LCP INSIGHT CLARITY ADVICE

LCP on point

Why is money being deducted from my state pension?

The mysteries of CODs, COPEs and Contracting Out explained

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Summary and Introduction

One element of the state pension system which probably causes more confusion than any other is the role of 'contracting out'. Millions of people spent one year or more of their working life as a member of a 'contracted out' pension scheme, either organised through their workplace or taken out personally. In many cases, a period of 'contracting out' will affect the state pension which they finally receive. But the way in which this works, and the amounts deducted as part of the state pension calculation are not well understood.

This paper aims to put that right.

We cover key questions such as:

- What exactly is 'contracting out'?
- How did it differ between different types of pension arrangement?
- How does being contracted out during your work life affect your state pension:
    - at retirement?
    - through retirement?
- How did the introduction of the 'State Second Pension' in 2002 affect things?
- How did the move to the new state pension in 2016 affect things?
- If my pension statement from the government or my pension scheme refers to a GMP or a COD or COPE, what do these things mean?
- How does contracting out affect the amount of state pension I may inherit if my spouse or civil partner dies?

Although contracting out has been abolished since 2016/17 for those still in the workforce, the impact of past contracting out will continue to be reflected in state pension calculations for decades to come. We hope that this guide will make a contribution to helping people to have a better understanding of how that calculation has been made.

01 What was contracting out?

When the first comprehensive state pension system was introduced in the UK after the Second World War, it consisted of one main element – what we would now call a 'basic' state pension. Someone with a minimum number of National Insurance (NI) contributions would get a full state pension regardless of the level of their earnings. Beyond the requirement to have a full NI record, the state pension started life as a flat rate payment. Indeed, in the early days of the National Insurance system, both NI contributions and NI pensions were flat rate.

One drawback of having a flat rate payment is that it is less useful to high earners who would see a slump in their income at retirement if they had no other pension income. In 1961 the system was changed to make NI contributions by workers more earnings-related and to introduce a modest earnings-related state pension – the Graduated Retirement Benefit (GRB). Although the GRB only ran from 1961 to 1975, many pensioners today are still receiving a few pounds a week for payments made under that scheme.

The 1975 Social Security Act introduced sweeping changes to the system, with the most notable being a comprehensive system of 'additional' earnings-related state pension payments. The resultant system, introduced in 1978-79, was SERPS – the State Earnings-Related Pension Scheme.

Whilst SERPS provided a welcome earnings-related pension to many millions of workers, there were some who already had an earnings-related pension from their workplace. This included some worked in the public sector or those who had access to a salary-related company pension. It would have been hard to justify a situation where such workers and firms were now paying increased NI contributions to fund the SERPS scheme and were building up an earnings-related pension from the state but were continuing to pay into an occupational earnings-related pension as well.

- As part of the new system, certain pension arrangements were allowed to 'contract out' of SERPS[1]. In essence, when the system began this was a deal whereby

- The employer and employee benefited from a reduced rate of NI contributions; this was done by applying a contracted out 'rebate' to their NI rate;

- The scheme guaranteed to provide a pension *at retirement* that was at least as good as the SERPS pension which the employee had given up; this was known as a 'Guaranteed

[1] Note that a form of 'contracting out' also applied to the GRB system, but the way this worked is not shown on state pension calculations.

Minimum Pension' or GMP; and

- Any GMP provided by the scheme was deducted from the SERPS pension the worker would otherwise have received in retirement.

When contracting out of SERPS was first introduced it applied only to traditional salary-related (often 'final salary') pension arrangements. However, as discussed below, the principle was later applied to other occupational pension schemes (so-called Money Purchase or 'pot of money' type pensions) and to approved personal pensions. In the next section we explain the differences between these different types of arrangements as they are important to understanding the impact of contracting out on the state pension calculation.

The description in the next section is based on the 'old' state pension system which applied to those who reached pension age before 6th April 2016. This was the state pension system which legislators had in mind when they designed contracting out. We consider later in the paper how all of this changed when the new state pension system was introduced for those reaching pension age on or after 6th April 2016. But it is important to note that because the new state pension system has significant transitional arrangements to protect those with rights built up under the old arrangements, even payments of 'new' state pension can often reflect key features of contracting out under the old regime.

