)* £10,000, *(i)* £11,000, *(j)* £12,000, *(k)* £13,000, *(l)* £14,000 and *(m)* £15,000. [153788]
>
> **Mr. Rooker** *[holding answer 15 March 2001]:* A full working life for pensions purposes is 49 years for a man and 44 for a woman if she was born on or before 5 October 1950 (the full working life for women increases incrementally to 49 years as a result of the equalisation of state pension age).
>
> The table shows a comparison of figures:

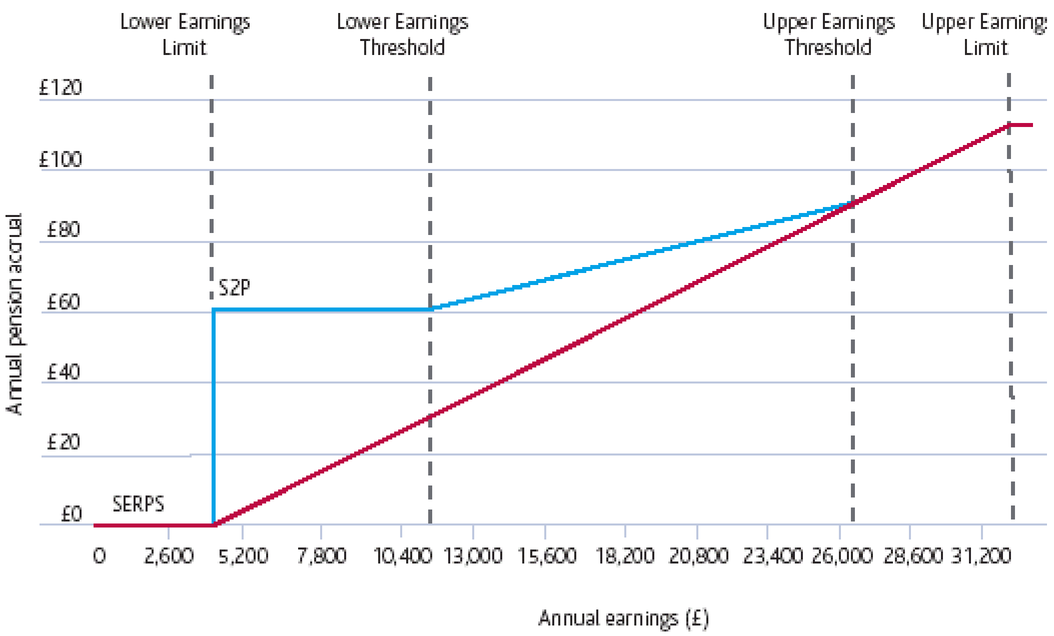
[31] DWP Press release "McCartney sets out action to combat pensioner poverty" 22 April 2002

£		For comparison		For comparison
Annual earnings	State second pension entitlement on 40 year working life	SERPS entitlement on 40 year working life	State second pension entitlement on 49 year working life	SERPS entitlement on 49 year working life
£4,000	50	5	59	6
£5,000	50	8	59	10
£6,000	50	11	59	13
£7,000	50	15	59	17
£8,000	50	18	59	21
£9,000	50	21	59	25
£9,500	50	22	59	27
£10,000	50	24	59	28
£11,000	51	27	61	32
£12,000	52	30	63	36
£13,000	54	33	65	40
£14,000	55	36	66	44
£15,000	57	39	68	47

Note: All figures expressed in 2001 earnings terms, and constant earnings terms 32

The Pensions Commission compared the accrual rates under SERPS and S2P in 2004/05: [33]

Figure F.8 S2P Accrual Rates, Compared to SERPS: 2004/05



In April 2012, the Information and Analysis Directorate of DWP published the results of its survey of *Second Tier Pension Provision,* covering the period 1978/79 to 2010-11:

