A Single State Pension

LGPS employers caught in the middle

The Department for Work and Pensions (DWP) has published its promised (overdue) White Paper on State pension reform. The current basic and additional State pensions will be replaced with a single-tier pension (StP) at some point during the next Parliament (i.e. following the general election), but not before ‘April 2017 at the earliest.’ The proposals would mean the end of contracted-out National Insurance. Without major changes in some form, this will increase LGPS employers’ costs by at least £0.5 billion per year.

The potential added costs arise because LGPS employers including local authorities, academies, contractors and others will pay higher National Insurance (NI) contributions. This is due to the ending of contracting-out, a key element of the reforms relating to State pensions. The increase for employers is 3.4% of relevant earnings.

Employees in the LGPS would also see their NI contributions increase, by 1.4% of relevant earnings. The increased NI contributions from employer and employee are required due to the increase in LGPS members’ State Pension, from the current Basic level to the higher StP, payable in addition to LGPS pension entitlement. As things stand, for those with salaries up to £15-20k and a full career pension in LGPS 2014, total income at retirement including the new StP will be greater than pay immediately before retirement (“replacement ratios” greater than 100%). This is poor design.

In the LGPS there may be concern that the reduction in employees' take home pay arising from higher NI contributions could result in more members opting out.

Further details of StP and the end of contracting out are given at the end of this note.

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We can see a number of ways, in theory, in which this issue could be handled. However, most of these solutions are impracticable and most come with flaws.
Solution 1: Reduce members’ LGPS benefits to offset the increase in State pension?
This could involve reducing future service benefits, employer contributions and (in theory but unlikely) employee contributions when the StP is introduced from 2017. The reduction in benefits could be achieved by, for example, an across the board reduction in the post-2014 1/49th accrual rate, or a change in the definition of pensionable pay so that no benefits are earned on earnings below a threshold. To give an idea of scale, this might involve a reduction in accrual rate from 1/49th to about 1/60th.

Lower LGPS benefits would reduce the cost to compensate for the increase in NI contributions. This route is open to private sector employers in a similar position. Indeed, the Government proposes one-off changes to allow private sector employers to more easily amend their scheme rules for this particular issue.

Problems: This solution is not legally possible for employers in the LGPS; it would need government legislation to amend Scheme benefits or member contributions.

It is unfortunate that imminent reform of the State Pension was not woven into the reform process which has taken place over the past year or two. The StP has been trailed for a long time and was mentioned in Lord Hutton’s final report, so this should have been taken into account during the reform negotiations.

Ministers have committed to maintaining the agreed LGPS for at least twenty-five years (what the Public Service Pensions Bill actually says is that any proposal to change the ‘protected elements’ of the schemes—their CARE nature, member contribution rates, and accrual rates—before 1 April 2040 must result in consultation ‘with a view to reaching agreement’).

As a result, public sector employers have no scope to offset their increased NI costs unless amendments are made to both this White Paper and the proposed benefit regulations; this would need to happen either now, or before 2017-18 when the increase in NI contributions and changes to State pension are expected to be implemented. Of course any delay now in finalising benefit regulations might jeopardise the timetable (already challenging) for implementation of LGPS 2014.

It might make better sense to proceed with LGPS 2014 as proposed and make further changes to the LGPS in 2016-17 in time for the introduction of StP and increases in NI from 2017-18. The downside would be another headache for administering authorities and potential confusion among members.

From a member’s point of view, this approach would still leave them with a 1.4% increase in NI contributions; unless compensating reductions in LGPS member contributions were also introduced, this would lead to reduced take-home pay. If the LGPS benefit reductions broadly match the increase in State benefits, there would be no increase to total benefits in retirement. However, this is the same as the outcome for a member of a private sector “contracted out” defined benefit scheme where the employer will be allowed to reduce scheme benefits to reflect the increase in State benefits for its scheme members. The reality is more complex: the State Pension changes for a given member will be more or less valuable than the increase in that member’s NI contributions; this means that any “across the board” LGPS benefit amendment is likely to be a fairly blunt instrument to tackle this issue from a member’s perspective.

