EXPLANATORY MEMORANDUM TO

THE SOCIAL SECURITY (REDUCED RATES OF CLASS 1 CONTRIBUTIONS, REBATES AND MINIMUM CONTRIBUTIONS) ORDER 2011

2011 No. 1036

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

This instrument sets the revised rebate rates for National Insurance contributions which will apply in respect of members of contracted-out occupational pension schemes from April 2012. Specifically:

the percentage reduction in primary and secondary Class 1 contributions[1] applicable to members of salary related contracted-out schemes (defined benefit schemes);

the flat-rate percentage reduction in primary and secondary Class 1 contributions and the appropriate age-related percentages which apply in respect of members of money purchase contracted-out schemes (defined contribution schemes); and

the appropriate age-related percentages which apply in respect of members of appropriate personal pension schemes.

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

This instrument contains figures to enable the calculation of rebates for members of defined contribution contracted-out schemes for the tax year 2012-13. However, it is planned to abolish contracting-out on a defined contributions basis from 6 April 2012. When the enabling legislation for abolition (section 15(1) of the Pensions Act 2007 and provisions in primary and secondary legislation which make consequential amendments) is brought into force, sections 42B and 45A of the Pension Schemes Act 1993 will be repealed. However, until that date, the requirement under sections 42B and 45A of the Pension Schemes Act 1993 that defined contribution rebates are reviewed every five years remains. But because these figures are not expected to be used, they are only provided for one tax year. This is explained at paragraph 7.2.

4. Legislative Context

[1] National Insurance contributions are amounts paid by employed earners (primary) and employers (secondary) into the National Insurance Fund to support the payment of contributory benefits.

4.1 The Pension Schemes Act 1993 provides for individuals who are contracted out of the additional state pension into either an occupational or a personal pension scheme to pay reduced rates of National Insurance contributions and/or to receive an age-related rebate payment (paid directly into their pension scheme) from HM Revenue and Customs. The sponsoring employer of a contracted-out occupational scheme will also pay reduced rate National Insurance contributions in respect of his employees who join the scheme.

4.2 The Act requires the Secretary of State to review the level of contracting-out rebate rates and the percentage reduction in National Insurance contributions at intervals of not more than five years. The current rebate percentages are set out in The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions Order 2006 (SI 2006/1009).

4.3 The review process involves the Government Actuary providing a report to the Government on any changes since the preparation of the last report in 2006[2] on the factors that affect the cost of providing benefits of an actuarial value equivalent to the state benefits given up. The new rebate rates are set out in the Order which is laid before Parliament along with a report by the Government Actuary on the percentages which, in his opinion, are required to reflect the cost of the benefits foregone by contracting out of the additional state pension; and a report by the Secretary of State stating what those percentages should be.

4.4 The legislation requires that the Order should be made more than a full tax year before it comes into force on 6 April 2012.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Minister for Pensions has made the following statement regarding Human Rights: 'In my view the provisions of The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2011 are compatible with the Convention Rights'.

7. Policy background

- ***What is being done and why***

7.1 Individuals may contract out through membership of a Contracted-out Salary Related Scheme (COSRs), a Contracted-out Money Purchase Scheme (COMPs), or an Appropriate Personal Pension (APPs).

[2] http://www.gad.gov.uk/services/Pensions_Policy_and_Regulation/Contracted-out_rebates.html

7.2 Enabling legislation provides for the abolition of contracting-out on a defined contribution basis and it is planned to bring this into force from 6 April 2012. However, in spite of the abolition of contracting-out for defined contribution arrangements in 2012, the Government Actuary has provided rates which should apply to members of these pension schemes in 2012/13. This is to meet a statutory requirement which has not yet been repealed – there is no intention to use these rates. The primary focus of the 2011 review is therefore on the contracted-out rebate for those contracted-out on a salary related (defined benefit) basis.

Contracted-out Salary Related Schemes (COSRs),

7.3 This instrument allows for the reduction of Class 1 National Insurance contributions payable in respect of members of COSRs. Both the employer and employee pay reduced rates of National Insurance contributions. A single contracted-out rebate percentage is applied in respect of all members of COSRs.

7.4 For the tax years from 2012 to 2017, the Government proposes that the rebate for defined benefit schemes should decrease from the current 5.3% to 4.8%, which is at the lowest point of the Government Actuary's range of estimates. The Government estimates that the annual savings to the Exchequer from reducing the rebate rate to 4.8% to be around £600 million.

