

Introduction

From 2010 the number of years of National Insurance Contributions (NICs) needed in order to qualify for a full Basic State Pension (BSP) will be reduced from 39 years for women and 44 years for men to a total of 30 years for both. This means that someone reaching State Pension Age (SPA) on or after 6 April 2010 will need 30 years of contributions to qualify for a full BSP, (currently £90 per week). However, people reaching SPA before 6 April 2010 will still need to have contributed for 39 or 44 years to qualify for a full BSP.

This sudden drop off in qualifying years, known as the 'cliff-edge', has been perceived by some stakeholders as unfair, especially to women, and has prompted an amendment to be tabled to the Pensions Bill 2007/08 that would extend individuals rights to buy back missed years of NICs.

This Briefing Note explores the potential advantages, disadvantages and costs of implementing the amendment in an attempt to clarify the issues involved.

How do National Insurance Contributions work?

Most UK residents who are aged between 16 and SPA are required to pay National Insurance Contributions (NICs), or are treated as having paid NICs, on earnings at or above the Lower Earnings Limit (LEL) (currently

How National Insurance Contributions work

Main Classes of National Insurance Contributions (NICs)		Who pays this class	What this entitles people to
Class 1	Paid by employers at a rate of 12.8% and employees aged between 16 and SPA who earn over the Primary Earnings Threshold (PT) at a rate of 11% and at a rate of 1% for earnings over the Upper Earnings Limit (UEL). People who earn at or above the Lower Earnings Limit (LEL) (currently £90 per week) but below the PT (currently £100 per week) are not required to pay but are treated as having paid NICs.		Each qualifying year counts towards an individual's pension entitlement and is used to calculate how much Basic State Pension (and Second State Pension) they will receive. People who earn below the LEL do not accrue entitlement to Basic State Pension
Class 2	Paid by people who are self employed at a fixed rate, people on low earnings can apply for exemption		Each Class 2 contribution is treated as one week of earnings at the LEL.
Class 3	Voluntary contributions people can pay in order to fill gaps in their contribution record. Payments must generally be made within 6 years from the end of the tax year for which payment is being made.		Can fill in gaps of full or partial years in order to make those years qualifying years for State Pension entitlement
Class 4	Additional contributions paid by self-employed people (as well as Class 2 NICs) at a rate of 8% on profits between the Lower Profits Limit and Upper Profits Limit (UPL) and 1% on profits above the UPL		Does not count towards qualifying years

£90 per week). People with several jobs cannot add their income together to determine their earnings level and must earn above the LEL in at least one job to be treated as having made NICs. People who have caring responsibilities or are unable to work due to illness may be eligible to receive NI credits without having to make contributions, or may have their required qualifying years of contributions reduced under Home Responsibilities Protection (HRP will change to a system of weekly pension credits after 2010).

A qualifying year is a year in which an individual pays, is credited with, NICs on earnings of at least 52 times the weekly LEL for the year. Where a year is not a qualifying year, individuals may be able to pay voluntary contributions (Class 3 NICs) to make that

year a qualifying year. Class 3 NICs must generally be paid within 6 years of the end of the tax year for which they wish to buy back. When people reach SPA, their qualifying years are added up to determine the level of BSP that they are entitled to. A person currently needs 10 to 11 qualifying years to be entitled to the minimum level, which is 25% of a full BSP. After reform, people will be entitled to BSP from the first qualifying year, with each year entitling them to 1/30th of a full BSP.

Women and the State Pension

The current pension system does not deliver equal results for both men and women. Currently, around a third of women reaching SPA before April 2010 will be entitled to a full BSP¹ (compared to 85% of men). Around 75% of women reaching SPA in 2010 will be entitled to a full BSP, following reform. This figure will rise

to be almost equal with men by 2025 at around 90%² as a result of the Government's reforms.

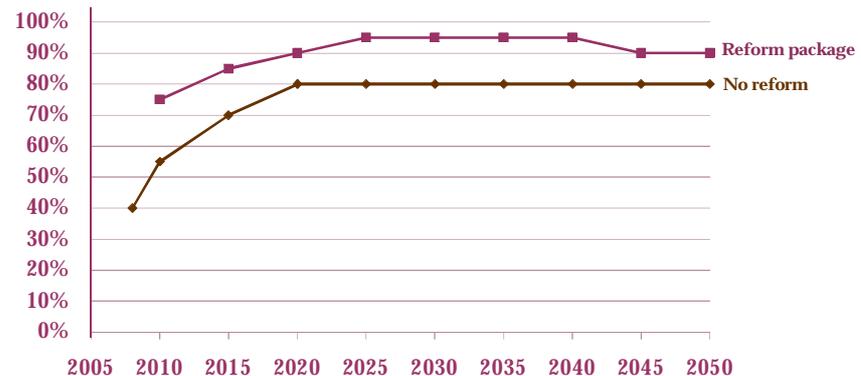
Many women currently retire without a full BSP because the NI system is geared towards the male model of continuous working life.³ Women may have unplanned caring breaks and are more likely to have one or more part-time jobs in order to accommodate their caring and home responsibilities. Despite the current protections provided for carers, and the new protections within the reforms, some types of caring are not eligible for HRP or weekly credits, and many people who have taken time out to care end up retiring without a full BSP.⁴ Women whose children were born before 1978, and service wives accompanying husbands abroad may also miss out on NICs. Women with several part time jobs are at risk of accruing low numbers of qualifying years because they may not pay, or be treated as having paid, NICs if they earn below the LEL in each job.

