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Class 3A voluntary National Insurance (NI) contributions

Introduction
Under the current national insurance system people are able to make voluntary National Insurance contributions to make up for any gaps in their contribution record—these are known as Class 2 and Class 3 contributions. These contributions are designed to improve Basic State Pension entitlement and do not give entitlement to higher levels of additional State Pension.

However, the Department for Work and Pensions (DWP) has recently outlined plans to introduce Class 3A voluntary National Insurance contributions, which will be called the State Pension top-up. Under these proposals individuals who reach State Pension Age (SPA) by April 2016 (the date of implementation of the single-tier pension) will be able to make voluntary National Insurance contributions to purchase extra additional State Pension. This briefing note provides an overview of proposals around Class 3A National Insurance contributions and assesses the implications of these for individuals who have accrued small amounts of additional State Pension.

Background
The state pension currently consists of the Basic State Pension and the additional State Pension. The Basic State Pension provides a regular income up to £113.10 per week, in 2014-15, to those individuals who have paid or been credited with National Insurance contributions, while the additional State Pension was initially designed to provide further pension income to employees in a way that is more closely related to their earnings level than the Basic State Pension.

The additional State Pension has existed in different schemes since 1961 with the State Second Pension (S2P) starting in 2002. Compared to previous schemes, such as SERPS, S2P aims to target greater resources at the lower paid and some individuals who cannot work due to disability or caring responsibilities. Despite this, certain groups, such as those people who have had career breaks before the introduction of S2P and the self-employed, are not well covered by S2P.

The new single-tier pension, proposed in the Pensions Bill 2013, will replace both the Basic State Pension and S2P.[1] The introduction of the single-tier pension looks to address concerns that the current system produces unequal outcomes. However, the changes will not apply to people who are over SPA in April 2016, including those people who reach SPA between now and then.

Individuals who could benefit from the single-tier pension are those individuals who would have qualified for relatively small amounts of S2P. These include:

- Individuals who have had career breaks, or low earnings, who were not well covered by SERPS or S2P credits; and
- The self-employed.

When the single-tier pension is introduced in April 2016, these groups may be able to benefit from the single-tier pension. However, individuals who have reached, or will reach, SPA before April 2016 will not be able to benefit from the single-tier pension.

Under the current system people are able to make voluntary National Insurance contributions to make up for any gaps in their contribution record—these are known as Class 2 and Class 3 contributions. People who are self-employed or living abroad are able to make Class 2 contributions. Class 3 contributions may be paid by individuals who are unemployed and not claiming benefits or employed but not earning enough to pay National Insurance contributions. However, these contributions are designed to improve Basic State Pension entitlement and will not give entitlement to higher levels of S2P.

Proposals for Class 3A voluntary National Insurance contributions
The Department for Work and Pensions has outlined plans to introduce Class 3A National Insurance contributions which will be called the State Pension top-up.[2] These are designed to help those people who have

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not been able to build up much additional State Pension but have reached SPA before the introduction of the single-tier pension.

Table 1: Cost for additional State Pension of £1 per week and maximum of £25 per week

Age	Cost for additional £1 per week	Cost for additional £25 per week
65	£890	£22,250
70	£779	£19,475
75	£674	£16,850
80	£544	£13,600
85	£394	£9,850
90	£270	£6,750
95	£185	4,625
100	£127	£1,270

The Government has indicated individuals will be able to make Class 3A contributions from October 2015 (but can register an interest in the scheme now) and the offer will be open for 18 months. There will be a cooling off period of 90 elapsed days after purchase during which time individuals can recover their contributions and will subsequently not accrue additional pension. Each Class 3A contribution will be used to acquire a unit of extra pension which will increase the individual's additional State Pension by £1 a week up to a cap of £25 per week.

There will be the following entitlement conditions:

- Contributors must have entitlement to a UK State Pension
- Contributors must reach SPA before 6 April 2016

This means that both people who have already reached SPA and those people who reach SPA before April 2016 will be able to make Class 3A contributions. This includes men born up to April 1951 and women born up to April 1953.

