The New State Pension

The House of Commons has produced a briefing paper on the new State Pension. This note provides a brief summary of this paper.

What you need to know

The government is introducing a new State Pension for those who reach State Pension age from 6 April 2016. The existing State Pension will continue to apply to those who have already reached State Pension age by that date.

Background

The Current State Pension

The current State Pension is made up of two parts:

- The basic State Pension
- The additional State Pension.

The basic State Pension is paid as a flat rate benefit not linked to earnings. Those people who have paid (or been credited with) 30 years of National Insurance Contributions (NICs) qualify for the basic State Pension when they reach State Pension age. The full basic State Pension for the 2015/16 tax year is £115.95pw.

The additional State Pension is usually earnings related. Since 1978 earning-related provision has been through:

- The State Earnings Related Pension Scheme (SERPS) which operated between 1978 and 2002; and
- The State Second Pension (S2P) which replaced SERPS from April 2002.

Prior to 1978 earnings related provision was provided through Graduated Retirement Benefit (GRB). This note does not cover GRB due to its historic nature.

SERPS and S2P were built up on contributions on earnings between lower and upper limits.

Contracting Out of the Additional State Pension

Since 1978 it has been possible for individuals to contract out of the additional State Pension, using a pension scheme which meets certain requirements. Where an individual is contracted out on a salary-related basis both they and their employer pay lower NICs. One of the requirements for contracting out was that the pension scheme you were paying into would provide you with a pension that was at least as good as the additional State Pension you were giving up. Many individuals will have been in occupational pension schemes which were contracted out of the additional State Pension without being consciously aware they were giving up their additional State Pension for the years they were in the pension scheme.

1 http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06525
The option to contract out on a money-purchase basis ceased from 6 April 2012 and the option to contract out on a salary-related basis is ceasing from 6 April 2016.

Means Tested Support for Pensioners

Pensioners on low incomes can qualify for means tested support through Pension Credit. One element of Pension Credit is the Guarantee Credit which tops up weekly income to a minimum amount. That amount for the tax year 2016/17 will be £155.60 for a single person and £237.55 for a couple.

The New State Pension

The government is introducing a new State Pension for those who reach State Pension age from 6 April 2016. The existing State Pension will continue to apply to those who have already reached State Pension age by that date. The new State Pension will combine the two parts of the existing State Pension and is to be set at £155.65pw in 2016/17 (marginally above the Pension Credit level). It follows that anyone getting the full new State Pension will not be eligible for Pension Credit and therefore the Treasury will save money on what would have been spent on Pension Credit.

Many people who were not in line for a large State Pension will gain from the introduction of the new State Pension. But the Treasury will not be paying for this increase. The reform has been designed to be cost neutral to the government in each and every year. So for everyone who gains under the new system somebody else is losing out. The proportion of losers and winners changes over time. In the first 15 years of the new State Pension around three quarters of people have a notionally higher new State Pension. By 2050 winners and losers are roughly equal. By 2060 losers outweigh winners by 55% to 45%. In the longer term the new State Pension will be less generous than the current system for most people.

In order to qualify for the full amount of the new State Pension an individual will need 35 qualifying years of NICs. Those with between 10 and 35 qualifying years will get a pro-rata amount. Those with less than 10 years will get nothing. The 35 years is an increase of 5 years from the current basic State Pension. In addition, with some transitional protection, the right to derive or inherit some entitlement based on contributions of a spouse, former spouse, or civil partner, or former civil partner, will end.

The Effect of Having Previously Contracted Out of the Current Additional State Pension

Those who have previously contracted out of the current additional State Pension will not get the full new State Pension. People who were contracted out of the additional State Pension and thus paid lower NICs in those years will receive a reduced new State Pension. A deduction will be applied to the new State Pension to reflect the period or periods of contracted out service. This deduction is intended to be broadly equivalent in value to the workplace pension the NIC rebate funded. A DWP factsheet has explained the calculation in more detail.

From April 2016 as contracting out ends everyone will start to pay the same amount of NICs and those who have less than the full new State Pension (due to insufficient years or a deduction due to contracting out) can increase their new State Pension each year up to the maximum of the full amount at a rate of one thirty-fifth for each year.

The Starting Point

Transitional arrangements mean that a calculation will be done in April 2016 of the amount of State Pension an individual has accumulated under the current system and the amount they would receive under the new system and the “foundation amount” they will begin with will be the higher of the two. Some people will therefore have a foundation amount in excess of the new State Pension. Those amounts which are paid on top of the new State Pension are called “protected payments”.

The new State Pension will be uprated in line with earnings, although the precise policy on uprating will be decided shortly prior to implementation.

Who are the winners and losers?

In its early years the new State Pension is expected to benefit those with low amounts of additional State Pension. This includes those who have taken time out of the labour market due to caring responsibilities before 2002 and the self-employed. Some 650,000 women who reach State Pension age in the first ten years of implementation are expected to be marginally better off (an average of £8pw).

Also better off are those who are younger and who contracted out for periods of their working life and who can now rebuild their entitlement to new State Pension after April 2016.
The losers include those who have already built up more than the full new State Pension by April 2016 and will not be able to accrue any further State Pension (many of whom will not have been contracted out of the additional State Pension) and higher earners with long service. In some cases they will be paying increased NICs for no further benefit.