[32] HC Deb 26 March 2001 c482W

[33] Pensions Commission, *First Report,* Appendix F, p152, Table F8

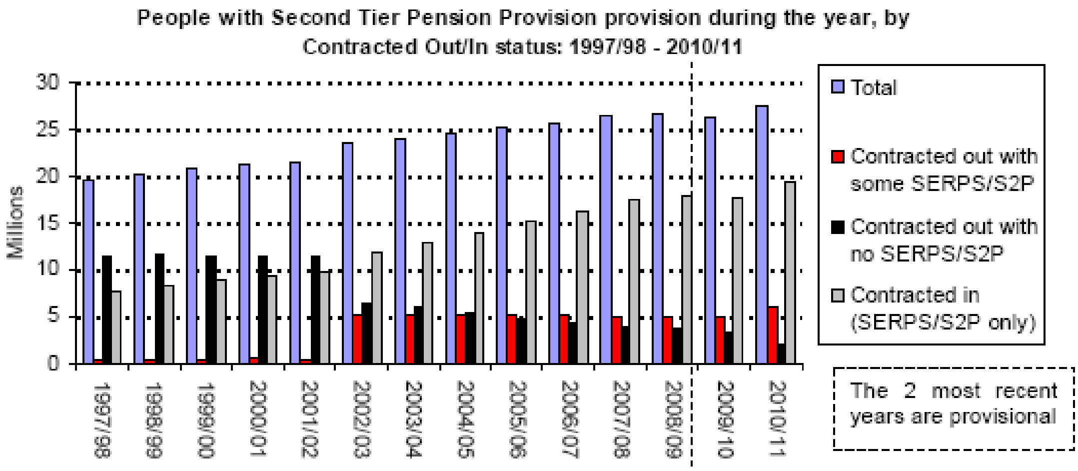
Second Tier Pension Provision key findings

Between 1978/79 and 2010/11, second tier cover rose from 17.7 million to 27.5 million. These increases have primarily been amongst women, with the exception of those contracting out through Stakeholders and Appropriate Personal Pensions where members are predominantly male. The introduction of State Second Pension (S2P) in April 2002 brought in more generous rules for low earners plus those who cannot work due to disability or caring responsibilities. Details can be found at:

http://www.direct.gov.uk/en/Pensionsandretirementplanning/StatePension/AdditionalStatePension/DG_4017827?CID=PRP&PLA=url_mon&CRE=contracted_out_pensions.

This has caused a step jump in second tier membership.

Please note that the "Contracted out with some SERPS/S2P" category relates to people who are contracted out (and therefore a member of an occupational pension scheme or a stakeholder/personal pension) but have accrued an amount of S2P/SERPS during that tax year.



In April 2002, low to moderate earners began to accrue S2P whilst still members of their contracted out scheme. See the Notes section for details on the UK pension system. Between 1997/98 and 2008/09 (the most recent non-provisional year) there had been a 27% fall in the number of people with some form of contracted out cover, 11.9 million in 1997/98 compared to 8.0 million in 2008/09. This reflects a long term trend of falling contracted out memberships. Provisional figures for 2009/10 indicate this trend is likely to continue. This move to State Second Pension is especially true of women as in 1978/79 under 2.4 million women were covered by State Earnings Related Pension Scheme (SERPS), however by 2008/09 11.8 million women were covered by the State Second Pension (S2P). There were 10.3 million people with some form of contracted out cover in 2010/11.

The number of people moving to the State Second Pension (S2P) has risen over time. 25.3 million people are covered under the S2P in 2010/11, up 10% on the 2009/10 figure of 23 million. 71% of people were covered principally through S2P in 2010/11 compared to 47% of people principally gaining cover through SERPS in 1997/98. At the same time 18% had cover principally through public sector schemes, 5% through private sector schemes and 5% through an APP or Stakeholder scheme

Due to the entitlement conditions for the State Second Pension, in 2010/11 an extra 5.2 million people gained cover from the rules for carers and long term sick or disabled compared to if SERPS arrangements were still in place. This has risen since 2009/10 due to additional cover being granted to those claiming Child Benefit and whose youngest child is 12 or under. More details on this change can be found at:

http://www.hmrc.gov.uk/childbenefit/start/claiming/protect-pension.htm#4.

In addition to those having entitlement to S2P during periods when they cannot work, a further 6 million people in 2010/11 who were contracted out were potentially accruing some extra second tier entitlement under the new scheme. This brought the total number of new people who potentially accrued extra pension benefits under the S2P arrangements to 11.1 million in 2010/11.[34]

3.2 Reforms

The Labour Government made two main changes to S2P in the *Pensions Act 2007:* measures were introduced that would result in S2P becoming flat-rate more quickly and the the crediting arrangements for people with caring responsibilities were improved.

