A Pensions Policy Institute Briefing Paper on the impact of the Coalition Government's public service pension reforms

Introduction

The Coalition Government has proposed a number of reforms to the public service pension schemes following the broad thrust of the recommendations made by Lord Hutton in his fundamental review of the public service pension schemes. In September 2012 the Government introduced draft legislation to Parliament in the form of the Public Service Pensions Bill which will provide the legislative framework to enable the Government to implement Lord Hutton's recommendations. The Public Service Pensions Act received royal assent on 25 April 2013. Some aspects of the reforms, such as the final agreements for tiered contributions, are still subject to negotiations.

The Government's proposed reforms include linking the pension benefits for public service workers to career average salary rather than to final salary, linking the Normal Pension Age to the State Pension Age for the four largest schemes: NHS, Teachers, Local Government and the Civil Service, and increasing the average contributions to be made by scheme members. The Government's reforms also cover the uniformed services (Police, Fire Service and Armed Forces) although the proposals are slightly different for these schemes; where a Normal Pension Age of 60 is proposed.

The proposed reforms apply to all members; however, members within ten years of their Normal Pension Age on 1 April 2012 will have their pension calculated according to the rules in place prior to the introduction of the proposed reforms.

Purpose of this Briefing Paper

The Pensions Policy Institute (PPI) is an independent, apolitical, educational research charity with a charitable objective to inform the policy debate on pensions and other provision for retirement. This briefing paper sets out the PPI's independent assessment of the potential impact of the Government's proposed reforms to the public service pension schemes on the value of pension benefit being offered to public service workers and the impact on long-term government expenditure on unfunded public service pension schemes. The analysis covers the four largest public service schemes: the NHS, Teachers, Local Government and Civil Service pension schemes which account for around 85% of public service pension scheme members. The Government has also proposed reforms to the schemes for the uniformed services (Police, Fire Service and Armed Forces).

The intention of this briefing paper is to aid understanding about the potential impact of the Government's proposed reforms to the public service schemes to inform the policy debate. The PPI is not lobbying for or against the implementation of the Government's proposals. The PPI is also publishing a full report today that covers the impact of the Coalition Government's reforms in more detail.

Previous reforms to the public service pension schemes

The Labour Government implemented reforms to the four largest public service pension schemes in 2007 and 2008. Under Labour's reforms all of the reformed schemes retained their final salary benefit structure except for the Civil Service scheme which moved to a new Career Average scheme for new entrants to the Civil Service from 30 July 2007.

As part of the 2007/8 reforms the Normal Pension Age (NPA) for the Civil Service, NHS and Teachers was increased from 60 to 65 – but only for new entrants; existing members of these schemes retained an NPA of 60. The Local Government Pension Scheme (LGPS) already had an NPA of 65, although the "rule of 85,"in which a member of the LGPS could retire with an unreduced pension before age 65 if the sum of their age and length of service exceeded 85, was abolished in these reforms.

For new entrants into the NHS and Teachers' schemes new accrual rates were introduced in the final salary schemes with the schemes moving from a system in which members accrued a pension of 1/80th of their final salary for each year of service and a lump sum of 3/80^{ths} of their final salary, to one where the accrual rate was 1/60th of their final salary for each year of service with a lump sum by commutation only. For the LGPS this reform applied to all existing members as well as new entrants.

In addition, higher rates of member contributions were introduced for all four of the largest schemes for all scheme members (both existing members and new entrants) and for some schemes (e.g. the NHS and LGPS) the introduction of tiered member contributions saw higher earners pay higher rates of contribution than lower earners for the first time.

In June 2010, the Coalition Government changed the inflation measure used to uprate public service pension benefits. From April 2011, public service pensions in payment and pensions accrued are uprated in line with changes in the Consumer Prices Index (CPI), instead of the Retail Prices Index (RPI) as had been the previous policy. The CPI typically rises more slowly than the RPI because different formulae are used to calculate each index and because the CPI excludes housing costs.

Methodology
In order to provide comparisons of the value of the benefits offered by alternative Defined Benefit pension schemes, such as a final salary scheme and a career average scheme, the Pensions Policy Institute calculates the Effective Employee Benefit Rate (EEBR) of different schemes for scheme members with different characteristics.

The Effective Employee Benefit Rate provided by a particular pension scheme is calculated by translating the value of the pension benefit offered in the scheme into an equivalent percentage of salary that the scheme member would need to be given to compensate for the loss of the pension scheme. For example, an Effective Employee Benefit Rate of 15% for a member of a public service pension scheme means that the scheme member would have to be given a 15% increase in their salary by their employer to compensate for the loss of the pension scheme. The member contributions are taken into account in the calculation of the EEBR. So if a scheme has a benefit structure that would be worth 20% of the member's salary, but the member is contributing 5% themselves in member contributions, then the Effective Employee Benefit Rate would be 15%.

