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The future of the public sector pensions

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In publishing this research the PPI is not calling for further reforms of the public sector pensions but aims to provide an evidence base which sets out the potential implications of possible Government reforms. The research considers the implications of possible further reforms to the public sector pensions for public sector employees but also for the overall affordability and sustainability of the schemes.

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A PPI research report by John Adams, Chris Curry and Sean James

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Executive Summary

This report is intended as a contribution to the on-going policy debate about possible further reforms to the public sector pension schemes. In June 2010 the Coalition Government asked Lord Hutton of Furness to undertake a fundamental structural review of the public sector pension schemes and to report by the Budget 2011. This research suggests that there are four broad options that the Government could consider for further reforms of the public sector pension schemes. These range from:-

- **Continue with the current public sector pension schemes** as reformed by the Labour Government between 2005 and 2008. This option would envisage that the already agreed cost-sharing and cost-capping agreements would be implemented. Following the Coalition Government's announcement in June 2010, it would also entail public sector pensions being linked to the Consumer Price index (CPI) rather than to the Retail Price Index (RPI).
- Further reforms **within the structure of the existing final salary schemes**. Reforms of this type might involve changes to the Normal Pension Age, to member contribution rates or to the accrual rate of the final salary schemes. Caps on pensionable salary or on the benefits paid out would also fall into this category.
- Reforms to the structure of the schemes that involve **a greater sharing of risks** between the scheme member and the employer/taxpayer. Reforms of this type would include the introduction of career average pension schemes in which pension benefits are tied to average, rather than final salaries. They could also include hybrid schemes, for example, where the pension offered is defined benefit (either final salary or career average) upon a base level of salary, with a defined contribution scheme top-up at higher levels of salary. Collective defined contribution schemes could also be considered within this category.
- A move to **defined contribution pensions** arrangements that are more similar to the types of pension arrangements more commonly found in the private sector today. A defined contribution scheme could be funded in the way that such schemes operate in the private sector or it could be "notional" in a similar way to the model used for the public sector in Sweden. In a notional defined contribution scheme the Government does not build up a pot of assets to pay future pension promises but the scheme instead operates on a pay-as-you-go basis, with current pension contributions meeting current pension payments.

Lord Hutton published his interim report in October 2010. In it he concluded that a continuation of current policy was not tenable. However, he also ruled out a wholesale move to funded defined contribution schemes of the type that operate in the private sector. The review team have made clear that they will be looking carefully at models of public sector pension schemes that share risks more equally between pension scheme members and public sector employers/ taxpayers and between current and future generations.

This research aims to provide an assessment of the full set of options that the PPI considers the Government could implement to the public sector pension schemes. It therefore includes an assessment of options that Lord Hutton has effectively ruled out, such as a move to a funded defined contribution arrangement.

The PPI has assessed these options against a range of policy objectives that the Government may have as policy objectives for the public sector pension schemes. These criteria include:

- to ensure that public sector pensions provide adequate pensions for public sector workers in their retirement,
- to address concerns that public sector pension schemes are unaffordable and not financially sustainable,
- to improve the transparency of the cost of the pensions being offered to public sector employees,
- to address perceptions that public sector pension schemes offer higher levels of benefits than private sector pension schemes,
- to address unfairness between members within the same public sector pension scheme, and
- to enable the Government to recruit and retain high quality staff.

These objectives are not necessarily all mutually compatible, for example there are likely to be trade-offs between ensuring adequacy and improving affordability.

Before setting out the main conclusions from the PPI's analysis it is worth saying something about our methodology and some of the caveats that should be borne in mind when interpreting this analysis. The public sector pension schemes are all quite different. There are substantial differences between the generosity of the public sector pension schemes that exist in the uniformed services (Armed Forces, Police & Fire) from those that are available in the larger public sector schemes (e.g. NHS, Teachers, Civil Servants and Local Government.) To model the full range of possible reforms in detail for each of the seven main schemes would be very cumbersome. As a result we have created a PPI proxy public sector pension scheme. This proxy scheme has similar characteristics to the reformed NHS, Teachers and Local Government schemes, including tiered levels of member contributions, at 5.25% for those earning less than £20,000, 6.5% for those earning over £20,000 and up to £40,000, 7% for those earning over £40,000 and up to £70,000, 7.5% for those

earning over £70,000 and up to £100,000 and 8% for those earning over £100,000. These schemes together account for 70% of the active membership of the public sector schemes and our objective here is to illustrate the broad impacts of any potential further reforms – rather than to provide very precise cost projections for a particular scheme.

In order to model the impact of hypothetical potential reforms to the public sector schemes on public sector workers and on the future affordability and sustainability of the schemes we have had to choose particular parameters for each reform that we wish to model. For example, we have had to form a judgement about how far the Normal Pension Age might rise, or how far an accrual rate might be reduced, or what type of career average scheme or defined contribution schemes the Government might implement. There are clearly an almost infinite number of possibilities for how such reforms could be structured – it is therefore important to focus more on the general lessons from our analysis of the reform options rather than to focus too much on the levels of benefit generosity or absolute levels of costs. For example it would be possible to design a very generous defined contribution scheme that actually offered higher levels of income replacement than the existing final salary schemes if the levels of employer contribution were sufficiently high.