The reforms address many of the gender inequalities in the State Pension system, however proponents for the amendment argue that changes are needed to help women who will lose out before 2010 and to redress inequalities that will still exist after reform.

What was the original amendment?

The amendment was intended

Proportion of women reaching State Pension age with full Basic State Pension with and without reform package in the Pensions Act 2007



- Source: Projections from DWP Forecasting Division using the Government Actuary's Department Retirement Pension model, Great Britain
- Chart recreated from Figure 4.ii, *The Gender Impact of Pension Reform*. DWP (2006).

to help women on low incomes, without private pension provision or other assets, who may rely solely on their State Pension in retirement. The original amendment would have allowed people to buy back 9 years of NICs that they missed at any point during their working lives, in order to make up for the drop in 9 qualifying years needed for a woman to claim a full BSP after 2010. Currently, people are generally required to pay for Class 3 NICs within 6 years from the end of the year for which they wish to buy back.

The original amendment passed in the House of Lords in July 2007⁵ but was set aside by agreement two weeks later in the House of Commons.⁶ The Government thought it was too costly and not appropriately targeted, as the majority of the spend on the amendment would be on people who live overseas, who would on

the whole have greater deficits of qualifying years to fill.⁷ However, the Government agreed to *'use our best endeavours to deliver the principles of (the) amendment'*.⁸

When designing the reforms, the Government considered ways of mitigating the cliff-edge⁹ such as implementing a more gradual reduction in the number of years a person needs to qualify for a full BSP. This would have meant that greater numbers of people would have needed more than 30 qualifying years to entitle them to a full BSP, than under the current reform package. The Government determined that a cliff-edge implementation would reach the most people, most quickly and *'maximise the benefit, particularly for women'*.¹⁰

What is the revised amendment?
The amendment is likely to be proposed again during the Lord's Reporting stage of the Pensions

Bill in October 2008. The amendment will probably be altered to specify that people can buy back up to 9 years of NICs (if reaching SPA before April 2010) and up to 6 years of NICS (if reaching SPA after April 2010) from any point within their life, as long as they have contributed for 20 years.

The added threshold of 20 years is intended to prevent people who have only contributed for a few years in the UK, but now live overseas, from being the main beneficiaries of the amendment. The 20 year threshold also protects some married women from paying back dated NICs when they might receive more through the married women's rate of BSP (2/3 of a full BSP), and some single women who may be better off under pension credit than through buying back.

Would the amendment benefit women?

The amendment could be beneficial to women because of their different working patterns and caring responsibilities. Women may not realise the consequences that decisions to care could have for their pension entitlement. Because of the uncertainty in work and caring patterns, many women have difficulty planning within the 6 year time frame currently allowed for Class 3 NICs buy back.

The amendment would give people an opportunity to buy

back NICs whenever they choose, for example, when they are closer to retirement and more likely to be aware of their pension entitlement.

Could women on low incomes afford to buy back 6-9 yrs of NICs?

To pay 6 years of Class 3 NICs currently costs about £2,500¹¹ (the cost rises with price inflation) and might be difficult for women on low incomes to afford. Also, allowing people to buy back NICs towards the end of their lives could reduce their entitlement to pension credit, which could put them in a worse off position financially.

However, proponents for the amendment argue that women could take a loan from a charity when they reach SPA and pay off the loan in around 5 years from the added return on their pension.¹² Also, in some cases women born before October 1944 may be owed more in backdated pension payments than they would need to pay in Class 3 NICs and are eligible to receive a cheque from the government for the difference.

Who would benefit from the amendment?

The Government estimates that if the revised amendment was allowed, (assuming 15% take-up) then around 105,000 people would take up the option by 2020 with a little less than a third (around 30,000) being people who live overseas but have spent some time working in the UK.