The amount paid out will be extra additional State Pension and will, therefore, share the same following characteristics:

- It will increase annually by any increase in prices, measured by the Consumer Price Index (CPI);
- It will be inheritable on death with a surviving spouse (including a civil partner) being entitled to at least 50% of the additional State Pension;
- It can be shared on divorce as part of a pension sharing order;[3]
- It can be deferred[4]; and
- It is taxable and taken into account for Income Related Benefits, such as Pension Credit.[5]

The price has been set at an 'actuarially fair' rate[6] and will therefore be lower for older pensioners as they will have, on average, a shorter life in retirement from the point when they make their Class 3A contributions.

Table 1 shows the price for selected years, published in April 2014. These are the same for males and females.

Comparison with Class 3 voluntary NI contributions

The DWP has pointed out that Class 3A will not replace Class 3 voluntary NI contributions, and intends to make it clear that individuals should consider making Class 3 contributions to cover gaps in their Basic State Pension provision, where possible, before making Class 3A contributions.[7]

Individuals usually have to purchase Class 3 contributions within 6 years of the end of the tax year (even if this takes them beyond State Pension Age) for which the contributions are being paid. However, there are extended time limits for the years 2006 to 2007 to 2015 to 2016.[8]

Class 3 voluntary contributions are sometimes considered to represent good value for money, as they cost £13.90 a week (£722.80 a year) in 2014-15 and entitle the individual to an extra £196.04 Basic State Pension per year. This means that an additional £1 per week of Basic State Pension would cost £191.72. This is considerably lower than the amount required to purchase an additional £1 per week of additional State Pension at most ages; even at age 90 an additional £1 per week of additional State Pension would cost £270. Class 3 voluntary contributions may be even more beneficial if the individual's spouse also builds up a pension based on their National Insurance contributions.

In addition, the Basic State Pension is currently uprated by the triple-lock (the higher of the Consumer Price Index, earnings or 2.5%) while the additional State Pension is uprated by the Consumer Price Index. This means that value of the Basic State Pension has extra protection in comparison with the additional State Pension.

At first glance, it appears that Class 3A voluntary NI contributions do not represent the same value for money as Class 3 NI voluntary contributions. However, this depends to some degree on an individual's circumstances.

Assessing the value of Class 3A voluntary NI contributions

There are two principle ways of measuring the value of Class 3A contributions:

- Comparison based on the cost of purchasing a similar annuity in the insurance market;
- Comparison based on life expectancy which considers at approximately what point they would recover the cost of 3A contributions and whether they are likely to live until this point.

The ability for spouses (including civil partners) to inherit up to 50% of this pension on an individual's death means that an individual's marital status may also have an impact on the extent to which Class 3A contributions represent good value to an individual.

Comparison based on the cost of purchasing a similar annuity

Table 2 compares the amount that an individual aged 65 receives from the additional State Pension, based on the purchase of £25 additional State Pension per week, with the amount that they would receive from an annuity provider (shown by the Money Advice Service's annuity calculator at 3 September 2014).[9] This has used £22,250 as the pension pot used to purchase an annuity—this is the amount that someone aged 65 would pay in order to buy the maximum additional State Pension permitted of £25 per week. These results are for an annuity and make the following assumptions:

- where the individual has a

Table 2: The value of the Additional State Pension depends on an individual's circumstances

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Comparison of annuities and additional State Pension on £22,250 pension fund for individuals aged 65 with different circumstances		
	Annuity	Additional State Pension
Married individual. On death surviving spouse would inherit 50% annuity/additional State Pension.	£906	£1,300
Single individual	£1,000	£1,300
Married individual -pre-existing health condition.* On death surviving spouse would inherit 50% annuity/additional State Pension.**	£987	£1,300
Single individual - pre-existing health condition.*	£1,117	£1,300

Source: Money Advice Service website search on 24 June 2014– assuming that annuities are uprated by 2% each year while the additional State Pension would be uprated by CPI
*Type II diabetes and BMI indicates overweight ** Spouse assumed to have no pre-existing health condition.

spouse they assume that the spouse would inherit 50% of the annuity on the individual's death.

- the annuity purchased increases by 2% each year.

