PENSIONS POLICY INSTITUTE PPI

The impact of the abolition of contracting-out

The impact of the Government's single-tier state pension reform is a research project funded by the Nuffield Foundation

The PPI is publishing a series of briefings to provide a detailed, comprehensive and independent analysis of the impact of introducing the single-tier state pension.

The first briefing (June 2013) described the main components of the Government's state reform plans and an initial analysis of the possible impact of the reforms on individuals. The second and third briefings (both published in October 2013) considered the management of the transition from the current system to the new single-tier pension and the potential impact of a switch away from the triple-lock back to uprating by earnings.

Other analysis will cover issues such as:

- Changes to the State Pension Age.
- Government cost, spending and long-term retirement income implications.

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This briefing considers the impact of the abolition of contracting-out on Defined Benefit pension schemes, employers and members.

The Government's proposals

The Pensions Bill proposes to implement a new single-tier state pension from April 2016 that will replace the current Basic State Pension (BSP) and the State Second Pension (S2P). The White Paper[1] illustrates the new pension as being set just above the current Guarantee Credit level, at £144 per week (in 2012/13 prices), although the actual level will not be set out in primary legislation, but will be announced by the Government of the day closer to the implementation date of April 2016. The changes will not apply to people who are over State Pension Age (SPA) in April 2016, including those people who reach SPA between now and then. The single-tier pension will lead to the end of new accruals of S2P and consequently contracting-out from S2P.

Background

Since the introduction of SERPS (the State Earnings-Related Pension Scheme) in 1978, the forerunner to the S2P, it has been possible to contract out of the additional pension part of the UK's state pension system. Where employees are contracted-out, both employees and their employers pay lower National Insurance (NI) contributions (by receiving a rebate on their contributions) on the condition that the pension scheme provides pensions broadly in line with, or better than, the future state benefits that the individual is giving up from contracting-out.[2] In 2013/14 this rebate meant that employees paid NI contributions at a rate of 10.6% instead of 12%, while employers paid NI contributions at a rate of 10.4% instead of 13.8% up to the Upper Accrual Point (UAP) of £40,040 (employers paid NI contributions at a rate of 13.8% on earnings over the UAP).

In turn, employees who have been contracted-out no longer qualify for SERPS or, from 2002, for S2P. Until recently, it was possible for members of Defined Contribution (DC) and personal pensions to contract out. This was abolished in April 2012 to simplify the system, leaving only Defined Benefit (DB) schemes with the option to contract out of S2P.

While the number of DB schemes in the private sector has declined, the majority of schemes that are still open to members are contracted-out and will be affected by the abolition of contracting-out in April 2016. In 2012, 25% of private sector pension schemes with only one section were DB.[3] However, in 2013, only 14% of DB pensions were open to new members.[4] Research conducted by the National Association of Pension Funds (NAPF) found that in 2013 almost 90% of those DB schemes either open to new members or future accrual were still contracted-out.[5] In 2012 there

Chart 1: Contracting-in will increase employees' National Insurance contributions for lower earners proportionately more than higher earners

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	Employee's monthly National Insurance contributions			
Annual salary	Contracted-out	Contracted-in	£ difference	% difference
£20,000	£106	£123	£17	16%
£30,000	£194	£222	£28	14%
£40,000	£282	£322	£40	14%
£80,000	£361	£401	£40	11%

Based on 2013/14 rates of National Insurance contributions were 1.7 million active members of 6,010 private sector DB schemes that were either open to new members or closed to new members but open to future accruals from existing members. The majority of these schemes and members will be affected by the abolition of contracting-out. 5.1 million public sector workers who are active members of contracted-out DB pension schemes will also be affected.[6]

Chart 2: Contracting-in will increase employers' National Insurance contributions for lower earners proportionately more than higher earners

	Employer's monthly National Insurance contributions			
Annual salary	Contracted-out	Contracted-in	£ difference	% difference
£20,000	£101	£142	£41	41%
£30,000	£188	£257	£69	36%
£40,000	£274	£372	£98	36%
£80,000	£734	£832	£98	13%

Based on 2013/14 rates of National Insurance contributions

Government savings

The Government estimates that it will collect around £5 billion a year in extra revenues from 2016 onwards due to the abolition of contracting-out.[7] Some of this has been earmarked to fund a cap on long-term care costs, which is estimated to cost £1 billion a year from 2016 onwards. However, the long-term care cap is also being funded by the extension of the freeze of the Inheritance Tax threshold.[8]

Implications for employees who have been contracted-out: NI contributions

Chart 1 shows the impact of the abolition of contracting-out on the NI contributions paid by employees at different salary levels (at 2013/14 NI contribution rates). While NI contributions would increase for employees at all salary levels, the proportional effect will be greater for employees at lower salary levels. This is because the contracting-out rebate only applies on earnings up to the UAP, around £40,000 per year. Beyond this point, employees pay NI contributions at a rate of 2% regardless of whether they are contracted-out. Therefore, the contracting-out rebate is worth less, as a proportion of their salary, for employees with salaries over £40,000 and the relative effect of the abolition of contracting-out is lower for them.