7.5 This Order provides that the new rebate of 4.8% will be split: 3.4% for employers (secondary Class 1 contributions), 1.4% for employees (primary Class 1 contributions).

Contracted Out Money Purchase Schemes (COMPs)

7.6 This instrument will allow for reduced rates of National Insurance to be paid, in respect of members of COMPs, by both the employer and the employee. Age related rebate payments are also made to the pension scheme by HM Revenue and Customs.

7.7 The Order specifies a new flat-rate percentage and new age-related percentages for the tax year 2012/2013. The new age-related percentages are set out in the table in Schedule 1 to the Order. As mentioned in paragraph 7.2 there is no intention to use these rates.

Appropriate Personal Pension Schemes (APPs)

7.8 Where an earner is a member of an APPs, HM Revenue and Customs shall pay minimum contributions to the trustees or managers of the scheme in respect of the member. The primary legislation provides for the amount of those contributions to be an amount equal to the 'appropriate age-related percentage' of so much of the member's earnings as exceeds the current lower earnings limit[3] but not the upper accrual point[4].

[3] For 2010-11 the lower earnings limit (LEL) is set at £5,055 per year
[4] For 2010-11 the upper accrual point (UAP) is set at £40,040 per year

7.9 This Order provides for the new age–related percentages for the tax year 2012/2013, as set out in the table in Schedule 2 to the Order. As previously mentioned in there is no intention to use these rates.

- ***Consolidation***

7.10 The Order replaces the previous Rebate Order (SI 2006/1009) made in 2006, which will cease to have effect at the end of the 2011/2012 tax year. There is therefore no need for consolidation.

8. Consultation outcome

8.1 The Government Actuary consulted on the rebate levels that, in his opinion, reflect the value of benefits foregone by contracting–out of the state second pension. The consultation set out three approaches for calculating the value of the rebate, based on three sets of assumptions: a best estimate' basis; a 'typical funding' basis; and a 'gilts' basis. The purpose of this approach was to allow the Secretary of State to take a decision on the appropriate rebate with a good understanding of the range of possible values which might be adopted.

8.2 A consultation document was issued on 23 August 2010 and closed on 15 November 2010. Twelve responses were received to the consultation. In the main, responses were received from actuaries and pension consultants. The full report, including the key points made in response to each of the consultation questions and the Government Actuary's suggested range of estimates for setting the rebate levels is laid alongside the Order.

8.3 The Secretary of State set the rebate percentages after giving due consideration to the Government Actuary's advice. The main relevant changes affecting the cost of providing benefits contracted-out on a defined benefit basis since the previous review are:

the profile of members of private sector contracted-out salary related schemes is changing as a result of continuing defined benefit scheme closures to new entrants and new accruals;

expectations of members' longevity continue to rise;

state pension age has been raised for many people, which reduces the amount of additional pension forgone by contracted-out members each year, and means that it is deducted later;

economic conditions are noticeably different, with possible implications for expected future investment returns and inflation;

state second pension will be increased in payment in line with the Consumer Prices Index rather than the Retail Prices Index. In general, this is expected to lead to smaller pension increases, which reduces the value of the second state pension, and hence leads to smaller rebates;.

the operation of the Pension Protection Fund and the employer debt regulations is now clearer;

a new funding regime for defined benefit schemes is now fully in place (deriving from the Pensions Act 2004).

9. Guidance

9.1 HM Revenue and Customs publish details of rates and allowances of National Insurance contributions on their website.

10. Impact

10.1 There is no new impact of the changes to the contracted-out rebate rate. However, the reduction in the rebate rate will lead to a small increase in the National Insurance contributions of public sector employers and employees. The value of the increase will depend on individual employee earnings.

10.2 A full impact assessment has not been published for this instrument as it has no new impact on the private sector and civil society organisations.

11. Regulating small business

11.1 The legislation applies to small business, but has no new impact on them.

12. Monitoring & review

12.1 The rebates rates will be reviewed in 2017.

13. Contact

Nicola Lloyd at the Department for Work and Pensions can answer any queries regarding this instrument, tel: 0207 449 7276 or email: Nicola.lloyd@dwp.gsi.gov.uk.