An indexation rate of 2% is used because annual increases of the additional State Pension are calculated based on the Consumer Price Index (CPI), and the long-term forecast for CPI is at 2%[10] (this was necessary because annuities linked to CPI are not available to purchase). However, as it is less risky for annuity providers to guarantee a particular level of increase rather than linking increases to an external measure such as CPI, the annuities in this table may pay more than a CPI-linked annuity would. However, this does permit a comparison of the value of the additional State Pension, depending on individuals' circumstances.

These results consider the variation in annuities depending on whether an individual has a spouse, who would inherit a 50% annuity/additional State Pension (the results are for a heterosexual married couple), and whether they have a pre-existing health condition that affects their life expectancy.

These results are based on individuals or couples living in a postcode area in Hertfordshire.[11] However, the annuities offered to individuals can vary according to their location and the average life expectancy in their location. For example, while a single individual living in a Hertfordshire postcode might receive an annuity of £1,000, the Money Advice Service's annuity calculator shows that the same individual living in a postcode area in Aberdeenshire could be offered a lower annuity of £959. Similarly, an individual in the same circumstance but living in a postcode area in Glasgow could be offered a higher annuity of £1,064.

Table 2 suggests that the additional State Pension may offer better value than a private annuity purchase for most individuals—however, the fact that it is inheritable by the spouse or civil partner on the individual's death means that it offers better value for married people and those with civil partners than single individuals.

Similarly, those people with pre-existing health conditions, such as type II diabetes, may be able to receive higher rates of annuity from insurers than those people with no pre-existing conditions. This suggests that the additional State Pension offers better value to those people with no pre-existing health conditions. A single individual, living in Hertfordshire, without a pre-existing health condition might receive an annuity of £1,000 while an individual who is overweight (indicated by their Body Mass Index) and has type II diabetes might receive an annuity of £1,117. Those individuals with more severe health conditions would receive higher annuities.

Comparison based on life expectancy

A basic calculation of approximately how long it would take an individual to recover their contributions might help them to identify whether they wish to make Class 3A contributions.

Table 3 compares life expectancy for men and women with the approximate number of years that it would take them to recover these contributions. It takes into account the fact that the additional State Pension will be uprated by CPI every year. The amount of additional State Pension that an individual would receive has been compared with what might happen if they instead placed the equivalent of the contributions into a building society savings account. In this way, it compares the initial contribution and the interest that an individual would receive from a building society account with the amount of additional State Pension that they would receive, and identifies the year in which the additional State Pension would exceed the cost of contributions (made up of contributions paid in and the building society interest that an individual would otherwise receive on these).

This comparison suggests that at age 65 and 75 Class 3A contributions would result in people receiving more than they pay in (along with the interest that they would otherwise have received on these contributions) based on average life expectancy. However, this also suggests that at ages 85 and 95 this might represent good value for women but not for men.

However, while these calculations might be valid for unmarried individuals they do not take into account the value of the fact that the additional State Pension is inheritable by the spouse (including a civil partner) on the individual's death.

Table 3 compares average (mean) life expectancy with the number of years that it would take an individual to recover their contributions. If an individual has underlying health issues that are likely to lead to a lower than average life expectancy, this calculation may not be useful for them. In practice, it is likely to be difficult for people to make judgements around their own life expectancy.

Life expectancy is not the only factor that individuals should take in to account when deciding whether to make Class 3A contributions. People also need to take account of the fact that extra additional State Pension will be included in an assessment of Income Related Benefits.[12] The benefits likely to be affected include Pension Credit (Guarantee Credit), Housing Benefit and Council Tax Benefit.

Table 3: Life expectancy affects estimates of the value of Class 3A voluntary NI contributions

Cohort life expectancy (years) of males and females at different ages in 2015

Age at which individual makes Class 3A voluntary NI contributions	Male life expectancy	Female life expectancy	Approximate length of time before individual would recover their contributions
65	86.6	89.3	16.5 years (age 81.5 years)
75	88.3	90.4	12.6 years (age 87.6 years)
85	91.8	92.9	7.5 years (age 92.5 years)
95	98.1	98.5	3.6 years (age 98.6 years)

Source: ONS population projections
Calculations assume building society annual interest rate of 1.4%

Guarantee Credit is paid to provide a safety-net of a minimum income if other sources do not reach a certain level.