To provide a measure of the affordability of public service schemes, this paper considers how much the Government spends on running public service pension schemes. For the unfunded schemes of the NHS, Teachers and Civil Service, the measure used is net government expenditure on unfunded public service schemes. This measure is expressed as a percentage of Gross Domestic Product (GDP). It indicates how much cash the Government must contribute each year in order to run the unfunded public service schemes, after deducting employee contributions.

Assessing the Impact of the Coalition's proposed reforms on scheme members
The Coalition Government's proposed reforms to the public service pensions include:

- The increased member contributions which will increase by an average 3.2% for each scheme (except the Local Government Pension Scheme);
- The switch to a Career Average Revalued Earnings (CARE) scheme;
- The linking of the Normal Pension Age with the State Pension Age for the four largest schemes.

In order to assess the impact of the Coalition Government's reforms on the value of the pension benefit for public service scheme members it is necessary to have a baseline to compare the value of the schemes before the proposed reforms.

As a result of some of the main elements of the 2007/8 reforms to the NHS, Teachers' and Civil Service schemes applying only to new entrants, some public service employees who joined the public service before the introduction of the reforms in 2007/8 are currently members of the pre 2007/8 public service schemes which have final salary benefits with accrual rates of 1/80th and a

3/80th lump sum and a Normal Pension Age of 60. Other public service employees who have joined the public service within the last four or five years since the introduction of the 2007/8 reforms will be in the post-reform schemes with Normal Pension Ages of 65 and accrual rates of 1/60th with a lump sum by commutation only.

We have therefore shown the impact of the Coalition's reforms for three different scenarios:

1. The impact of the Coalition's reforms on the value of the pension benefit offered to a scheme member who joined the scheme before the introduction of the 2007/8 reforms. At this point in time, the majority of public service employees are likely to have joined the schemes before the 2007/8 reforms were introduced. These scheme members will have a benefit structure that pre-dates the 2007/8 reforms. For example, members who joined the NHS scheme before 1 April 2008 have an NPA of 60, a final salary scheme with a 1/80th accrual rate and a 3/80ths lump sum but will be paying rates of member contributions of between 5% and 8.5% depending on their salary because the 2007/8 reforms to contribution levels applied to all members of the schemes.

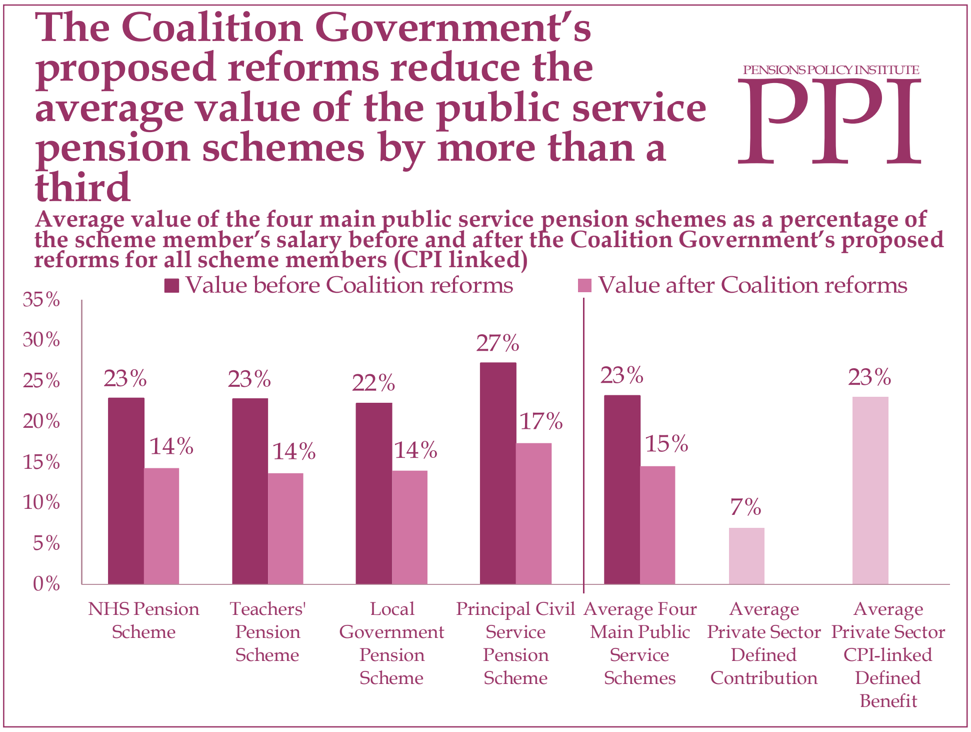
2. The impact of the Coalition's reforms on the value of the pension benefit offered for a scheme member who has joined the scheme since the introduction of the 2007/8 reforms. Fewer members will be in this situation, but members who have joined the schemes within the last four or five years are likely to be in this position. These scheme members will have a benefit structure that reflects the 2007/8 reforms. For example members joining the NHS scheme after 1 April 2008 have an NPA of 65, a final salary scheme with a 1/60th accrual rate and a lump sum by commutation only and will be paying rates of member contributions of between 5% and 8.5% depending on the member's salary level.

