The Future of the Public Sector Pensions

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The Future of Public Sector Pensions

• Where do we start from?
• What are the policy objectives?
• What are the possible reform options?
• What are the implications of the different reform options?
Where do we start from?
The seven main schemes have almost 5 million members

Number of active members at 31 March 2008

- Local Government: 1.7m
- NHS: 1.3m
- Teachers': 0.6m
- Civil Service: 0.6m
- Armed Forces: 0.2m
- Police: 0.14m
- Fire: 0.05m
The main four public sector pension schemes

<table>
<thead>
<tr>
<th></th>
<th>NHS and Teachers’ (for new entrants)</th>
<th>Civil Service (for new entrants)</th>
<th>Local Government (for future service)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal pension age</td>
<td>60 to 65</td>
<td>60 to 65</td>
<td>Remains 65, Rule of 85 abolished</td>
</tr>
<tr>
<td>Basic design</td>
<td>Remains final salary</td>
<td>Final salary to career average</td>
<td>Remains final salary</td>
</tr>
<tr>
<td>Accrual rate</td>
<td>80ths to 60ths, separate lump sum abolished</td>
<td>60ths to 2.3%</td>
<td>80ths to 60ths, separate lump sum abolished</td>
</tr>
<tr>
<td>Member contributions (future service)</td>
<td>6% to: 5-8.5% (NHS) 6.4% (Teachers’)</td>
<td>No change from 3.5%</td>
<td>6% to 5.5–7%</td>
</tr>
<tr>
<td>Cost sharing and cost capping</td>
<td>Certain unanticipated future increases in costs to be shared 50:50 members and employers, subject to employer cap</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Average benefit rates have fallen as a result of recent reforms and uprating changes

Evolution of the average effective employee benefit rates for the seven main public sector schemes

- **Current Members pre-reform (RPI)**: 24%
- **Joiners post-reforms (RPI)**: 21%
- **Joiners post-reforms (CPI)**: 18%
The public sector schemes are still more generous than the average DC scheme

Average effective employee benefit rates for the reformed public sector schemes for new entrants and for the private sector DB and DC schemes (post CPI change)

<table>
<thead>
<tr>
<th>Scheme</th>
<th>High benefits DB</th>
<th>Medium benefits DB</th>
<th>Average DC incl S2P</th>
</tr>
</thead>
<tbody>
<tr>
<td>NHS/Teachers'</td>
<td>17%</td>
<td>16%</td>
<td>15%</td>
</tr>
<tr>
<td>Civil Service</td>
<td>18%</td>
<td>16%</td>
<td>10%</td>
</tr>
<tr>
<td>Local Gov.</td>
<td>20%</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>Armed Forces</td>
<td>32%</td>
<td>23%</td>
<td>15%</td>
</tr>
<tr>
<td>Police</td>
<td>20%</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td>Fire</td>
<td>20%</td>
<td>20%</td>
<td>15%</td>
</tr>
</tbody>
</table>
What are the policy objectives?
Any future reforms should be tied to specific objectives

- Potential objectives for reform could be
  - To ensure **adequacy** of retirement provision for public sector employees
  - Improve **affordability and sustainability**
  - Increase **fairness** between public and private sector pensions
  - Address **unfairness** between members within the same public sector scheme
  - Enable the public sector to **recruit and retain** high quality staff
What are the reform options?
Risks inherent in all pension schemes

- Longevity
- Investment
- Interest rate
- Price inflation
- Salary inflation
- Workforce growth
Direction of further reform to public sector pensions

- Continue Current Policy
- Changes to existing Final Salary schemes
- Structural Changes – Career Average or Hybrids
- Defined Contribution
What are the implications of different reform options?
Continue Current Policy
Current final salary schemes may allow median earners to achieve their benchmark replacement rate.

Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector.

- Final Salary: 64%
- Accrual reduced to 80ths: 52%
- Career Average: 55%
- Hybrid: 55%
- DC with NAE fund increases: 43%
Leaving a final salary scheme early reduces the value of future pension benefits.

The weekly pension received at retirement in respect of the first twenty years of service in a final salary scheme for a median earning member who leaves early vs a member who remains until retirement.
Tiered contributions do not fully offset the subsidy to high flyers

Effect of tiered contributions on the effective employee benefit rate to a high flying 20 year old throughout their employment compared with a employee with standard salary progression.