Accelerating the move to a flat-rate

As explained in section 3.1 above, the Labour Government's intention when it introduced S2P was that it should become flat-rate over time, once stakeholder pensions had established themselves.

In 2002, it set up the Pensions Commission to review the adequacy of private pension saving. In its first report, published in 2004, it said it had found that previous government initiatives to stimulate the growth of voluntary pension saving - including the introduction of stakeholder pensions - had not succeeded:

> A primary policy initiative that focused on increasing participation, the Stakeholder Pension, while achieving some reduction in costs, has not achieved any measurable increase in participation. Eighty per cent of all employer designated Stakeholder schemes are "empty shells": nominated schemes but with no members.[35]

The extent of means-testing in the system had increased overtime and would increase further if existing indexation approaches were continued indefinitely.[36] The Commission considered that means-testing within the state system both increased complexity and reduced (in some cases reversed) the incentives to save in a pension.[37]

The Commission's second report, published at the end of 2005 recommended two key elements of reform. To encourage and support private pension saving, it recommended:

> The creation of a low cost, national funded pension savings scheme into which individuals will be automatically enrolled, but with the right to opt out, with a modest level of compulsory matching employer contributions, and delivering the opportunity to save for a pension at a low Annual Management Charge.

[34] DWP and National Statistics, First release, 18 April 2012, National Insurance Contributions and Qualifying Years and Second Tier Pension Provision: 2010/11

[35] Pensions Commission, Pensions: Challenges and Choices: The First Report of the Pensions Commission, October 2004, page 48

[36] Ibid, p224

[37] Ibid, pxiii

State pension reform was needed to provide “clear incentives and an understandable base on which private pension saving looking forward can build.” The Commission said:

> State Pay as You Go (PAYG) pension provision should, after a transition phase, become flat-rate. The use of constrained tax/National Insurance resources should be focused on:
>
> - Ensuring that all people are kept out of poverty in retirement;
> - Making the system as non-means-tested as possible; and
> - Reducing present problems in the treatment of those with interrupted work records and caring responsibilities.[38]

The structure of S2P meant it was in any case becoming more flat-rate over time:

> The main cause of the future flat profile of S2P entitlement is the current plans for the indexation of the LEL and UEL. Current indicative plans (used for state expenditure forecasting) are that these should rise with prices only and therefore fall relative to average earnings. But the LET is linked to earnings, which means that an increasing band of income will be deemed to be earnings at the level of the LET. As a result the accrual system becomes more flat rate in nature.[39]

The Commission recommended that this process should be accelerated by “freezing the Upper Earnings Limit for S2P accruals in nominal terms.”[40] Along-side this, reforms should be made to the basic State Pension to improve its coverage and generosity over time.

Pensions White Paper, May 2006

The Government responded to the Pensions Commission’s recommendations in its White Paper, *Security in retirement: towards a new pension system,* published on 25 May 2006. It accepted the Pensions Commission’s suggestion that the transition to a flat rate S2P should be accelerated as a way of boosting and clarifying the “foundation” of state pension on which people can build with their own private provision:

> 3.43 On top of the basic State Pension, many people are accruing a second tier of state pension, through the State Second Pension, which replaced SERPS in 2002.
>
> 3.44 The State Second Pension has given many people, particularly women and carers, access to an additional pension for the first time. Currently those bringing up children under the age of six, certain carers and people with a long-term disability are all credited into the State Second Pension at a flat rate of around £1.20 a week at retirement for every year worked or credited, with those earning above the Lower Earnings Threshold (£12,500 a year) accruing some earnings-related provision on top.
>
> 3.45 The State Second Pension has also helped those on low incomes by treating anyone earning over the Lower Earnings Limit (£4,368 a year) but earning below £12,500 as if they earned at this higher level. In addition, the rate at which the pension accrues at £12,500 has been doubled under the State Second Pension, making the scheme far more redistributive than SERPS (1978–2002).
>
> 3.46 But while the Government will this year spend £19 billion on the State Second Pension, or its contracted-out equivalents through the rebates, this aspect of the