3. The impact of the Coalition's reforms on the value of the pension benefit offered for all scheme members (both pre 2007/8 entrants and post 2007/8 entrants). This is an average of the figures for the impact on pre 2007/8 entrants and post 2007/8 entrants weighted by the size of the respective scheme memberships.

We have assumed in the baseline that from 1 April 2011 all public service pensions in payment and pensions accrued are uprated in line with changes in the Consumer Prices Index (CPI), instead of the Retail Prices Index (RPI) as had been the previous policy. In the report that the PPI is publishing alongside this briefing paper we have also calculated a counterfactual analysis of what the schemes would have been worth if the Government had continued to uprate public service pensions in line with the RPI.

Headline Findings:
The PPI's analysis suggests that the Coalition Government's proposed reforms to the NHS, Teachers, Local Government and Civil Service pension schemes will **reduce the average value of the benefit offered <u>across all scheme members</u> by more than a third**, compared to the value of the schemes before the Coalition Government's proposed reforms. Across the four largest public service pension schemes the value of the schemes reduces, on average, from 23% of a scheme member's salary before the reforms to 15% of a scheme member's salary after the Coalition Government's proposed reforms (Chart 1).

Chart 1[1]



Nevertheless, even after the Coalition's proposed reforms the benefit offered by all four of the largest public service pension schemes remains more valuable, on average, than the pension benefit offered by Defined Contribution (DC) schemes that are now most commonly offered to employees in the private sector, into which employers typically contribute around 7% of a DC scheme member's salary.

There are still some Defined Benefit schemes in the private sector, although less than 10% of private sector employees are active members of a Defined Benefit Scheme. A typical Defined Benefit scheme in the private sector has an average pension benefit value of 23% of a member's salary, assuming that the scheme benefits are linked to the Consumer Prices Index (CPI). Some private sector schemes still have benefits linked to the Retail Prices Index (RPI), and for

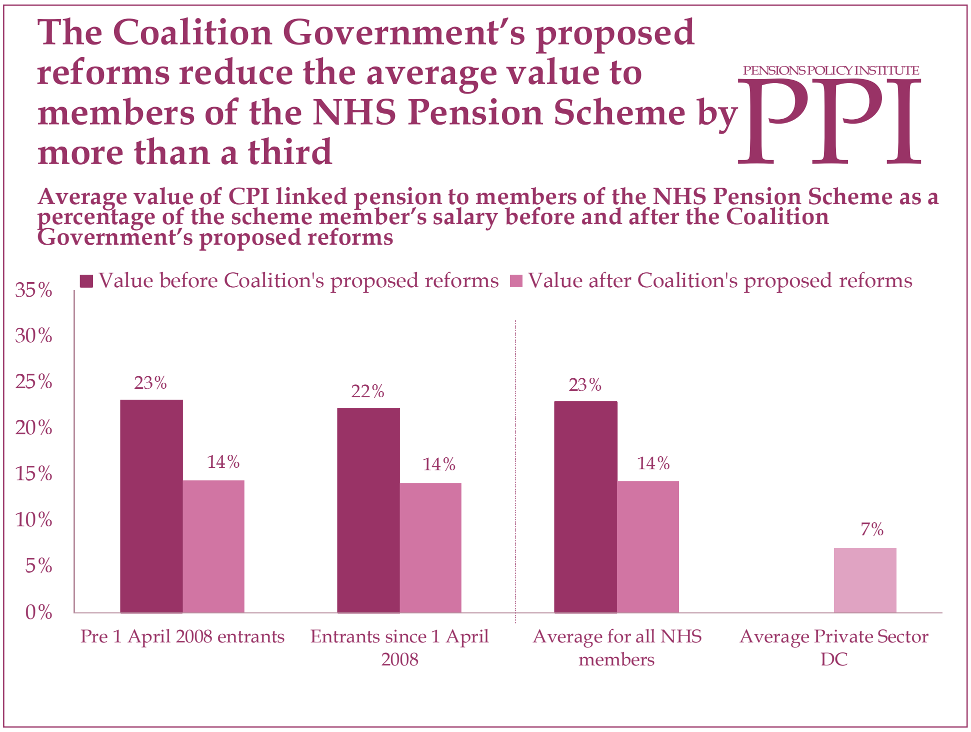
[1] PPI EEBR analysis using scheme designs as set out in the Proposed Final Agreements for each scheme. Figures rounded to the nearest 1%.

a typical private sector Defined Benefit scheme linked to RPI the average value of the pension benefit is 27% of a member's salary.