<table>
<thead>
<tr>
<th></th>
<th>High flyer (fixed conts)</th>
<th>Impact of tiered conts</th>
<th>High flyer (tiered conts)</th>
<th>High flyer subsidy</th>
<th>Standard member (tiered conts)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>5%</td>
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<tr>
<td>10%</td>
<td></td>
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<tr>
<td>15%</td>
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<tr>
<td>20%</td>
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<tr>
<td>25%</td>
<td></td>
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</tr>
<tr>
<td>30%</td>
<td></td>
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<tr>
<td>26%</td>
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<td>25%</td>
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<td>20%</td>
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<tr>
<td>1%</td>
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</tbody>
</table>
Switching from RPI to CPI reduces the long-term cost of unfunded public sector pension schemes.

Projected future annual cost to the taxpayer of the unfunded public sector schemes, after deducting member contributions, as a % of GDP.
Reforms within Final Salary
Reforming final salary scheme: reducing accrual rate has the largest impact on employee benefit rate

Average employee benefit rate for public sector pension schemes

Scope: NHSPS, TPS and LGPS members
Based on CPI indexation
Median earners are likely to meet their replacement rate under reforms to final salary schemes unless the accrual rate is reduced.

Gross replacement rate at 68 for a public sector male employee aged 25 in 2010 who retires on a median salary at their normal pension age.

Median earners are likely to meet their replacement rate under reforms to final salary schemes unless the accrual rate is reduced.

Gross replacement rate at 68 for a public sector male employee aged 25 in 2010 who retires on a median salary at their normal pension age.
Amending final salary schemes for new entrants would have little impact on costs to the taxpayer.

Projected payments to public sector pension provision as a % of GDP after reforming final salary schemes for new entrants

Scope: Unfunded public sector pension schemes
Structural Change

- Career Average
- Hybrids
Career average or hybrid schemes may offer lower levels of adequacy for median earners than final salary.

Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector.
A Career Average pension scheme does not subsidise high flyers

Effect of tiered contributions on the effective employee benefit rate to a high flying 20 year old throughout their employment compared with a employee with standard salary progression
Risk sharing schemes could reduce the cost to the taxpayer of public sector pension schemes

Projected payments to public sector pension provision as a % of GDP after adopting risk sharing schemes for new entrants

Scope: Unfunded public sector pension schemes
Defined Contribution

- Funded
- Notional
Moving to a funded scheme would increase costs in the short to medium term

In 2008-09 £22.5 billion was paid out to public sector pensioners, of which £19.5 billion was financed from contributions and £3 billion was financed by the Treasury. In a hypothetical funded DC scheme contributions would have been invested, so the Treasury would have to finance the total of £22.5 billion.
Notional DC with combined contributions of 15% gives lower adequacy for median earners

Gross replacement rate at 68 for a male employee aged 25 in 2010 who retires at age 65 on a median salary after 40 years service in the public sector

- Final Salary: 64%
- Accrual reduced to 80ths: 52%
- Career Average: 55%
- Hybrid: 55%
- DC with NAE fund increases: 43%
Moving to a notional DC scheme could significantly reduce the cost to the taxpayer of public sector pensions

Projected payments to public sector pension provision as a % of GDP after reforming final salary schemes for new entrants (including allowance for net spending on S2P)

Scope: Unfunded public sector pension schemes
The impact of reforms on the cost to the taxpayer will depend on whether reforms are applied only to new entrants or to all members.

Projected annual expenditure on public sector pensions as a % of GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>2010</th>
<th>2050</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members that reforms are applied to</td>
<td>Baseline</td>
<td>New Entrants</td>
</tr>
<tr>
<td>Current Policy</td>
<td>1.2%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Career Average</td>
<td>1.2%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Hybrid</td>
<td>1.2%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Notional DC (linked to earnings)</td>
<td>1.2%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>
The Future of the Public Sector Pensions

- Government may want to address adequacy, fairness, labour market mobility and affordability and sustainability in any reforms.

- Reform options range from changes within existing schemes to more structural changes and a move to DC arrangements.

- All the reforms could reduce the generosity of the current schemes.

- Changes within the final salary schemes could have little impact on costs. Structural changes and a move to DC may decrease costs significantly, especially in the long term.