02 Contracting out of different types of pension schemes

The way contracting out worked differed according to the type of pension arrangement of which you were a member. There were three broad approaches depending on whether you were a member of:

- A 'Defined Benefit' (DB) pension scheme (typically a final salary scheme)
- An occupational pension scheme run on a 'Defined Contribution' or 'pot of money' basis (also known as a 'money purchase' pension scheme);
- An approved personal pension

We consider each in turn, before describing the additional incentives offered for contracting out in the decade from 1988 onwards.

a) Contracting out into a Defined Benefit (DB) pension scheme

As noted above, when contracting out of SERPS was first introduced it was primarily for members of DB pension schemes[2]. One important point to note at the outset is that it was the scheme as a whole which contracted out. This was not a choice made by individual members.

The way that contracting out worked was that the employer and employee were given a rebate on their NI contributions and in return the scheme promised to provide a pension at retirement at least as good as the pension the member was giving up from SERPS.

The rate of the rebate was reviewed every 4-5 years by the Government Actuary and was changed periodically to reflect changing market conditions and other factors. Table 1 shows the total NI rebates for DB pension schemes, and the split between employee and employer:

Table 1. Rates of NI rebates for Defined Benefit pension schemes 1978/79-2015/16

	1978-1982	1983-1987	1988-1992	1993-1996	1997-2001	2002-2006	2007-2011	2012-2015
Total rebate	7.0%	6.25%	5.8%	4.8%	4.6%	5.1%	5.3%	4.8%
- **Employee**	2.5%	2.15%	2.0%	1.8%	1.6%	1.6%	1.6%	1.4%
- **Employer**	4.5%	4.1%	3.8%	3.0%	3.0%	3.5%	3.7%	3.4%

[2] It was also possible to contract out of a DC scheme with an 'underpin' which guaranteed a certain minimum level of benefit.

This is an important table to bear in mind. Many people are unhappy when an amount is deducted from their state pension to reflect past contracting out but they may have forgotten (or be unaware) that they saved money on their NI bills by being contracted out. To pay a full state pension without deduction to those who benefited from a contracted out rebate when they were working could well be seen as unfair to those who were not contracted out. Indeed, as we shall see later, this was an important consideration in the design of the new state pension system.

The exact way in which contracting out worked in a DB arrangement changed over time as below:

- **DB Contracting out 1978-1997**

As part of the deal of contracting out, the scheme promised to provide the worker with a pension at retirement at least as good as the SERPS pension they had given up. This was known as a 'Guaranteed Minimum Pension' or GMP, and these rules applied between 1978-79 and 1996-97.

The rules around GMPs are complex, and a series of court decisions have found that the differences in treatment under the GMP system between men and women were unlawful. These differences are now being resolved by a process known as GMP equalisation. But for our purposes, there are a few important things to be aware of as regards GMPs:

- GMPs have to be 'revalued' between the year in which they were earned and the year of retirement; this is to prevent the value of the GMP being eroded by inflation;

- For those who remained active in the DB scheme, the GMP entitlement had to be revalued each year by national average earnings; for those who left the scheme (eg because they changed firm), revaluation could be (depending on period):

    - in line with average earnings or
    - by a 'fixed rate' or
    - (subject to payment of a premium) by average earnings up to a cap of 5%

  Note that 'fixed rate' revaluation could in some cases result in relatively rapid increases in the value of the GMP.

- When GMPs were first introduced in 1978-79, the scheme could simply pay the relevant GMP at retirement and had no duty to pay post-retirement increases; however, in 1988 the rules changed and GMPs in payment now have to be inflation-linked by the scheme up to a maximum inflation rate of 3% for service between 1988/89 and 1996/97.

As we will explain in more detail later, at retirement an individual's additional state pension for the period 1978/79-1996/97 would be the SERPS pension they would have built up if they had not been contracted out *minus* the GMP for that period. In many cases the GMP would wipe out (or more than wipe out) the SERPS figure and the member would have a zero additional pension at retirement for that period[3]. However, because of the limited price indexation on GMPs in retirement (compared with full price indexation of SERPS rights), a retiree with no additional pension at point of retirement could start to receive a SERPS pension later on. This would be because the gross SERPS figure increased faster than the GMP which was being deducted from it.