38 Ibid, p6 and 18

39 Pensions Commission, *First Report. Appendix F, p 156.*

40 Ibid, Executive Summary

> system is poorly understood. Few people are aware of it at all, and even fewer of how their entitlement to it builds. Many people are building entitlement to the State Second Pension without even being aware that they are doing so.
>
> 3.47 The beginning of this chapter made clear that, in the face of an ageing population and the need for the state system to provide a foundation for people's savings, the State should move away from the direct provision of pensions related to individuals' earnings and concentrate on flat-rate provision in the future. The introduction of the new personal accounts scheme will mean that for the first time everyone will have access to a genuinely low-cost private savings vehicle. We do not want the State Second Pension to duplicate this, which is why we are able to reinforce and speed up its change in focus to a flat-rate top-up benefit for years spent working, caring or parenting.
>
> 3.48 Accruals will start to become flat rate more quickly at the same time as we start to uprate the basic State Pension by earnings [2012, or by 2015 at the latest]. We estimate that the State Second Pension will become completely flat rate in around 2030, or shortly afterwards. (…)
>
> 3.50 We therefore plan to accelerate the way in which accruals in the State Second Pension are becoming flat rate. This benefit will be protected against rises in average earnings during accrual, and then against inflation once in payment. Combined with a basic State Pension linked to earnings, this will produce a total State Pension that is uprated partly by earnings and partly by prices in payment, as recommended by the Pensions Commission. Under the new benefit, each year of work, parenting or caring will effectively top up the State Pension by at least £1.20 a week at retirement in average earnings terms. [41]

Debate on the Pensions Bill 2006-07

The merits of moving to a flat-rate S2P were debated when the *Pensions Bill 2006-07* was before Parliament: some argued that there was a disadvantage - people would get less S2P in future while continuing to pay the same NICs; others argued it should become flat-rate more quickly.

Sally Keeble, for example, tabled amendments to "bring forward the flat-rating of the accrual state second pension to increase redistribution rather than giving increased benefits to the higher earners."[42] She argued that this was particularly important for a generation of women between now and about 2020 or 2030 who might need more financial support in retirement.

In response, the Pensions Reform Minister, James Purnell, explained that although the amendment would save money until 2050, there would be a "quite a big spike" at that point, with costs starting to grow "up to £7.5 billion annually by 2070".[43] There might also, he argued, be negative implications for contracted out schemes:

> A sudden move to flat-rating, which the amendments aim to deliver, would impact not just on those who would otherwise get a transitional amount of earnings relation, but on the contracting out of state second pensions. That could have an unpredictable and quite damaging effect on final salary

[41] Department for Work and Pensions, *Security in retirement: towards a new pensions system*, Cm 6841, May 2006,

[42] Pensions Bill Deb, 30 January 2007, c188

[43] Ibid, c189

schemes, which, of course, are supported by the contracted-out element related to S2P. ….

The Government's approach, he argued was "is simpler to understand and strikes the appropriate balance between flat-rating and a transitional amount of earnings relation".[44]

The then Opposition spokesman, Nigel Waterson, asked whether it was fair that anybody earning "more than £18,000 a year would continue to pay the same level of national insurance contribution, but would have his or her State Second Pension (S2P) benefit significantly reduced."[45] In response, the Minister argued that:

> The key part of the reform that removed the relation to earnings was the move towards the state second pension, away from the state-earnings related pension scheme. I do not think that the hon. Gentleman is proposing that we go back to that system. To do so would cost a significant amount of money: we would be talking about a cost of £10 billion a year over the long term.[46]

The Government's proposed reforms would enable it to "target additional resources on low and moderate earners."[47] Savings were being "recycled to make the combination of the state pension and the state second pension more generous."[48]

The *Pensions Act 2007* received Royal Assent on 26 July 2007. Sections 10 to 12 accelerate the process to a flat rate State Second Pension:

> 60. Under the provisions of this Act, state second pension will be restructured.
>
> 61. The first step will be to merge Bands 2 and 3, so that all earnings exceeding the low earnings threshold (but not exceeding the upper earnings limit) will fall into Band 2 and accrue additional pension at a rate of 10%. This change will have effect for the tax year 2010-11 onwards.
>
> 62. In addition, from a date to be determined by the Secretary of State by order, the current 40% accrual band (Band 1) for earnings between the lower earnings limit and the low earnings threshold will be replaced with a weekly flat rate accrual amount of £1.50 (giving an equivalent annual amount of £78.00). This will be accrued by all contributors and people credited into state second pension in respect of each year of contribution. For a time, the additional earnings-related component of state second pension (accruing at 10%) will remain in place. This component will ultimately be withdrawn by around 2030, leaving a flat-rate benefit.
>
> 63. These changes will have an effect on the contracted-out rebate for defined benefit schemes. If a pension scheme member is opted out of state second pension they receive a "rebate" from the Government, delivered through reduced-rate National Insurance contributions, which is based on the amount of state second pension foregone. Therefore changes to state second pension need to be taken into account when calculating the rebate.[49]

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[44] Ibid, c190
[45] Ibid, c187
[46] Ibid, c199
[47] Ibid, c200
[48] bid, c200
[49] Explanatory Notes to the *Pensions Act 2007*

The other aspects of reforms recommended by the Pensions Commission are covered in Library Standard Note SN 4847 *Pensions: automatic enrolment and employer contributions* and SN 5787 *State Pension reform.*

Carers' credits

A further reform to S2P proposed in the May 2006 Pensions White Paper was improved coverage for carers. The 2006 White Paper explained:

> **Combining contributions with credits to get a qualifying year for State Second Pension**
>
> 3.87 Currently a person can build up entitlement to State Second Pension through the award of credits with certain benefits. However, these benefits must normally be awarded over a complete tax year in order to get State Second Pension. It is not possible to be eligible for State Second Pension through a combination of credits from benefits or with contributions from earnings in any single tax year.
>
> 3.88 We propose to move from the current system of annual credits in the State Second Pension to weekly credits. This will provide more flexibility, enabling people to combine credits and paid contributions during a tax year to build up a year of State Second Pension. It ensures that we are recognising social contributions and earnings equally for the purposes of state pension entitlement and consistently in both tiers of the State Pension.
>
> **A new credit for carers**
>
> 3.89 The introduction of Carer's Allowance has helped recipients build up entitlement to the basic State Pension since 1976. Recipients have also been able to get State Second Pension from 2002. Around 440,000 people, caring for 35 hours a week or more, are receiving Carer's Allowance.
> (…)
> 3.91 While Carer's Allowance and HRP provide comprehensive cover, they only do this for people who are effectively full-time carers – those who would have most difficulty engaging in the labour market. Those caring for less than 35 hours or for more than one disabled person are not recognised and we know that some caring responsibilities can compromise an individual's ability to work and build up a state pension. (…)
>
> 3.93 The Government now proposes that people who undertake care for the severely disabled for 20 hours or more a week should become entitled to credits for both basic State Pension and State Second Pension. We estimate that around 70,000 people a year could gain a credit for basic State Pension from this proposal, and over half of these will be women. The new credit for those caring for 20 hours or more should mean around 110,000 more women and 50,000 more men will be accruing entitlements to State Second Pension.
>
> 3.94 A system of certification will be required to claim the new credits. We will consult with key stakeholders on the most effective way to implement the new arrangements for those reaching State Pension age from 2010. We propose that the new crediting arrangements for carers, including the replacement of HRP with a weekly credit and the introduction of a new carer's credit, will apply to bereavement benefits.
>
> 3.95 The more generous crediting arrangements will mean up to 1 million more individuals (around 90 per cent of which are women) will be accruing State Second Pension credits in a given week – which should feed through to higher State Second Pension entitlements in retirement.[50]

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[50] DWP, Security in retirement: towards a new pensions system, Cm 6841, May 2006, paras 3.80-3.95

When the *Pensions Bill 2006-07* was before Parliament, concerns were expressed that not all carers would be entitled to credits towards their pension under the legislation as drafted. The Liberal Democrats tabled an amendment intended to ensure that people providing care for 20 hours a week or more, but not covered by the proposed changes (because, for example, the disabled person was not in receipt of a qualifying benefit), should receive credits towards their state pension. The proposal was that a health or social care professional should be able to certify that a person was providing the requisite number of hours of care.[51] Then Pensions Reform Minister, James Purnell, explained that responded that he was sympathetic to the intention behind the amendment, although the issue could be dealt with through secondary legislation. The Government intended to find a way of including the estimated 40,000 people providing at least 20 hours care but not already covered by the measures in the Bill.[52]

These changes were introduced in the *Pensions Act 2007.* Under section 3, from 6 April 2010, parents and carers can build up entitlement to the State Second Pension through "carer's credits." The *Social Security (Contributions Credits for Parents and Carers) Regulations 2010* (SI 2010/19) provided for the inclusion of certain people who were caring for 20 hours or more a week for someone not receiving one of the qualifying benefits.