In choosing the parameters to model we have tried as far as possible to be guided by existing custom and practice or where the Government has already indicated reforms in related areas (e.g. in proposals to increase the State Pension Age) we have linked our reform options to these proposals.

It is also important to note that the reforms are not necessarily always mutually exclusive – for example, it would be possible to both make changes to the Normal Pension Age and to amend the scheme structure to a career average defined benefit structure. The reform options that we have modelled in this paper include:-

Reforms within the structure of the existing final salary schemes

1.1 Linking changes to the Normal Pension Age to the increases in the State Pension Age already legislated for in the 2007 Pensions Act: the NPA increases from Age 65 to 66 by 2026, from 66 to 67 by 2036 and from 67 to 68 by 2046.

1.2 Reducing the accrual rate in the final salary schemes from 1/60ths to 1/80ths. Both accrual rates are commonly used in private sector final salary schemes.

1.3 Increasing member contributions by 1% across the board – this is intended as a ready reckoner approach and it should be recognised that increases in contributions could vary across the schemes or for employees with different salary levels.

1.4 Impose a cap on the pensionable salary used to calculate benefits at £75,000 per annum. This is consistent with the Conservative Party's pre-election proposal to cap the public sector pensions paid out to public sector workers at £50,000 per annum.

Risk-Sharing Reforms

2.1 Moving to a career average scheme with a benefit structure similar to the Nuvos section of the Civil Service scheme. However, as member contributions are low in the Nuvos scheme compared to other public sector pension schemes, we have modelled the tiered employee contribution structure of the PPI proxy scheme with contributions of between 5.25% and 8% depending on the salary of the scheme member. Member contributions in this modelled scheme are therefore considerably higher than in the actual Nuvos scheme.[4]

2.2 Moving to a Hybrid scheme – this is based on a Career Average scheme the same as in 2.1 above up to earnings of £37,000 per annum (the 75th percentile of public sector earnings). Earnings above that level are subject to a Defined Contribution top-up arrangement. We have assumed that the employee and the employer both contribute at 6.5% of salary on earnings above £37,000 per annum.

Defined Contribution Schemes

3.1 Move to a funded defined contribution scheme. We have assumed in this option that employees contribute 5% of salary and employers contribute 10% of salary. This is towards the generous end of current DC schemes in the private sector – only 10% of private sector employers and employees currently contribute at this level. Clearly the Government could implement any combination of employer and employee contributions that it chose to.

3.2 In the notional defined contribution model we have also assumed that employees contribute 5% of salary and employers contribute 10% of salary. We have revalued notional defined contribution pots in line with average earnings as operates in Sweden. However, a different index could be used.

The schemes modelled are intended to be illustrative, not definitive. It would be possible, for example, to design a Career Average scheme that might be expected to provide a higher pension than the current Final Salary scheme by increasing the Career Average accrual rate.

The results are therefore only relevant to the specific examples modelled here, and should not be generally applied across all schemes of a particular type – for example all Career Average schemes, or all Final Salary schemes. The examples that we have chosen here are closely linked to reform options put forward by stakeholders, or examples used in other countries, and it would be perfectly possible to design other suitable reform options.

It is also the case that no one single scheme design may be appropriate for all of the different public sector pension schemes. The analysis here considers the public sector pension schemes as a single entity, but in reality

[4] Member contributions to the Nuvos scheme are 3.5% for all members, while in the modelled scheme member contributions range from 5.25% for low earners to 8% for the highest earners

they are different schemes meeting different needs for different employers.[5] It could be perfectly possible that a scheme design that best meets the needs of, for example, the NHS, would not be suitable for the armed forces. This analysis is designed to show the differences between different types of schemes to aid evaluation and the choice of the right option for each separate public sector scheme.

The main conclusions that have emerged from the PPI's analysis in relation to each of the potential options modelled for possible further reform follows.

Continuation of Current Policy

A continuation of current policy assumes that the previous Labour Government's reforms to public sector pensions and that the Coalition Government's change from RPI indexation to CPI indexation announced in June 2010 are both implemented.

Prior to the Labour Government's reforms and the change to indexation the PPI estimated that a typical public sector pension scheme was worth around 24% of salary on average to a typical public sector worker. The Labour Government's reforms reduced this to around 21% of salary and the CPI change has further reduced this to 18% of salary for members who have joined the schemes since the reforms were implemented. The combined impact of the Labour Government's reforms and the Coalition's CPI change has been to reduce the value of a public sector pension scheme by 25% on average.

These changes have already reduced the cost to the taxpayer of providing the public sector pensions schemes. In 2010 the Government spends about 1.2% of GDP on the public sector pensions after deducting the contributions made directly by members themselves. Under the previous Labour Government reforms and RPI indexation this was predicted to rise to 1.3% of GDP in 2030 and then fall back to 1.2% of GDP by 2050. As a result of the CPI change, public expenditure on public sector pensions is now projected to fall over this time frame – from 1.2% of GDP in 2010, to 1.1% of GDP by 2030 to 1% of GDP by 2050.