[3] Note that in some circumstances schemes could 'unwind' contracting out by buying members back into SERPS by payment of something called a 'contributions equivalent premium' to the Government. Schemes which wound up could also in some cases pay a premium to reinstate members back into SERPS, though this was calculated on a different basis.

- **DB Contracting out 1997-2002**

In a bid to simplify the system, the process of DB contracting out was reformed with effect from 1997. Instead of detailed calculations of GMPs, schemes simply had to satisfy a 'reference scheme test'. This was a certification that the benefits provided by the scheme would broadly be at least as good as the SERPS benefit given up, but this operated at a scheme level rather than for each individual member.

Unlike in the period from 1978 to 1997, members built up no SERPS entitlement for these years and there was no GMP. Their additional pension was simply paid by the scheme in line with the rules of the scheme. However, as part of the 'reference scheme test', pensions in payment had to be indexed each year in line with inflation up to a ceiling. That ceiling was initially 5% but was later lowered to 2.5% from 2005.

- **DB Contracting out 2002-2016**

In 2002 the Government reformed the SERPS scheme and renamed it the State Second Pension or S2P. S2P had many of the same features as SERPS but it was weighted more towards low earners. Those earning below a certain threshold built up more in S2P than they would have done under the SERPS calculation.

However, the reference scheme test for occupational pension schemes was not changed. In other words, although the state had decided that lower earners should get bigger pensions, that duty was not passed on to contracted out occupational pension schemes.

To make sure that low paid contracted out workers benefited from the new arrangements, the way in which contracting out was reflected in retirement was changed again. For service from 2002/03 to 2015/16 (when contracting out was abolished), a retiree would be awarded an 'S2P top-up', which was simply the difference between the state pension they would have got under the SERPS scheme and their entitlement under S2P. The core of their earnings-related pension continued to be paid by their workplace pension scheme.

b) Contracting out into a Defined Contribution occupational pension scheme

In the late 1980s, the Government decided that it would extend the scope of contracting out to other sorts of pension arrangements. This was both to reduce the future cost of the SERPS scheme and to encourage more people to make their own pension arrangements.

For occupational pension schemes, the big change was that schemes run purely on a Defined Contribution (DC) basis could also now contract out[4] without having to promise to provide a GMP or other specified level of benefit.

Of course, the big difference between a DB scheme and a pure DC scheme is that in a pure DC scheme there is no guarantee of the final pension that will be paid. The only thing 'defined' is the contribution that goes in. This meant that rebates had to be worked out in a different way.

To calculate the appropriate NI rebate to apply, the Government Actuary looked at what would happen if the rebate was invested in the DC scheme and then used at retirement to buy an

[4] Such schemes are often known as 'Money Purchase' arrangements and the abbreviation COMPS which is sometimes used in legislation refers to a 'Contracted Out Money Purchase Scheme'.

'annuity' or income for life. Broadly speaking, on average the rebate should generate an annuity income which at least matched the SERPS pension which the contracted out worker was giving up.

As with DB rebates, DC rebates were reviewed on a regular basis, not least because of changing assumptions about investment returns and annuity rates.

One major change occurred in 1997 when rebates began to be structured on an age-related basis. Over time it had become clear that having a single rate of rebate favoured younger workers (who had longer to enjoy investment growth on their rebate) over older workers. The system of age-related rebates was designed to redress that balance although the adjusted system still did not fully compensate the oldest workers for the SERPS pension they were giving up.

Table 2 shows the total rebates which were applied to occupational DC schemes from 1988-89 when the system was introduced[5] to 2011-12 when DC contracting out was abolished. It shows separate figures for a worker in a younger age group and in an older age group, to reflect the move to age-related rebates in 1997.

Table 2. Rates of NI rebates for Defined Contribution occupational pension schemes 1988-2012 for a younger worker and an older worker

	1988-1992	1993-1996	1997-2001	2002-2006	2007-2012
20 year-old	**5.8%**	**4.8%**	**3.4%-2.4%**	**2.8%**	**3.4%**
Of which: employer	3.8%	3.0%	1.8%-0.8%	1.2%	1.8%
Of which: employee	2.0%	1.8%	1.6%	1.6%	1.6%
58 year-old	**5.8%**	**4.8%**	**9%**	**10.5%**	**7.4%**
Of which: employer	3.8%	3.0%	7.4%	8.9%	5.8%
Of which: employee	2.0%	1.8%	1.6%	1.6%	1.6%

At retirement, a deduction would be made from the worker's additional state pension to reflect the period of contracting out – this is known as a 'Contracted Out Deduction' or COD for short. The deduction reflects the SERPS pension which the worker would have received had they not been contracted out.