The Pension Service Leaflet, *State Pensions – Your Guide* explains the provision for carers and people who are ill or disabled, as follows:

> **I'm a carer. Can I get a State Second Pension?**
>
> If you're a carer, you can build up a State Second Pension if you're not working at all or you're earning less than [£5,565 a year (in 2012/13)], and any of the following apply to you:
>
> - You are looking after a child under 12 and are receiving Child Benefit for that child (before April 2010 the child had to be under 6)
> - You spend at least 20 hours a week caring for a severely disabled person
> - You are an approved foster carer
> - You are entitled to Carer's Allowance – even if you're not getting it because you get another benefit that pays you more.
>
> In any of those cases, we'll treat you as if you are earning at the low earnings threshold [£14,400 in 2012/13]
>
> **I'm ill or disabled. Can I get a State Second Pension**
>
> You can build up a State Second Pension if you're not working at all, or you're earning less than [£5,565 a year (in 2012/13)], and if any of the following apply to you:
>
> - You're entitled to long-term Incapacity Benefit or Employment and Support Allowance – even if you're not getting it because you get another benefit that pays you more.

[51] PBC Deb, 23 January 2007, c72; *Pensions Bill, Memorandum on Delegated Powers from the Department for Work and Pensions*, *House of Commons Library Deposited Papers* 06/2812 c391

[52] PBC Deb, 23 January 2007, c72; *Pensions Bill, Memorandum on Delegated Powers from the Department for Work and Pensions*, *House of Commons Library Deposited Papers* 06/2812 c396

- You get protected Severe Disablement Allowance or Income Support.[53]

Introduction of the Upper Accrual Point

In Budget 2007, the Labour Government announced that the NI Upper Earnings Limit and the threshold at which higher rate income tax becomes payable would be aligned.[54] The Pensions Policy Institute pointed out that this would have the effect of increasing the value of S2P built up by higher earners, running counter to the intention that S2P should become flat-rate:

> The alignment of the UEL for National Insurance (NI) Contributions with the higher rate tax band will increase the revenue collected in the NI fund. S2P is currently paid on all earnings between the lower and upper earnings limit. So unless the link between S2P and NI contributions is broken before 2012, it will increase the annual build up of S2P for people earning above the UEL of £38,840. Those earning above the new UEL of £40,625 will build up a pension of £2.83 a week in 2009 compared to £2.38 without the Budget changes. The increase in the value of S2P built up by higher earners runs counter to the direction of reform of state pensions, which aims gradually reduce the difference between the S2P received by low and high earners. The new increase for high earners will mean that low and higher earners will not receive the same S2P each year until 2035, compared to 2031 in the current system.[55]

To address this, the Government announced that the introduction of the Upper Accrual Point would be brought forward to April 2009. This, it said, would ensure that the changes announced in the May 2006 White Paper would take place as originally intended. [56]

The legislation to introduce the Upper Accrual Point is in the *National Insurance Contributions Act 2008*. A concise explanation of the change is in the *Explanatory Notes.* This legislation is discussed in more detail in Library Research Paper 07/88 *National Insurance Contributions Bill* and RP 08/07 *National Insurance Contributions Bill- Committee Stage Report.*

Pensions Act 2008 – further simplification

The Labour Government considered the complexity of the Additional Pension to be a weakness:

> 4. The complexity of Additional Pension makes calculating or explaining a person's entitlement extremely difficult. It also means that the Department is unable to offer many contributors a reasonable estimate of their future state pension entitlement. As a result these contributors have to make decisions on pension saving with little knowledge of what they can expect from the State. This is a key weakness at a time when we are re-emphasising the role of State Pension as a foundation for private saving as we prepare the ground for the introduction of personal accounts.[57]

The *Pensions Act 2008* contained measures designed to simplify the AP by consolidating rights accrued prior to 2012 into a cash amount.[58] A DWP factsheet to explain the proposals said:

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[53] Pension Service, State Pensions – your guide, PM2, November 2010, p37-8

[54] HM Treasury, Budget 2007: Budget Notes: BN01. *Modernising the Personal Tax System.*

[55] Pensions Policy Institute Briefing Note Number 37, *Was Budget 2007 good for pensioners?* April 2007.