Chart 2 shows the impact of the abolition of contracting-out on the NI contributions paid by employers for employees at different salary levels (at 2013/14 NI contribution rates). Again, while employers' NI contributions would increase for employees at all salary levels, the proportional effect will be greater for those employees at lower salary levels.

While some employers may choose to leave their DB scheme unchanged and pay these additional NI contributions, others may look to offset these by increasing employees' contributions or reducing employees' benefits, particularly as the majority of those employees are expected to benefit from a higher state pension under the single-tier pension. The DWP estimates that 90% of those people who reach SPA in the two decades following the introduction of the single-tier state pension will receive enough extra state pension over their retirement to offset their increased NI contributions and any changes to their occupational pension.[9]

Impact on the amount of single-tier pension received

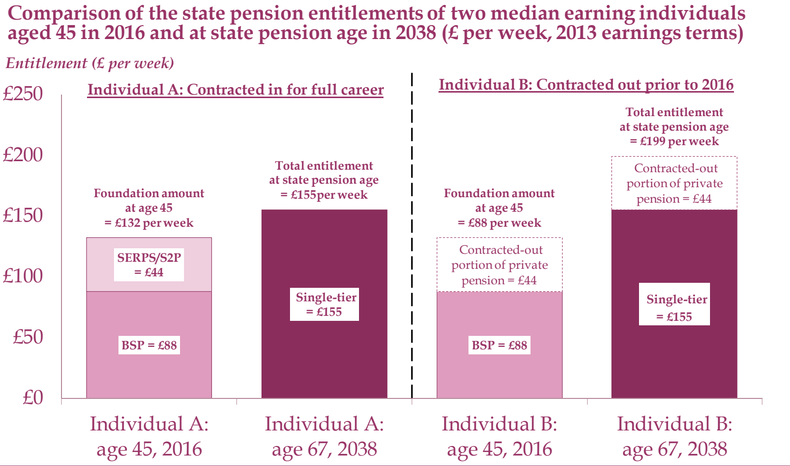
Under the single-tier pension people who have been contracted-out of SERPS and S2P will be treated as having built up less state pension rights than similar individuals who have not contracted-out. As part of their 'state' pension will be delivered through a private pension scheme, an equivalent value will be calculated and deducted from their 'foundation' amount at the time the single-tier is introduced. This means that an individual who has been contracted-out will have a lower foundation amount than an identical individual who has not been contracted-out.

If these individuals are close to retirement, then the contracted-out individual is likely to receive a lower single-tier pension than the individual who has not contracted-out. However, if these individuals are younger and have a number of years still to go to retirement, the contracted-out individual is likely to receive a similar or equivalent single-tier pension at SPA to the individual who has not contracted-out. This is because the individual with the lower 'foundation amount' can continue to build up new entitlement to the single-tier up to a maximum of 35 years whilst still receiving their contracted-out SERPs/S2P, built up before April 2016, through their private pension. They are therefore getting a greater return on their NI contributions than the individual who has not contracted-out.

Chart 3 illustrates this, using the example of two median earning individuals, aged 45 in 2016, who started to build up entitlement to the state pension from the age of 21. These individuals have identical earnings histories, but one has contracted-out of SERPS/S2P for their entire working life, while the other has remained contracted-in.

Based on their 24 years of contributions, both have built up higher entitlement at age 45 under the current system in 2016 than if the single-tier pension had been in place, so this becomes their foundation amount. However, the contracted-out individual has a lower foundation amount, reflecting the fact that he or she paid lower NI contributions and so part of this 'state' pension is being provided through his or her private pension.

Chart 3: Individuals that have contracted-out in the past may be able to build up more entitlement than those that have not



By the time the individuals reach SPA, both have enough qualifying years on top of their foundation amounts to reach the full single-tier pension level. However, the contracted-out individual will still receive the contracted-out private pension, equivalent to the SERPS/S2P that he or she would have built up before 2016 if he or she had been contracted-in. The contracted-in individual does not receive this, as it was included as part of his or her foundation amount.

Impact on Defined Benefit pension schemes

There has been discussion around the impact of the abolition of contracting-out on DB schemes, with the pensions industry expressing concerns around the increased costs and administration burdens to employers. While it is difficult at this stage to estimate the potential impact on DB scheme closures it is possible to make some relevant observations.