One important point to note is that there is no particular reason why the COD and the annuity generated by the pension should be the same. When rebate rates were set it was on the basis of long-term assumptions about future investment returns, interest rates and life expectancies. For rebate rates set in the late 1980s and during the 1990s, investment returns generally turned out to be better than the Government Actuary had expected. But annuity rates, particularly from around 2010 onwards, ended up being far lower than expected. As a result, many people, and particular those who were contracted out later in their working lives, may find that the amount deducted from their state pension is significantly higher than the equivalent annuity that they purchased (or could have purchased) with their DC pension pot. We discuss this point in more detail later.

[5] Although DC contracting out started in 1988-89, in certain circumstances those who were newly contracted out were able to backdate their decision to 1987-88.

c) Contracting out into an approved personal pension 1988-2012

The extension of contracting out to DC arrangements did not only apply to occupational personal schemes. By far the largest number of newly contracted out people were those who took out approved personal pensions. These pensions also operated on a 'pot of money' basis where a fund was built up with a view to buying an annuity at retirement.

Members of approved personal pensions also qualified for NI rebates but the way in which these worked was different to the arrangements for workplace DC pensions. Rather than the saver benefiting from a reduced (rebated) rate of NI contributions, in the case of personal pensions, the saver continued to pay the full rate of NI but a rebate was instead paid directly into their personal pension. They were free to top up these rebates but were under no obligation to do so.

As with occupational DC pensions, the standard rebates were initially set at a flat rate regardless of age, but in 1997 rebates paid into approved personal pensions were paid on an age-related basis. The Table shows the rates of rebates paid into approved personal pensions, again for a worker in a lower age group and one in a higher age group.

Table 3 – National Insurance rebates for approved personal pensions 1988/89-2011/12

Scheme	1988-1992	1993-1996	1997-2001	2002-2006	2007-2011
20 year-old	5.8%	4.8%	3.6% - 4%	4.4%	5.0%
58 year-old	5.8%	4.8%	9%	10.5%	7.4%

As with occupational DC pensions, at retirement a member of an approved personal pension would have a 'contracted out deduction' set against the SERPS pension they would have built up, and this could reduce their net SERPS pension to zero. Instead, they would get a pension bought from their personal pension fund. As noted above, depending on factors such as when they were contracted out and when they retired, there could be a significant difference between the SERPS pension they would have got and the annuity that they did actually buy.

d) Additional incentives for contracting out 1988/89-1997/98

In order to encourage the move to contracting out, those who were in newly contracted out schemes were entitled to a significant additional NI rebate of 2% for the period from 1988-89 to 1992-93. A smaller rebate of 1% was paid to the over 30s contracted out via an Approved Personal Pension from 1993-94 to 1997-98.

To the extent that the base rebate calculation was expected to be actuarially neutral when it was set, the decision to pay an additional incentive (dubbed a 'bribe' by some critics) was part of a clear drive to increase the scale of contracting out. In terms of numbers who contracted out, the policy was a big success – generating what some experts called a 'stampede'[6] – with around 8 million people taking out personal pensions. The policy was however not without its controversy as personal pensions were in some cases 'mis-sold' to workers in high quality Defined Benefit schemes and compensation for this mis-selling ended up running into more than £10 billion.

In the next section we set out in more detail how being contracted out can affect your state pension.

[6] See: "The Personal Pensions Stampede" by Richard Disney and Edward Whitehouse, IFS, 1993: r40.pdf (ifs.org.uk)

03 Contracting out and the old state pension

When contracting out was designed it was against the backdrop of what we now think of as the 'old' state pension system – the system which applied to those who reached pension age before 6th April 2016. In this section we explain what happened at retirement and through retirement for those who reached pension age under this system. However, the new state pension system has carried forward many elements of this calculation so this section is relevant even for those who retired after the 2016 changes were implemented.

We start by looking at how state pension at retirement[7] is worked out where someone has been contracted out and then we describe how the pension payment evolves through retirement.

a) Pension at retirement

Starting with pension at retirement, the best way to understand the interaction between the state pension and periods of contracting out is to look separately at the three periods described earlier – 1978-1997, 1997-2002 and 2002 and beyond.

