Could contracting-out be abolished?

PPI Briefing Note Number 12

Introduction

Many state pension reform options propose simplifying the system by abolishing contracting-out of the state second pension (S2P)[1]. This Briefing Note looks at who would be affected by the abolition of contracting-out, and how.

What is contracting-out?

Everybody in work, aged below state pension age and earning above the Lower Earnings Limit (LEL)[2] is entitled to state second pensions, or S2P (formerly SERPS). However, individuals can 'contract-out' of S2P into a private pension. This means that they give up entitlement to S2P, but in return they pay lower National Insurance Contributions (NICs) if they have an occupational pension, or have some of their NICs paid into a personal pension.

The contracting-out system is complex, to ensure that people get a pension benefit very similar to that they have given up in the state system. Schemes must meet a number of tests in order to be contracted-out, and contributions and benefits are strictly regulated. It is this complexity that has led commentators to suggest that contracting-out should be abolished.

How many people contract-out?

Since 1978 the number of people contracting-out has increased

Chart 1: The number of people contracting-out has not increased since the 1990s
Number of people with second-tier pension provision by contracted-out status, millions
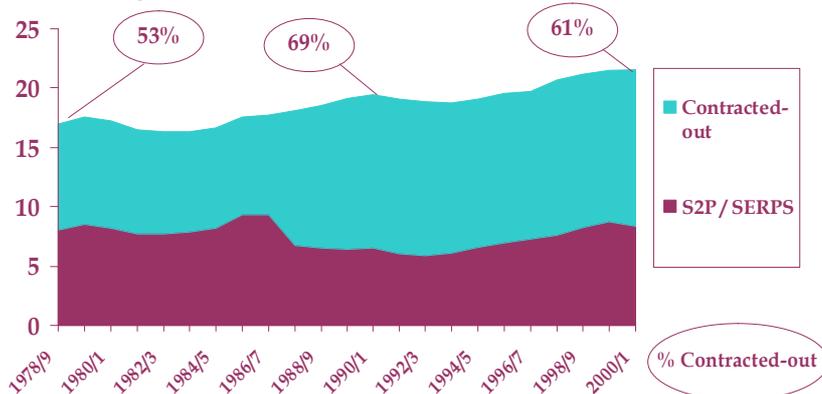
from 9 million to 13 million. This was boosted in 1988 by the introduction of personal pensions, allowing people whose employer did not have a pension scheme to contract-out.

However, since the early 1990s there has been little growth in the number of people contracted-out, despite an increasing number of people eligible for second tier provision (Chart 1)[3]. This has resulted in a steady growth in the number of SERPS/S2P members.

Why are more people remaining in S2P?

Change has occurred entirely within private sector Defined Benefit (DB) schemes (Chart 2)[4]. There has been little change in the contracted-out nature of public sector DB provision.

An increasing number of private sector DB schemes have been replaced by Defined Contribution (DC) schemes. But while virtually all members in DB schemes are contracted-out, only one-third of DC occupational pension scheme members are contracted-out through their scheme[5]. A new DC scheme is often set up as contracted-in to avoid the complexity of contracting-out.

Since the latest data was collected in 2000/1, this shift from DB to DC is likely to have accelerated[6]. Contracting-out in personal pensions may also have become less popular. A number of providers and advisers have recommended contracting-in after the rebates were recalculated in 2002[7], and the ABI are encouraging people cur-

PPI Briefing Notes clarify topical issues in pensions policy.

rently contracted-out in an APP to review their options[8].

What would happen if contracting-out was abolished?
Most people would not be directly affected by the abolition of contracting-out.

The 12 million[9] people without any second tier provision and the 8 million people earning above the LEL who are contracted-in are not affected.
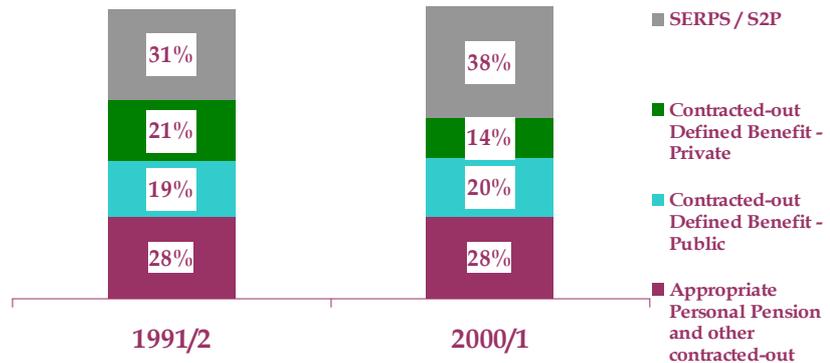
The 6 million people who contract-out in an Appropriate Personal Pension (APP) would continue to pay the full NIC rate, but rebates would no longer be paid into their personal pension. All other things being equal their personal pension would ultimately be smaller, but they would receive a larger state pension as S2P pays their second-tier benefit.

The 8 million people who contract-out in an occupational scheme (4.5 million of them public sector workers) would pay the full NIC rate, rather than the current reduced rate - up to £8.30 a week extra[10]. But they too would also receive a larger state pension.

Their employer would also have to pay higher NICs, but would no longer be expected to make pension contributions to their

Chart 2: The proportion of workers in contracted-out DB schemes has fallen
Proportion of people with second-tier pension provision by type of provision, 1991/2 and 2000/1

Legend:
- SERPS / S2P
- Contracted-out Defined Benefit - Private
- Contracted-out Defined Benefit - Public
- Appropriate Personal Pension and other contracted-out

1991/2: 31%, 21%, 19%, 28%
2000/1: 38%, 14%, 20%, 28%

occupational pension scheme to provide a benefit to replace S2P.

The impact on private pensions
APPs and DC occupational pension schemes would receive lower contributions if contracting-out were abolished. But they would no longer have to pay benefits to replace S2P.

DB occupational pension schemes would face a choice. Long-term contributions to the scheme could be increased to keep the benefits payable at the same level (and increasing pension provision overall); or the future benefits paid by the scheme could be reduced, taking account of more future pension income being provided by the state.

Conclusion
Abolishing contracting-out would simplify the pension system. There are signs that outside of the public sector contracting-out is already reducing.

A minority of people would be directly affected by abolition. Contracted-out personal pension funds and DB occupational pension schemes would be more significantly affected; their response is unclear.

Abolishing contracting-out could make a wider review of state pension provision and NICs easier.

For more information on this topic, please contact
Chris Curry
020 7848 3731   chris@pensionspolicyinstitute.org.uk
www.pensionspolicyinstitute.org.uk

[1] Such as the NAPF, IPPR and the Conservative party.
[2] £4108 a year from April 2004.
[3] DWP (2004) *Second Tier Pension Provision 1978/79 to 2000/01*
[4] DWP (2004) *Second Tier Pension Provision 1978/79 to 2000/01* Figures are based on scheme memberships, and people may have more than one membership. Totals may not sum due to rounding.
[5] GAD (2003) *Occupational pension schemes 2000.* Occupational scheme members can also contract–out individually using an Appropriate Personal Pension (APP).
[6] PPI Briefing Note Number 2 *The shift from DB to DC*
[7] For example, AXA Sun Life, in *Financial Times* 21 June 2003
[8] Association of British Insurers fact sheet to be released Summer 2004
[9] PPI estimates
[10] PPI calculation for 2004