[56] 2007 Pre-Budget Report and Comprehensive Spending Review, 9 October 2007, PBRN 1, *2007 Pre-Budget Report and Comprehensive Spending Review*

[57] DWP, 'Simplification of State Second Pension Schemes', Dep 2008-1955

[58] *Pensions Act 2008*, section 102

We want to legislate to wrap-up all the old pre-2012 schemes, work out what people are entitled to at that point and simply put a cash amount on their account. The cash amount and the way it is revalued up until someone retires will be worth at least as much as it would have been were we still using the old rules and calculations.

7. We are proposing to consolidate all of an individual's rights to Additional Pension that will accrue prior to April 2012 into a single cash amount.

8. Using the existing legislation we intended to calculate a person's Graduated Retirement Benefit, State Earnings Related Pension and State Second Pension as at April 2012, add them together and preserve this 'value' as a single cash amount on the National Insurance account.

9. This figure will be revalued annually in line with earnings up to State Pension Age. Thereafter the value of the Additional Pension will increase by prices. These provisions effectively maintain the current revaluation and uprating arrangements.

10. When someone claims their state pension this revalued amount will be added to any accruals they have built up since April 2012 in the simplified Additional Pension scheme. It is this combined amount, together with the basic State Pension, that will make up the award of state pension.

11. Primary legislation is required in order to achieve this simplification. It will provide for the assessment of accruals up until 2012, and for this new and separate calculation to form part of the State Pension that someone can claim at State Pension age.

The Labour Government intended to apply the consolidation only to those who reach State Pension age after 5 April 2020 (at that stage, people born after 6 April 1955). This was in part because of the number of state pension reforms already being introduced over the period 2010 to 2020.[59]

4 A single-tier State Pension

4.1 Green Paper consultation

A Green Paper published in April 2011 argued that there were three main problems with the existing system:

- **The complexity and uncertainty of outcomes in the state pension** – makes it difficult for people to know what they will get when they retire, meaning it is more difficult to plan and save for retirement.
- **High levels of means testing** – can deter people from saving as the incentives are not sufficiently clear and too many pensioners are forced to rely on Pension Credit to top up their income. Around a third of pensioners do not claim the Pension Credit they are entitled to.
- **Significant inequality remains in the system** – groups such as women, the low paid and the self-employed tend to have lower state pensions.[60]

The Green Paper asked for views on two broad options for reform, including a proposal for "more radical reform to a single-tier flat-rate pension set above the level of the Pension Credit standard minimum guarantee." It explained that this option

59 DWP factsheet, *Simplification of State Second Pension Schemes, 2008*, para 12
60 Ibid, p13

would mean combining the basic State Pension and State Second Pension into a single-tier for people who reach State Pension age on or after the date any changes are introduced. Key features of this option would be that:

- Everyone with 30 years of contributions or credits reaching State Pension age would receive a weekly flat-rate payment currently estimated at around £140, which would be above the Pension Credit standard minimum guarantee.

- Everyone would qualify individually – whether single, married, divorced or widowed and no special rules for marriage, bereavement or divorce.

- For self-employed as well as employees (subject to National Insurance considerations).

- Uprated by the higher of earnings, prices or 2.5 per cent.

- Minimum qualification of seven years of National Insurance contributions or credits.

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

- The State Second Pension, and with it the ability to contract out of the State Second Pension.