• 1978-1997

On state pension statements, entitlement to SERPS is referred to as 'additional pension'. For years of contributions between 1978-79 and 1996-97, there are two elements to the calculation:

- The DWP work out how much SERPS pension you would have received if you had not been contracted out;
- DWP then set against this a deduction to reflect past contracting out. Regardless of whether you were contacted out into a DB or DC pension, this figure is shown on the statement as a 'contracted out deduction' or COD for short. For those who were in a DB scheme, the COD is simply the Guaranteed Minimum Pension which your scheme undertook to pay. For those were in a DC scheme, the COD at retirement is a GMP equivalent figure. For those who were contracted out for the whole period, at retirement this will generally wipe out the 'gross SERPS' figure.

One important point to note is that if the calculation produces a negative outcome (because, for example, the GMP exceeds the gross SERPS figure) it is rounded to zero before the rest of the calculation is made.

[7] To be more precise, we should talk of pension entitlement 'at state pension age', as there is no requirement to be retired to draw a state pension, nor is there any obligation to draw a state pension as soon as you reach state pension age.

- **1997-2002**

For the period 1997-2002 a similar calculation is made, except that there is no GMP promise to deduct. Instead the deduction is simply the SERPS pension which the member would have received if they had not been contracted out. This means that for contracted out DB and DC savers, the net additional pension for the period 1997-2002 will generally be zero at retirement.

- **2002 and beyond**

The main change for years of work from 2002/03 onwards is the creation of the State Second Pension (S2P). As noted earlier, under S2P, lower earners accrue a higher additional pension than they would have done under the SERPS rules. But the deduction at retirement because of past contracting out is unaffected. This means that for years of work from 2002 up to the end of contracting out (2012 for DC, 2016 for DB), low earners will get a non-zero additional pension in the form of an S2P 'top-up', even if they were contracted out. The way this is delivered is simply to calculate the difference between the S2P they would have got if they had not been contracted out and the SERPS they would have got if they had not been contracted out. Low earners will thereby get an additional state pension payment from the government even if they were contracted out, and on top of the payment from their company.

A slightly different regime was in place for those contracted out via an Approved Personal Pension. As the rebates were based on the full S2P pension available for the member, the offset for those contracted out via a personal pension was the whole S2P pension.

b) Pension through retirement

Once a state pension is in payment, the amount payable is reviewed every April thereafter. In part this is to reflect general increases in the rate of the basic pension etc., but it is also to take account of the fact that the different elements of the additional state pension can change over time. As a result, the amount of additional state pension payable can sometimes rise by more than the rate of inflation.

As with the calculation of pension at retirement, it is worth splitting the post retirement calculation into the three phases in which it was earned:

- **1978-1997**

For this period the basic calculation is still a gross SERPS pension minus a Contracted Out Deduction (COD). But the two figures can change at different rates.

The SERPS pension is generally increased each year in line with inflation[8]. But DB pension schemes are not required to provide full indexation on the GMP which they have promised to pay. In particular, GMPs only have to be indexed in respect of service from 1988/89 onwards, and only up to a ceiling of 3%.

From this description it should be clear that there are a number of situations in which a pensioner's additional pension could increase by considerably more than inflation or go, for example, from zero to a positive figure. Examples could include:

[8] The measure of inflation used has however changed over time, notably from the Retail Prices Index until 2011 to the generally lower Consumer Prices Index since then.

- Where someone has service between 1978-79 and 1987-88; their 'gross' SERPS figure for those years used in the calculation will rise in line with inflation but their GMP for those years will be frozen;
- Where inflation is higher than 3%; for example, for the 2012/13 uprating inflation was 5.2%; this means that gross SERPS entitlements in the calculation would rise by 5.2% but GMP payments for service post 1988 would rise only by 3%;

As with the calculation at retirement, this element of the calculation is 'ring-fenced', and a negative result will be set to zero before the rest of the additional pension is worked out.

- **1997-2002**

For this period, members were not entitled to SERPS for the years they were contracted out, and so whatever the future increases there was no SERPS pension payable for this period.

- **2002-2016**

The calculation in retirement for this period mirrors the calculation for the period 1997 to 2002 for those contracted out via a personal pension, but with the addition of an (indexed) S2P top-up for lower earners for those contracted out via an occupational (DC or DB) pension scheme.

