

EXPLANATORY MEMORANDUM TO

THE SOCIAL SECURITY REVALUATION OF EARNINGS FACTORS ORDER 2012

2012 No. 187

and

THE SOCIAL SECURITY PENSIONS (LOW EARNINGS THRESHOLD) ORDER 2012

2012 No. 188

and

THE SOCIAL SECURITY PENSIONS (FLAT RATE ACCRUAL AMOUNT) ORDER 2012

2012. No 189

1. This explanatory memorandum has been prepared by The Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.

2. Purpose of the Instrument

2.1 The Social Security Revaluation of Earnings Factors Order ('the Revaluation Order') is made each year to revalue historic earnings factors in line with the movement in average earnings.

2.2 The Social Security Pensions (Low Earnings Threshold) Order ('the LET Order') is made each year to set the low earnings threshold for additional pension for the following year.

2.3 The Social Security Pensions (Revaluation of Flat Rate Accrual Amount) Order ("the FRAA Revaluation Order") provides for the flat rate accrual amount, a new statutory threshold for calculating additional state pension (formerly called the State Earnings Related Pension Scheme now the State Second Pension) entitlement, to be increased in line with the rise in national average earnings.

3. Matters of special interest to the Joint Committee on Statutory Instruments

None.

4. Legislative Context

4.1 When entitlement to additional state pension (SERPS/State Second Pension) is calculated the earnings on which it is based need to be revalued in line with earnings growth. The percentages set out in the Revaluation Order will be used for revaluing earnings factors for additional state pensions in tax years 2011/12 and earlier tax years.

4.2 The low earnings threshold was first used when State Second Pension was introduced in 2002. Section 148A of the Social Security Administration Act 1992 requires the Secretary of State to review each year the general level of earnings and to make an order increasing the low earnings threshold if he concludes that the general level of earnings has increased. This yearly LET Order is being made to effect the annual up-rating of the low earnings threshold for 2012/13.

4.3 The FRAA Revaluation Order is being made to set the value of the flat rate accrual amount on its introduction in 2012. SI 2011/2953 set the flat rate introduction year as the tax year beginning on 6 April 2012.

5. Territorial Extent and Application

These instruments apply to Great Britain. Equivalent provision in relation to Northern Ireland will be made by statutory rule.

6. European Convention on Human Rights

As these instruments are subject to negative resolution procedure and do not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

The Revaluation of Earnings Factors Order

7.1 Earnings factors are the formulae for converting flat-rate and earnings-related National Insurance contributions into entitlement to flat rate and earnings-related benefits, and for calculating earnings-related entitlement over a person's working life. They are derived from earnings upon which primary Class 1 contributions are paid, or treated as paid, and from Class 2 and Class 3 contributions paid¹. For years from 2002/03 onwards additional pension accrues on primary Class 1 contributions only. Carers and disabled people entitled to certain benefits are treated as having an earnings factor for these purposes.

7.2 Each year the earnings factors derived in each previous year since the additional state pension was introduced in 1978/79 are revalued in line with the movement in average earnings. This annual revaluation exercise allows earnings factors derived from historic earnings to be restated at current values as part of the calculation of new pensioners' entitlement to additional pension under both the State Earnings-Related Pension Scheme (SERPS) and the State Second Pension. Earnings factors are also used to calculate the Guaranteed Minimum Pension for early leavers and retired persons in contracted-out salary-related pension schemes.

7.3 Revaluations have been calculated by reference to the change in earnings over the period of 12 months from September-September. This allows sufficient time for the resulting Order to be made before the beginning of the tax year in which it is to apply.

7.4 During the period between September 2010 and September 2011, the Office for National Statistics' Average Weekly Earnings statistic September year-on-year change (non-seasonally adjusted, including bonuses)² showed that average earnings in Great Britain increased by 1.8 %.

7.5 The Revaluation Order therefore provides for earnings factors for 2011/12 to be increased and for earnings factors for earlier tax years to also be increased by percentages which reflect, in addition, the increases provided for by previous Orders. The Order also makes provision for the rounding of earnings

¹ Class 1 National Insurance contributions are paid by employed earners. Class 2 are paid by the Self-employed. Class 3 National Insurance contributions are usually voluntary contributions to make up gaps in a persons National Insurance contributions record.

² See table 6 NSAsect monthly growth ibia in EARN02: Average weekly earnings by sector at <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/november-2011/index-of-data-tables.html#tab-Earnings-tables>

factors to the nearest whole pound for the purpose of calculating the additional pension element of any long-term benefit.

The Low Earnings Threshold Order

7.6 The State Earnings-Related Pension Scheme (SERPS) was reformed with the introduction of the State Second Pension from 6 April 2002. An important aim of the reform was that additional resources should be targeted on low earners. Additionally, carers and some long-term disabled people unable to maintain a full work record due to their caring responsibilities and disabilities could build additional pension entitlement for the first time.

7.7 Employees with earnings between the annual National Insurance lower earnings limit and the low earnings threshold are treated for additional pension purposes as having earned at this higher level.

7.8 The lower earnings limit (LEL) is the level at which a person's earnings become relevant for National Insurance purposes.