The 50/50 option
Interestingly, the benefits under the 50/50 option combined with the improved State pension could still provide perfectly decent replacement ratios for many members on lower earnings. The reduction in take home pay as a result of member NI contributions could make this an attractive option for many, as the 50/50 option results in reduced LGPS member contributions. This would suit employers too since higher uptake of the 50/50 option reduces their pension costs.
Solution 2: Extra funding from government to local authorities to compensate for the NI increase?
This may be the preferred option for local authority employers; it has logic to the extent that the increase in employer cost arises from government action.

Problems: HMT is reported to have stated that extra funding would be a matter for future spending reviews and local government settlement negotiations. In other words, the government has made no commitment to compensating local authority employers for their increased costs. With austerity measures continuing, is it really likely that the government would take away with one hand and give back the full amount with the other? Even if it did, this solution would not work for non-local authority employers in the LGPS including academies, contractors and others.

(Whether or not the government does compensate employers for the increase in NI, there may be an impact on future outsourcing costs: contractors’ NI contributions will increase and they will want to pass this back to local authorities.)

This solution would also do nothing to address the issue of post-retirement income in excess of pre-retirement income (replacement ratios in excess of 100% for those on salaries up to £15-20k or so).

Implications of doing nothing?
Employers would bear the added cost. This would be the worst case scenario for employers. It could easily have been avoided if some joined-up thinking had been undertaken at the outset of the reform process. Hutton, the actuarial advisers and others had warned the government of this situation in advance.

In summary, the consequences of doing nothing include:

- LGPS employers pay more in NI contributions. The additional cost as a result of abolishing NI rebates is significant (3.4% of relevant earnings). This increase will wipe out expected savings in employer future service costs when LGPS 2014 is introduced (circa 1.5% of pay on average).
- Employees in the LGPS pay more in NI contributions (1.4% of relevant earnings). Outcomes might include an increase in opt-outs and/or higher uptake of the 50/50 option which would help reduce employer costs.
- Lower salaried employees (e.g. those earning less than about £15-20k p.a.) could end up with a pension from the LGPS and StP combined which exceeds their salary while working. This is bad design.
- In future the cost to local authorities of outsourcing could increase as contractors participating in the LGPS pass their higher NI costs back to local authorities via contract pricing.

We include further background on the StP and Contracting Out on the final page of this briefing note.
Single-tier pension (StP)
At present, UK employees earn entitlement to a Basic State Pension (BSP) and an earnings-related State Second Pension (S2P). The proposal is that these should be combined and replaced by a new Single-tier Pension (StP). The StP will be set above the basic level of means-tested support at the time of implementation—£142.70 per week currently—and increased at least in line with average earnings. Aims of StP are to remove the need for significant means testing of additional state pension benefits, to direct more of the state benefit spend towards the lower paid (mainly women) and to provide more certainty to savers that their occupational or private pension savings will not erode their State benefit entitlement.

There are many other technical aspects to the proposals which we do not cover here; details are provided in our 60 Second News Summary on the topic: http://www.hymans.co.uk/media/150918/1301_state_pension_60sns.pdf

Contracting Out
In the current system, it is possible to “contract out” of S2P, if there is at least equivalent pension being provided from a workplace pension. In return for contracting out, the employer and employee both pay reduced NI contributions. The amount of NI reduction is referred to as the “contracting out rebate”. At the present time, this is based on relevant earnings between a lower earnings limit (around £5,500 currently) and upper accrual point (around £40,000 currently) at the rate of 3.4 per cent for employers and 1.4 per cent for employees.

The proposed StP will call time on contracting out. Active members of contracted-out public and private sector pension schemes (including the LGPS) and their employers will in future pay full-rate NI contributions. In return for this, members will receive higher State pensions than the present Basic State Pension. This implies an increase in NI contributions for employees and employers broadly equivalent to the contracting out rebates both currently receive. It is this increase in NI contributions which will be an extra burden on LGPS employers if nothing else changes.

Number crunching

1.5% = saving on LGPS employers’ payroll as a result of much trumpeted pension reforms

2.0% = added LGPS employers’ payroll costs (conservative estimate) as a result of the State Pension changes, quietly alluded to in the proposals document: section 3, page 41, paragraph 71