Did members benefit from contracting out of the old state pension?

As we have seen, the effect of contracting out for people who reached State Pension Age before 6th April 2016 depends on the type of contracted out pension scheme as well as their individual circumstances:

- Those contracted out via a DB scheme were not usually worse off as a result of contracting out, and could be better off if their GMP revalued at a particularly high rate before retirement;

- Those contracted out via a DC scheme could have been better or worse off, depending on three main things:

    - The investment returns they achieved before retirement – over the relevant period the total returns on equity investments were generally slightly better than assumed by the Government Actuary;

    - The annuity rates available for those looking to buy a pension with insurer at retirement. Whilst the Government Actuary had set the rebates in line with expected changes in annuity rates, the actual annuity rates available over the period significantly worsened. There may be people, such as those with impaired lives, who did not see such a significant deterioration in annuity rates; and

    - The member's age – before the rebate rates were age-related, older members were more likely to lose out from contracting out and younger members were more likely to gain. After the rebates were made age-related, anyone contracted out above the age at which rebates were capped is also more likely to lose out.

The net impact of contracting out will thus be highly dependent on individual circumstances. Those who were mainly contracted out when they were younger, who benefited from additional rebates, who enjoyed good investment growth and annuitised before annuity rates fell sharply may have done well.

By contrast, those who stayed contracted out for longer and who annuitised later may have lost out overall. As we see in the next section however, any losses for those who contracted out may have been reduced or eliminated for those who come under the new state pension system.

04 Contracting out and the new state pension

The introduction of the new state pension on 6th April 2016 coincided with the abolition of contracting out for Defined Benefit pension schemes[9]. This means that for those who spend their entire working life under the new state pension system, contracting out is irrelevant. None of their contributions will be made during a period of contracting out and no adjustment will be needed to their final pension for contracting out. For these people, their state pension is paid at the full flat rate if they have 35 'qualifying' years of contributions or credits, and is paid pro rata if they have less than 35 years. A minimum of ten qualifying years is needed for any payment to be made[10].

However, for many years to come, large numbers of the people who reach pension age under the new system will have years (all pre 2016/17) when they were contracted out. It was therefore necessary for the designers of the new state pension system to decide how to handle this.

There were two extreme options available:

- To completely ignore past contracting out; this would have had the huge advantage of simplicity but would also have been very unfair; to pay the same pension to someone who had 35 years of full rate NI contributions as to someone who had 35 years of contracted out NI contributions would be open to serious challenge on grounds of fairness; OR

- To continue to take full account indefinitely of past contracting out. In other words, for as long as anyone reaching pension age had some past periods of membership of a contracted out scheme, their final state pension would continue to be debited by a 'contracted out deduction' of some sort. This approach would clearly tick the 'fairness' box in the sense that those who had benefited by paying reduced NI during their working life would always see a deduction at retirement. But it would have hugely slowed down the pace at which the new 'flat rate' pension became a reality for the majority of retirees and would have left deductions for contracting out in the system for many decades.

In the end, the government came up with a compromise.

The compromise all revolves around what happens at the start date for the new state pension, namely 6th April 2016. Under the new system, someone's total state pension will be comprised of two elements:

[9] Contracting out into DC schemes had already been abolished in 2012.
[10] There is however a concession for certain women who paid the reduced 'married woman's stamp' who can receive a new state pension at a concessionary rate even if they do not have 10 qualifying years.

a) A 2016 'starting amount', based on the NI record of the worker up to that point

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b) An additional 1/35 of the full flat rate for each complete qualifying year from 16/17 onwards, until the worker attains the full flat rate.

The concept of the 2016 'starting amount' is designed to provide a measure of transitional protection for those who had already built up state pensions under the old rules that were already in excess of the full flat rate. But it also provided a way to include a 'once and done' adjustment for past contracting out.

The way the 2016 starting amount is worked out is that it is the *higher* of:

- Figure A: The amount of old state pension (including basic pension and SERPS) that the worker had built up by 2016 under the old rules AND
- Figure B: The amount the worker would get under the new rules – a full flat rate pension for 35 years of contributions minus a deduction for past contracting out.

It is important to note that both of these figures take account of past contracting out – it is not simply ignored.