7.9 Also, the following groups are treated as if they had earnings at the low earnings threshold (LET) for State Second Pension purposes:

- Qualifying carers.
- Qualifying disabled people.

7.10 The LET is £14,400 for the 2011/12 tax year. Each year the Secretary of State is obliged to review the level of average earnings and, where he sees fit, set the LET for the following year accordingly by Order.

7.11 The Office for National Statistics' Average Weekly Earnings statistic September year-on-year change (non-seasonally adjusted, including bonuses) showed that average earnings over the period 1 October 2010 to 30 September 2011 is 1.8%. This means that, with rounding, the threshold is increased to £14,700 for 2012/13. The level of this threshold is set by the LET Order.

The FRAA Revaluation Order

7.12 Since 2002 the earnings-related part of the state pension - the additional state pension - effectively builds up at a flat rate for employees with annual earnings below the low earnings threshold. The low earnings threshold is set at around half median earnings and is £14,400 in 2011/12. It is increased annually in line with average earnings. People with earnings below the threshold, carers and people with long term health conditions are credited with earnings at this level for the purposes of calculating their entitlement to the additional State Pension. For people with earnings above this level entitlement is based on the level of their earnings. So, when calculating a person's entitlement earnings are split into two bands i.e. earnings at or above the low earnings threshold.

7.13 When calculating additional state pension entitlement there are two further factors that make it difficult to determine a person's future entitlement. The first is the fact that there is no fixed period over which entitlement can build up. Entitlement is based on the number of years in a person's working life since 1978 so differs for each successive group of pensioners. Secondly, entitlement builds up at different rates depending on the period covered and, since 2002, the amount a person earns. Earnings in the first band build up at four times the rate of earnings in the second band - 40 and 10 per cent respectively.

7.14 Measures introduced in the Pensions Act 2007 to reform the state pension system sought to replace entitlement in the first earnings band with a single cash amount, the flat rate accrual amount. This was intended to fix the pension accrued by those with earnings in that band making it easier for a person to determine their future state pension entitlement.

7.15 The flat rate accrual amount will be introduced from the start of the 2012/13 tax year. The annual flat rate accrual amount is set at £72.80 based on earnings in 2004/2005. Under existing legislation³ the Secretary of State is required to set the rate on introduction by reference to changes in average earnings since 2004/2005. To ensure consistency the flat rate accrual amount will be revalued in line with historic earnings indices used for other additional State Pension purposes such as revaluation of the low earnings threshold.

7.16 The earnings measure used is, prior to 2011, the Office for National Statistics September year on year change in the whole economy Average Earnings Index and thereafter the Average Weekly Earnings statistic. The increase in average earnings between October 2004 and September 2011 as measured by these indices is 21.9%. Therefore, with rounding the annual flat rate accrual amount is £88.40 for 2012/13.

7.17 The Department estimates that around 23 million people building additional state pension entitlement in 2009/10 - the latest year for which figures are available, will potentially benefit from the changes in this Order. Of these some 4 million were credited with earnings as a result of caring or ill-health⁴.

Consolidation

7.18 As these instruments do not amend other instruments, and in the case of the FRAA Revaluation Order this is the first time the flat rate accrual amount is being revalued, the question of consolidation does not arise.

8. Consultation

8.1 Consultation on the annual Revaluation Order and the LET Order is not appropriate.

8.2 The changes in the FRAA Revaluation Order formed part of the State Second Pension simplification measures outlined in the White Paper, 'Security in retirement: towards a new pensions system' (Cm 6841) on the Government's proposals for pensions reform. The consultation ran from 25 May 2006 to 11 September 2006. A summary of responses to the consultation was published in October 2006 and those (less than 1%) that commented on the simplification proposals were broadly in favour of reform. However, there was some concern expressed that the pace and extent of the changes was insufficient. Copies of the papers can be found on the Department's website at <http://www.dwp.gov.uk/policy/pensions%2Dreform/background%2Dto%2Dreform/>. There was a brief debate on the measure during passage of the Pensions Act 2007 see: <http://www.publications.parliament.uk/pa/cm200607/cmpublic/pensions/070130/pm/70130s01.htm>

8.3 Also, an overview of the changes was provided in the House of Commons Library Research Paper 07/05 which can be found at <http://www.parliament.uk/commons/lib/research/rp2007/RP07-005.pdf>.

9. Guidance

³ Section 148AA(3) to (6) of the Social Security Administration Act 1992

⁴ DWP, Second Tier Pension Provision tabulation tool, <http://83.244.183.180/NIRS/live/tabtool.html>

Leaflets and guidance will be up-dated to reflect the new figures as part of the yearly leaflet review covering the annual uprating in April. The figures will also be published on the Department for Work and Pensions website.

10. Impact

10.1 These instruments have no new impact on the costs of business and civil society organisations.

10.2 The impact on the public sector is negligible.

10.3 A full impact assessment has not been prepared for these instruments.

11. Regulating small business

These instruments have no new impact on the costs of small business.

12. Monitoring and review

The position is subject to review each tax year.

13. Contact

Dave Annison at the Department for Work and Pensions Tel: 020 7449 7145 or e-mail: dave.annison@dwp.gsi.gov.uk can answer any queries regarding these instruments.