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Public sector pension reform: what happened?

Introduction

The Government and public sector unions agreed 'framework principles' for the reform of the biggest public sector pension schemes on 18 October 2005 (Chart 1). Commentary suggested that tax bills would rise as a result and that the agreement would make it more difficult to extend working lives more generally.

This Briefing Note examines what was agreed and what it means. There should be no higher cost to be funded by higher tax. But the communication has not helped Government signalling on later working, and confusion between "pension age" and "retirement age" still bedevils the debate.

Chart 1: Key points of the October 2005 agreement

- Applies to the 3 largest national public sector schemes only, with over 2.5m active members: NHS, Teachers and Civil Service
- Same cost savings to be made - per scheme - as assumed in December 2004 Long Term Public Finance Report
- Normal Pension Age for new entrants to the schemes will be age 65
- Scheme-specific negotiations on all other aspects of scheme design (including NPA for existing members) to be completed by June 2006

No new cost to the taxpayer

The public sector employers and unions have been discussing reform proposals for all major public sector pension schemes for some time. The negotiations are largely scheme-specific[1].

Under these proposals, the expenditure on unfunded public sector scheme benefits is still expected to increase from 1.5% to 2.3% of GDP over the next 30 years[2]. This is largely because of improving longevity and the increasing numbers of public sector workers, who have had strong salary growth in recent years. Some of the cost will be met by members' contributions, but most will be met by Government spending, so ultimately from tax revenues.

Without the proposals, the cost would be even higher. The proposed reforms were expected to lead to net savings (over the next 50 years) of £13bn[3]. The October agreement did not change this £13bn number, rather it confirmed that all parties to the negotiations will respect it.

Therefore, there is no new reason to believe the tax bill should go up. Until we know the outcome of the detailed negotiations, it seems an exaggeration to suggest the taxpayer is worse off as a result of the October agreement.

The change to NPA

The original reform package proposed that the Normal Pension Age (NPA) should increase from age 60 to 65 for new entrants and for the future service of existing members after 2013. The October agreement is that NPA should still be 65 for new entrants, who will have the choice of paying higher contributions in order to keep their own NPA at 60. But there is no obligation on schemes to change NPA for existing members.

The £13bn cost saving had originally been planned to come from the increase in NPA, net of agreed scheme benefit improvements. Any other proposed scheme benefit redesigns, such as a change to 'career average', were proposed to be cost-neutral.

Of the £13bn saving, £11bn (85%) comes from the change to NPA for new entrants[4].

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Assuming the schemes decide not to raise NPA to 65 for existing members, they will have to find their contribution to the remaining £2bn cost saving. They can choose how to do this: by benefit cuts or increased member contributions. It is possible that some existing members—particularly younger ones—would prefer an NPA at 65 instead of higher member contributions.

The signal on working later

NPA is the first age at which full pension is payable. For people who start their pension at younger or older ages an actuarially reduced or enhanced pension is available. People can start their pension at any age between 55 and 70, and it will be possible to collect a pension while still working[5].

So, while the proposal to increase NPA is often referred to as "raising the retirement age", it is not increasing the age at which people must retire (that is another story, to do with employers being able to set default retirement ages)[6].

To illustrate the difference between NPA and actual retirement age: in the three schemes being considered here, all with NPA of 60, members retire on average[7] at age 62.

Raising NPA for existing public sector workers would have made a relatively small contribution to cost savings. The proposal to do so was instead a response to the continuing improvement in healthy longevity. Raising NPA is a powerful signal that working later is expected to be a natural reaction to greater longevity. The agreement signals this to new entrants, but not to existing members of public sector schemes.

Not quite a "cave-in"

As a result of the October agreement, the Government looks more certain to achieve the cost saving targets, as the unions have agreed the cost savings to be made. The principle of raising NPA as a consequence of improving longevity has also been agreed. The pension rights of current public sector workers have been preserved, following the precedent of major changes to private sector pension schemes (e.g., the change from Defined Benefit to Defined Contribution has often only been applied to new entrants).

The agreement has not altered the value of the average public sector pension compared to the average private sector pension. Provided the £2bn cost saving is made, then even after the reforms the typical public sector pension will still be worth an extra 3% to 18% of salary[8].

An opportunity has been missed to underscore expectations about working later, indeed, that working later may be desirable, especially for younger workers who otherwise face higher pension contributions.

A higher NPA does not mean everyone will automatically work for longer, and if phased in, perhaps over a longer timeframe than envisaged by the 2013 proposal, would only have a gradual effect. But it would have been a signal for people to consider working longer a possible, perhaps likely, option for their own future.

The difference in NPA between the public sector and the private sector (where it is mostly 65 for existing members) is going to last for longer than it would have done under the original proposals. The perception that this means a growing divide between public and private sector pension arrangements is not helpful for pension policy more generally.

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[1] PPI (2005) *Occupational pension provision in the public sector*
[2] HM Treasury (2004) *Long-term Public Finance Report*. 1.5% GDP in 2003/4 is £16.5bn.
[3] HMT figures
[4] HMT figures
[5] From April 2006
[6] The current proposal for the 2006 age anti-age discrimination legislation is that people cannot be required to retire before age 65 unless their employer has proper (non-age-related) justification
[7] HMT figures
[8] PPI (2005)

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