The Government argues that it is likely that within the UK the revised amendment would mostly

benefit well-off people who could afford to buy back large periods of NICs. However, there is currently no data on the potential gender impact of the amendment or how it might affect different income groups.

How much would it cost?

The Government estimates that the cost of allowing the revised amendment (assuming a 15% take-up) would provide a net benefit from 2007 to 2009 and would then cost the exchequer £30—£55 million a year until 2030, after which the costs would taper off.¹³ However, current take-up of Class 3 NICs is around 5%, and proponents for the amendment argue that take up might be more in the range of 10%, incurring costs of £20—£35 million a year from 2010 to 2030.¹⁴

The Government feels that the cost of implementing the revised amendment would be too high considering the size of financial commitment already made in the pensions reform package and because the amendment may not reach its target group of women on low incomes.

Proponents for the amendment accept that allowing the amendment would have some cost implications for the exchequer. However, they argue that the costs would be minimal compared to the amount already spent on Class 3 NICs (£450 million in 2007)¹⁵ and the value of the National Insurance Fund,

which is often in surplus of amounts greater than the cost of the amendment.

The amendment and funding of National Insurance.

The Government feels that allowing the revised amendment would encourage people to delay making their NICs until they were about to retire and that this would create administrative and cost problems for the National Insurance Fund. They argue that *'time limits are an important feature of the "pay as you go" system of NICs, in that current payments of contributions pay for current claims to contributory benefits.'*¹⁶

The Government contends that Class 3 NICs are already quite generous. People are currently allowed to buy back NICs at about a quarter of the price of their actual value. A weekly Class 3 NIC is currently priced at £8.10 per week, and has a return of £28 a week¹⁷ (£45 after reform).

Conclusion

The Government has argued that the revised amendment would not target women on low incomes but would mostly benefit wealthy people and people who have moved overseas. They feel that the costs of introducing the amendment would be too high in the context of the financial commitment already made to improving pensions and considering that

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Costs of implementing the revised amendment

Costs of allowing people reaching SPA between 2008-2010 to pay Class 3 contributions for an additional nine years, and those reaching SPA after 2010 to pay class 3 contributions for an additional six years, provided that they already have at least 20 qualifying years (taking account of HRP), assuming 15 per cent take-up.

	Net costs less revenue, £ million in 2007-08 price terms					People taking up the option ('000s)		
	2010	2020	2030	2040	2050	Net Present Value - total cost by 2050	By end 2010	By end 2020
UK	20	25	20	10	0	240	50	80
Overseas	10	30	25	15	5	365	10	30
All	30	55	45	25	5	605	65	105

• Source: DWP data obtained from Lifetime Labour Market Database 2, 2005 release
• Table recreated from Lords Hansard, 28 April 2008, Column WA8

the amendment might only help a small portion of the women on low incomes that it is targeted at.

Supporters feel that the amendment would address the unfairness of the 'cliff-edge' by allowing women to buy back the 9 years that they will miss out on if they retire before April 2010; and will address further inequalities in retirement by allowing women to patch up their contribution records with the benefit of hindsight, once they are approaching SPA.

This note has highlighted the trade-off that the Government faces, between, on the one hand, helping more women on low incomes to receive a full BSP

and, on the other hand, incurring costs to the exchequer, possibly without being able to target the benefit at women on low incomes.

Proponents are still keen to push the amendment, however, and the trade-off may be further dealt with when the revised amendment is debated in the House of Lords in October 2008.

^{1,2} DWP (2006) *The Gender Impact of Pension reform*
³ Baroness Hollis, Lords Hansard, 4 June 2007, 4:30
⁴ DWP (2006) *Security in Retirement: Towards a New Pensions System*
⁵ Lords Hansard, 4 July 2007, Column 1048
⁶ Commons Hansard, 17 July 2007, Column 240
⁷ Lords Hansard, 4 July 2007, Column 1043
⁸ Commons Hansard, 17 July 2007, Column 240
^{9,10} Lord McKenzie, Lords Hansard, 4 June 2007, 3:07, 4:15
¹¹ www.hmrc.gov.uk/rates/nic.htm, 09/08
¹² Baroness Hollis, Lords Hansard, 30 Apr 2008, Column 311. A loan for 9 years of NICs is £3,790. Paying off at 7% interest in 4.6 years would provide an extra £2-4 a week, after which full extra return on pension would be £1,088 per year.
^{13,14} Lords Hansard, 28 April 2008, Column WA8
¹⁵ Baroness Hollis, Lords Hansard, 30 Apr 2008, Column 304
¹⁶ Lord McKenzie, Lords Hansard, 4 June 2007, 4:15
¹⁷ www.hmrc.gov.uk/rates/nic.htm, 09/08