The 'new rules' calculation (Figure B) uses many of the same concepts to adjust for past contracting out as the 'old rules' calculation. But there is one important difference. If the new rules calculation simply took the full flat rate and took away the contracted out deduction as defined earlier, there would be an anomaly for the period from 1997 to 2002. During this period, as we have described, contracted out workers simply accrued no SERPS and there was no contracted out deduction. But those workers did benefit from reduced NI contributions and this needs to be reflected in the final calculation.

So, DWP work out what SERPS pension the worker would have built up during any contracted out years between 1997 and 2002 and add this to the contracted out deduction. This total deduction is what was originally called a 'Rebate Derived Amount' and is now shown on pension statements as the 'Contracted Out Pension Equivalent' or COPE. There is more on the COPE in the box.

What is the COPE?

COPE stands for "Contracted Out Pension Equivalent". It is a figure factored into the calculation of the new state pension. In simple terms it is designed to give the retiree a feel for how much has been knocked off during their state pension calculation to reflect past periods of contracting out. People with a COPE on their pension calculation have (or had in the past) rights from an occupational or personal pension scheme and will have benefited from rebates on their NI contributions. The actual pension that comes from these pensions could differ considerably from the COPE figure, particularly for those who were contracted out into Defined Contribution pensions.

One important point to note is that any state pension forecast will *already* have taken account of the COPE and therefore when receiving a state pension statement there is no need to do mental arithmetic to work out what you will get. The headline figure on the statement has already done this for you. The COPE is simply mentioned as a 'memorandum' item to remind retirees that they also have (or have had) rights under a contracted out pension instead of part of their state pension rights.

Once the starting amount as at 2016 has been worked out, anyone short of the full flat rate can build up further state pension by adding further 'qualifying years' from 2016/17 up to state pension age.

Do members benefit from contracting under the new state pension system?

This new way of working out the state pension has three important consequences with regard to the impact of past contracting out:

a) For those who have a starting amount below the full flat rate as at 2016, making contributions from 2016/17 onwards provides the opportunity to 'burn off' some or all of the effect of past contracting out; for example, if someone is £20 per week short of the full flat rate in 2016/17 because of past contracting out, working four more years will add enough to their starting amount to bring them up to the full flat rate. In this respect, the new state pension is highly favourable to those who have been contracted out, provided that they have enough working years post April 2016 to benefit. This group can get the same flat rate pension as people who were not contracted out, but also get a contracted out pension on top.

b) Because of the ability to 'burn off' past contracting out with each additional year worked post 2016, the number of people reaching state pension age with a full flat rate state pension will rise steadily. In the first year of transition to the new state pension it was estimated that less than half of new retirees reached the flat rate, mainly because of past contracting out. But by the end of the current decade, it is expected that four in five of those retiring will be on the full flat rate. More and more of these workers will have had time to 'burn off' any deductions for past contracting out by dint of 'qualifying years' post 2016.

c) Conversely, there is one element of the new state pension calculation which is to the detriment of those who were contracted out. As described earlier, additional pension built up between 1978 and 1997 was the difference between the SERPS someone would have got and the GMP promised by the scheme. Over the years of retirement, the SERPS figure should be fully price-indexed but the GMP gets only partial inflation protection. This can generate a gap – and a growing gap – between the gross SERPS figure and the GMP. This gap (arising from the incomplete indexation of the GMP) was previously picked up by the state through a SERPS pension. But under the new state pension SERPS no longer exists. As a result, contracted out workers will simply receive their new state pension, indexed according to the policy of the government of the day, plus an incompletely indexed GMP from their scheme. Concerns over this loss of indexation have led the government to make up the loss of this indexation for members of public sector schemes by means of additional payments through the scheme itself, but private sector workers receive no such protection.

It will hopefully be apparent from this description that the new state pension represents a compromise with respect to past contracting out. Past contracting out is not ignored completely – it is still factored into the Figure A v Figure B calculation of the 2016 starting amount – but its impact diminishes with every passing year. With every year since 2016 more and more workers will add post 2016 qualifying years which can gradually erode any deduction for contracting out until it is eliminated altogether. So, contracting out still matters during the progressive implementation of the new state pension, but its importance diminishes with each new cohort of retirees. Whilst there are still winners and losers from contracting out under the new system, we expect that, over time, more people who have contracted out will be winners than losers.