- Savings Credit, as most people could expect to retire on a state pension that lifted them clear of the Pension Credit standard minimum income guarantee.[61]

In the March 2012 Budget, the Chancellor said the Government would reform the State Pension into a single tier:

> The Government will reform the State Pension into a single tier pension for future pensioners. The new system will be introduced early in the next Parliament and will be set at a level above the means-tested standard Guarantee Credit and all State Pension records will be recognised.[62]

4.2 How individuals would be treated in the transition to the single tier

In his statement to the House of Commons on publication of the Green Paper, Pensions Minister, Steve Webb, explained that both options would affect future pensioners only:

> Both options are for future pensioners; pensioners who have already reached state pension age by the date of reform would not be affected, so no existing recipient of state pension would see their income reduced.[63]

The Minister also explained that "for future pensioners, we would also continue to honour the contributions that people have built up to the date of reform":

> The first option involves bringing forward existing reforms so that the state pension would evolve into a two-tier, flat rate system more quickly. The second, more radical, option is to move to a single-tier state pension. Both options are for future pensioners; pensioners who have already reached state pension age by the date of reform would not be affected, so no existing recipient of state pension would see their income

[61] Ibid, p30

[62] HM Treasury, Budget 2012, para 2.10

[63] HC Deb, 4 April 2011, c795 ff

reduced. For future pensioners, we would also continue to honour the contributions that people have built up to the date of reform.[64]

The Green Paper acknowledged that in managing the transition to a single-tier, there would be two main issues to address. One of these would be recognising the fact that some people will already have accrued a higher State Pension entitlement through the State Second Pension. The other would be calculating the entitlement of people who have been contracted-out during working life, who would therefore receive part of their single-tier from the State and Part from their contracted-out scheme:

> **1. Recognising people's pension records under the existing system in a way that is fair, but facilitates transition to the new system as quickly as possible:** This could be achieved by calculating pension records under the existing system and then, during transition to the new system, recognising amounts in excess of the currently estimated single-tier pension of £140. This would mean people with higher amounts of additional State Pension before the introduction of single tier would receive correspondingly higher weekly payments than the current estimate of £140.
>
> **2. Calculating entitlement to the new pension taking account of periods spent contracted out of the State Second Pension in a way that is fair, but delivers simplicity and clarity as quickly as possible:** This would mean that during the transition many would receive their single-tier pension from a combination of their state and contracted out scheme, as happens now. This means they would receive less than the currently estimated £140 directly from their state pension. We estimate that around half of pensioners could have an offset applied to their single tier pension by around 2050. Further detail is provided in the box on page 32.[65]

In a Parliamentary Written Answer of June 2012, the Pensions Minister said that if individuals were heading for a pension of more than the single-tier at the point of change, this would be respected:

> **Mr Frank Field (Birkenhead) (Lab):** Will the Minister give an undertaking that those coming down the track—*[Interruption.]* I am already there; I am one of those pensioners being discriminated against. Will he give an undertaking that those who would be entitled to a higher pension than his flat-rate pension would provide will get the entitlement that they have paid for and not his lower flat-rate pension?
>
> **Steve Webb:** I can reassure the right hon. Gentleman that the next generation of pensioners will be well looked after and specifically that the starting point for our calculation will be what people have in the bank—that is to say, rights already accrued—and specifically, therefore, if people are heading for a pension of more than £140 at the point we change it and have got that in the bank, it will be respected.[66]

On 12 July 2012, the Pensions Minister announced that further detail would be set out in a White Paper:

> **State Pensions Reform**
>
> The Minister of State, Department for Work and Pensions (Steve Webb): I should like to inform the House about the progress this coalition Government are making with their plans for state pensions reform.

[64] Ibid
[65] Ibid
[66] HC Deb, 25 June 2012, c4

At Budget 2012, the Chancellor confirmed that we will reform the state pension system to introduce a simpler, single tier state pension for future pensioners to better support saving for retirement. A simple flat-rate state pension above the basic level of the means test will bring much needed clarity and simplicity to the pension system, and provide the foundation needed to support automatic enrolment into workplace pensions, enabling people to save for their retirement with confidence. The reforms will be introduced in the next Parliament and will not cost any more than the current system overall.

The Budget also confirmed that the Government will introduce a mechanism so that future increases in state pension age take changes in longevity into account.

Together, these reforms will deliver a state pension system that is fit for the 21st century.

Given the scale, complexity and importance of these two significant reforms we are still working on the details, to ensure we get them right. Therefore, we will set out further detail on both the single tier reform and state pension age review mechanism in a White Paper in the autumn.[67]

This is discussed in more detail in Library Standard Note SN 5787 *State Pension reform.*

[67] HC Deb, 12 July 2012, c65-6WS