The Pensions Bill gives employers the power, through a statutory override, to amend their DB schemes rules subsequent to the abolition of contracting-out, without obtaining trustee consent. However, employers must not increase employee contributions, or reduce employees benefits, by a greater value than the amount of their lost National Insurance rebate. In addition, the statutory override will not apply to public service pension schemes, such as the NHS Pension Scheme, Teachers' Pension Scheme, the Local Government Pension Scheme and Civil Service Pension Scheme. This is because during the recent process of reform of public sector pension schemes the Government gave a commitment to Parliament that these reforms should endure for 25 years. This means that, in practice, public sector workers will pay higher NI contributions and receive the new single-tier state pension while still receiving the same DB pension from their employer. In contrast, DB private sector pensions are likely to change following the abolition of contracting-out.

Some former nationalised industries, such as those in the utilities and energy sectors, are limited in their ability to change scheme rules by legislation introduced at the time of privatisation. This legislation is known as the 'Protected Persons Regulations'. At the time of privatisation a guarantee was made to employees that their pension rights would be no less favourable than the relevant pension rights that they had before their industry was privatised. In February 2014 the Minister for Pensions announced the DWP's proposal that these industries should not be covered by the statutory override.[10] In practice this would mean that these employers would have to meet the costs of extra employers' NI contributions because of the introduction of the new single-tier state pension and the abolition of contracting-out, unless a change to the scheme can be negotiated with trustees and members.

Early research conducted by the NAPF indicated that 60% of the schemes who took part in their survey had not yet held discussions about the abolition of contracting-out while 7% said that the sponsoring employer is likely to use the statutory override.[11] The statutory override given to employers to amend their scheme rules without trustee consent means that employers should be able to offset a large proportion of extra costs by increasing employees' contributions or reducing employees' benefits. However, with the Pensions Bill still being debated in Parliament, and with an implementation date of April 2016, employers have only limited time to consult and make changes to their schemes.

It could be argued that there is a valid reason for private sector employers amending their DB schemes in this way, as many employees are expected to benefit from building up rights to a higher single-tier pension in future. However, the cost and administrative burden to employers of restructuring their DB schemes is likely to be significant as, even with the statutory override in place, actuarial advice and consultation with trustees and members will still be required. There is a concern that, as employers are required to go through this process of consultation, they may take the opportunity to close down their DB schemes entirely.

The Government has recently consulted about Defined Ambition pensions, a type of risk-sharing arrangement that strikes a balance between DB and DC pension schemes. The consultation has proposed to allow some easements to DB pensions that will make it more attractive for employers to continue to sponsor DB pension schemes, by allowing greater flexibility over the benefits that they provide or reducing the risks of the costs increasing in future.[12]

The abolition of contracting-out and associated regulations ends the requirement for DB schemes to provide spouse's benefits. The Government is building on this development by consulting on removing the requirement to index-link pensions in payment. The Defined Ambition paper also proposes making it easier for schemes to change their normal pension age in line with changes in life expectancy. It is possible that, if implemented, these easements could provide some of the leeway needed for employers to keep their DB schemes open when the contracted-out rebate is abolished.

There is also a concern around public service pensions, particularly the funded Local Government Pension Scheme used by organisations such as local councils and their contractors. As the statutory override is not available to these employers, they will be unable to offset the costs of extra NI contributions unless HM Treasury chooses to compensate them for these extra costs in the next Spending Review. However, if HM Treasury does not compensate local authorities, the planned increases to the SPA announced in the Chancellor's Autumn Statement (to which public sector pension ages are now automatically linked), may go some way to offsetting some of these extra costs.[13]

Conclusion

The abolition of contracting-out has implications for both employees who are members of contracted-out DB schemes and their employers. While employees' NI contributions will increase many will be able to build up new entitlement to the single-tier pension from April 2016.

The power given to employers to amend their occupational schemes without trustee consent means that employers should be able to offset a large proportion of their extra costs by increasing employees' contributions or reducing their benefits. However, the cost and administrative burden to employers of doing so may encourage them to consider making more radical changes, including closing their DB schemes altogether.

1 *Pensions Bill 2013/14* http://services.parliament.uk/bills/2013-14/pensions.html
2 House of Commons Library (2011) *Contracting-out of the State Second Pension*
3 DWP (2013) *Occupational pension scheme survey 2012*
4 The Pensions Regulator (2013) *The Purple Book*
5 NAPF (2013) *Annual survey 2013*
6 DWP (2013) *Occupational pension scheme survey 2012*
7 DWP (2013) *Single-Tier Impact Assessment*
8 https://gov.uk/government/news/landmark-reform-to-help-elderly-with-care-costs
9 DWP (2013) *The single-tier pension: a simple foundation for saving*
10 *WMS 15: DWP - Workplace Pensions*, published 12 February 2014
11 NAPF (2013) *Annual Survey 2013*
12 DWP (2013) *Reshaping workplace pensions for future generations*
13 https://www.gov.uk/government/speeches/chancellor-george-osbornes-autumn-statement-2013-speech

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