05 Contracting out and widows/ widowers

The rules for those who inherit SERPS pensions from a late spouse are complex, and we do not attempt to set out the full rules here. But there is an interaction with contracting out which is worthy of note.

When SERPS was first introduced it was envisaged that surviving spouses would inherit 100% of their late spouse's SERPS pension. In time this was regarded as unduly generous, and the inheritance rate was cut to 50% under the terms of the 1986 Social Security Act. However, this change was not well communicated and many of those affected were shocked to discover an inheritance rate far lower than they had been led to believe.

In response, the Government reinstated 100% inheritance for a fixed time period and then gradually scaled down the percentage to 50% for younger retirees. The table below shows, separately for men and women, how date of birth translates into the percentage of SERPS which can be inherited:

Man's date of birth	Woman's date of birth	Maximum % of SERPS and State Pension top up you can inherit
5 October 1937 or before	5 October 1942 or before	100%
6 October 1937 to 5 October 1939	6 October 1942 to 5 October 1944	90%
6 October 1939 to 5 October 1941	6 October 1944 to 5 October 1946	80%
6 October 1941 to 5 October 1943	6 October 1946 to 5 October 1948	70%
6 October 1943 to 5 October 1945	6 October 1948 to 5 July 1950	60%
6 October 1945 and after	6 July 1950 and after	50%

Source: https://www.gov.uk/additional-state-pension/inheriting

The reason that this is important is that although the 'gross' SERPS which a widow or widower can inherit can still be up to 100%, depending on date of birth of the deceased, the amount of COD which is inherited is always 50% of the COD of the deceased. This creates the strange situation where a worker who was extensively contracted out was getting zero additional pension while he was alive, but his/her widow/widower can nonetheless end up with inherited additional pension.

A simple example will illustrate this.

Consider the case of a couple who both come under the old state pension system and where the man was born before 5th October 1937. According to the table above, his widow is set to inherit 100% of his gross SERPS pension. Suppose also that he was contracted out from 1978 to 1997 and would have built up a SERPS pension of £50 per week had he not been contracted out. Suppose also that his scheme offers a GMP of £50 per week at retirement, so his net additional pension at retirement for this period is zero.

If the husband dies, his wife's state pension is recalculated to take account of her late husband's SERPS entitlement. For the period from 1978 to 1997, her calculation now includes a gross figure of £50 (100% of the SERPS her late husband would have got if he had not been contracted out) and an inherited contracted out deduction of 50% of the GMP, namely £25. As £50 minus £25 is £25, the widow now gets an additional state pension of £25 a week in respect of her late husband's contributions.

Although it may seem strange, keeping the inherited COD/GMP at 50% of the late spouse's SERPS pension while allowing the widow/widower to inherit up to 100% means that it is possible to end up with an inherited SERPS pension even if your late spouse had zero entitlement as part of his/her state pension.

06 Conclusions

Contracting out was a deal. Employers and employees benefited from reduced NI contributions and as part of that deal employees had a reduced entitlement to state pension at retirement. The way that this was implemented varied between DB and DC pensions and between occupational and personal pensions. It also changed over time, with big changes in 1988 and 1997. On top of this we have state pension reform in 2002, replacing SERPS with the State Second Pension and further state pension reform in 2016 with the introduction of the new state pension. It is hardly surprising that people who have been contracted out are confused as to how their state pension has been worked out.

We hope that this short paper has helped to explain something of what is going on 'under the bonnet' when it comes to state pensions and contracting out. As explained earlier, the final abolition of contracting out in 2016 and creation of the new state pension means that contracting out will have progressively less impact on state pension outcomes with each passing year. But there remain millions of retirees whose past contracting out will continue to affect their state pension entitlement for as long as they live, and it is only right that they understand how their pension has been worked out. And while the new state pension is designed to be much simpler than the system it replaced, the process of transitioning from the old system to the new has meant retaining a lot of the complexity around contracting out.

The good news is that, going forward, things should be much simpler. More and more retirees will have either no contracting out or an amount which has no impact on their final state pension. But state pension statements and forecasts still cite a Contracted Out Pension Equivalent (COPE) figure which continues to cause confusion. We hope that this paper will have helped at least a little to de-mystify this piece of jargon and some of the other obscure terms which surround the state pension calculation.

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