A continuation of current policy would offer the most generous pension to public sector workers of the options that we have modelled. This may prove helpful to the Government as a recruitment and retention tool. Under current policy, a median earner could be expected to hit their target replacement rate with a projected replacement rate of 64%. This option also represents the highest cost to the taxpayer of the options that we have modelled, although it is important to note that expenditure by the Government is still projected to fall from 1.2% of GDP in 2010 to 1% of GDP by 2050 under a continuation of current policy. There may be concerns about the fairness of a system which

[5] For example new entrants to the Civil Service are already entered into a career average scheme rather than a final salary scheme.

provides more generous pensions to high flyers than low-flyers and long-stayers than short-stayers.

Further Reforms within the structure of the existing final salary schemes
The reforms modelled here would keep the structure of the existing final salary schemes (higher Normal Pension Age, lower accrual rates, increased member contributions, or salary or benefit caps) but reduce the generosity and therefore the adequacy of public sector pension provision. For example, reducing the accrual rate in a final salary scheme from 1/60ths to 1/80ths would reduce the projected replacement rate from 64% to 52% for a median earner.

This may have a detrimental impact on recruitment and retention between the public and private sectors (although it may increase labour force mobility) compared to the current public sector pension schemes.

However, any impact on recruitment and retention is likely to be relatively small as the schemes would still be more valuable than those generally on offer in the private sector. The inherent unfairness between short and long-stayers, and low and high-flyers would remain, unless benefit or salary caps were low enough to affect a significant number of higher earners.

The impact of making changes within the structure of the final salary schemes on affordability and sustainability is likely to be relatively small. Of such reforms modelled, reducing the accrual rate has the largest impact on cost – reducing the cost to the taxpayer of public sector pensions in 2050 from 1% of GDP to 0.9% of GDP. Increasing the Normal Pension Age in line with the State Pension Age changes in Pensions Act 2007 will reduce the cost of providing benefits – but even by 2050 the amount saved would be less than 0.1% of GDP if this change applied only to new entrants. Setting a cap on pensionable salary at £75,000 has a negligible impact on the affordability of the schemes because so few public sector workers would be affected by such a cap.

Risk-sharing schemes
The Career Average and hybrid pension schemes analysed in this report would reduce levels of adequacy compared to the current final salary public sector pension schemes. The projected replacement rate for a median earner falls from 64% under the current final salary schemes to 55% under a career average benefit structure similar to the Nuvos scheme in the Civil Service.

As a result, the schemes would be more affordable for the taxpayer. Our projections suggest that a career average scheme with a benefit structure similar to the Nuvos scheme in the Civil Service but with much higher, tiered contributions might reduce public expenditure on public sector pensions to around 0.9% of GDP by 2050, compared to 1% of GDP under the current final salary schemes. The cost profile for the hybrid scheme modelled is broadly similar to the career average scheme modelled.

The reduced generosity of the public sector pension may mean that recruitment and retention may be made more difficult. However, labour mobility may be better if public sector employees are more willing to move to private sector jobs.

Differences would remain in the structure of public sector schemes and private sector provision, as the public sector pension would remain Defined Benefit rather than Defined Contribution, albeit a less generous version. However there would be more fairness between the members of public sector schemes, as a career average structure gives more equal outcomes between short and long-stayers, and between low and high-flyers.

Defined Contribution Schemes

Defined contribution pension schemes tend to receive lower contributions than defined benefit pension schemes. This leads to lower pensions being paid and a greater risk that income in retirement does not achieve the benchmark replacement rate. This could be offset to some extent by DC arrangements being contracted-in to S2P, which would increase the state pension received by public sector workers but would also increase the state's liability to pay state second pension.

It may be harder for the public sector to attract employees, but flexibility and movement between public and private sectors may be increased as public sector and private sector pensions become more comparable. There would not be any cross-subsidies or unfairness between different scheme members, as each member would have their own individual pot. A funded DC scheme would be more expensive than the current public sector pension schemes in the short to medium term as member contributions could no longer be used to fund pensions in payment.

Depending on the level of contributions to a Notional DC arrangement and the way in which contributions were indexed, the affordability and transparency of public sector pension schemes could be improved compared to the current system, with contributions being clear and long-term costs low. There would also be higher state pension costs, and higher levels of NI contribution collected each year.

The PPI modelled a notional DC scheme with a 10% employer contribution and a 5% employee contribution. A notional DC scheme of this type linked to increases in average earnings is projected to give a median earner a replacement rate of 43% even allowing for the additional state pension received. This is significantly lower than the replacement rate of 64% projected for a median earner from the current final salary schemes. Under this option, and allowing for the additional NI contributions raised and S2P expenditure arising from the schemes being contracted-in, Government spending on public sector pensions is projected to fall to 0.7% of GDP by 2050, compared to 1% of GDP under the existing arrangements.