Housing Benefit is paid to people on low incomes who rent their home. It is designed to help with housing costs, including rent and some accommodation-related service charges.

Council Tax Support is a rebate to provide help with up to 100% of an individual's Council Tax.

All of these benefits are means-tested with the amount of benefit depending on an individual's income and savings. Therefore, any calculation around this may be complicated as individuals need to take account of the income and capital thresholds for each benefit, and how these interact. For instance, a single individual with less than £148.35 will receive Guarantee Credit to give them an income of £148.35. However, lower levels of benefit will be paid if any individual has over £10,000 of savings.

An individual with sufficient savings to make Class 3A contributions who is in receipt of Guarantee Credit or who is likely to receive Guarantee Credit once they reach SPA would have to consider the interaction of these thresholds in the light of their own circumstances to determine whether making Class 3A contributions is likely to be in their best interest.

Any calculation around this may be complicated as individuals will have to make assumptions regarding their likely circumstances in the future; for instance, how likely it is that they will receive Income Related Benefits in retirement. Similarly, the benefits regime may change in the future, something that further complicates any calculations.

In addition the purchase of Class 3A contributions might affect an individual's tax position. For instance, if the additional State Pension increases their income so that it is above the Personal Allowance, an individual will have to pay tax on the excess over the Personal Allowance.

Likely take-up

Based on an online polling exercise, the DWP estimates that around 265,000 people may take up the offer.[13] However, the level of take-up is still uncertain.

Summary

Comparison of the additional State Pension with private annuities suggests that the payment of additional Class 3A contributions may offer better value than a private annuity purchase for many individuals. However, the fact that it is inheritable by the spouse (including a civil partner) on the individual's death means that it offers better value for married than single individuals.

Similarly, those people with pre-existing health conditions, such as type II diabetes, may be able to receive higher rates of annuity from insurers than those people with no pre-existing conditions. This suggests that the additional State Pension offers better value to those people with no pre-existing health conditions.

A comparison based on life expectancy suggests that at age 65 and 75 Class 3A contributions would result in people receiving more than they pay in (along with the interest that they would receive on these contributions) on average.

However, this analysis also suggests that at ages 85 and 95 this might represent good value for women but not for men. However, while these calculations might be valid for unmarried individuals they do not take into account the value of the fact that the additional State Pension is inheritable by the spouse (including a civil partner) on the individual's death.

Life expectancy is not the only factor that individuals should take in to account when deciding whether to make Class 3A contributions. People need to take account of the fact that extra additional State Pension will be included in an assessment of Income Related Benefits and that the purchase of Class 3A contributions might affect an individual's tax position.

1 *Pensions Bill 2013-14* http://services.parliament.uk/bills/2013-14/pensions.html
2 Steve Webb, *Written Ministerial Statement*, 2 April 2014
3 DWP (2013) *Class 3A voluntary National Insurance policy detail*
4 DWP (2013) *Class 3A voluntary National Insurance policy detail*
5 DWP (2013) *Class 3A voluntary National Insurance policy detail*
6 DWP (2013) *Class 3A voluntary National Insurance policy detail*
7 DWP (2013) *Class 3A voluntary National Insurance policy detail*
8 More information is available at http://www.hmrc.gov.uk/ni/volcontr/whentop-up.htm
9 moneyadviceservice.org. uk
10 OBR (2013) *Fiscal sustainability report – July 2013*
11 Annuity rates vary by postcode, rates for individuals living in Hertfordshire are not at the highest or the lowest end of the range
12 DWP (2013) *Class 3A voluntary National Insurance policy detail*
13 Steve Webb, *Written Ministerial Statement*, 2 April 2014

Further information

The DWP has provided a facility for people to register their interest so that they can receive updates in advance of the State Pension top up becoming available. This includes a calculator which enables people to work out the contribution needed for people to increase their pension by a weekly amount. More information is available at: www.gov.uk/government/publications/additional-state-pension-top-up

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