The next sections look at the impact of the Coalition Government's reforms on members of the four largest Public Service Pension Schemes, depending on when members joined the schemes.

NHS Pension Scheme

Chart 2[2]



- For members of the NHS scheme who joined the scheme <u>before</u> 1 April 2008 the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 23% of a member's salary before the proposed reforms, to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- For members of the NHS scheme who joined the scheme <u>since</u> 1 April 2008 the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 22% of a member's salary before the proposed reforms, to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- The impact across <u>all members</u> of the NHS scheme is to reduce, on average, the value of the pension benefit from 23% of a member's salary, before the proposed reforms to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

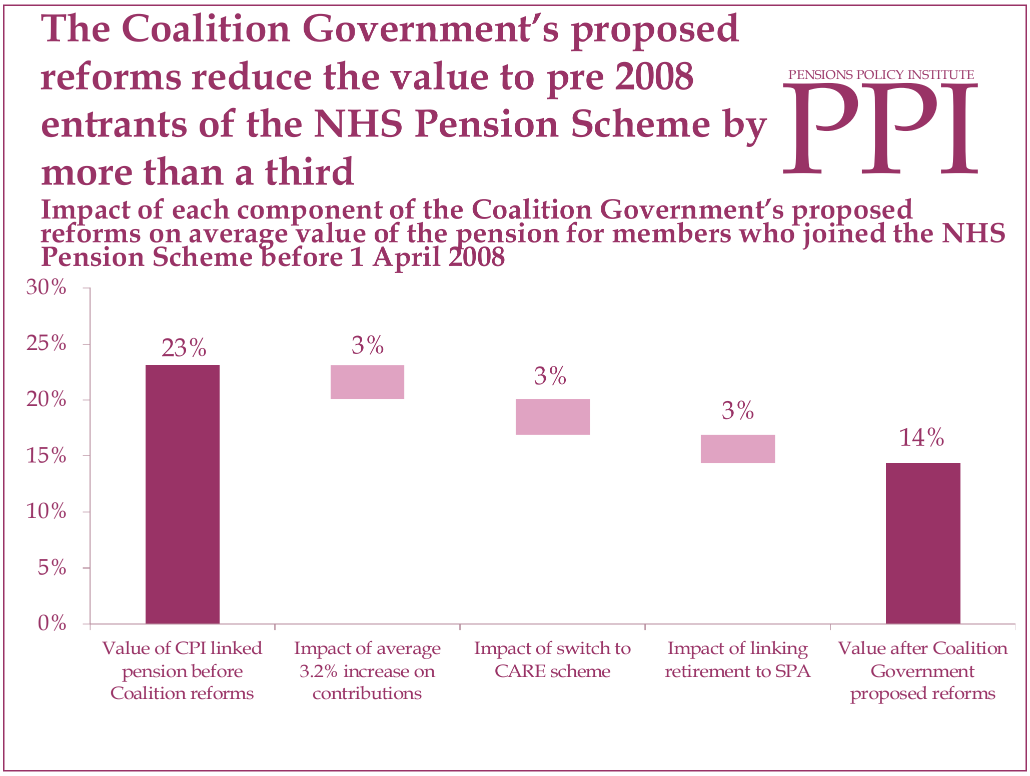
- Nevertheless, even after the reforms the value of the NHS pension scheme remains more valuable than an average private sector Defined Contribution, into which employers typically contribute around 7% of a DC scheme member's salary.

[2] PPI EEBR analysis using scheme designs as set out in the Proposed Final Agreement for the NHS Pension Scheme. Figures rounded to the nearest 1%.

The impact of the components of the Coalition's proposed reforms on the value of the NHS scheme

To illustrate how the different components of the Coalition's proposed reforms would impact on members of the NHS Pension Scheme who have joined the scheme before 1 April 2008 we have shown below how each component of the Coalition's reforms contributes to the average reduction in the value of the scheme. The equivalent analysis for the Teachers, Local Government and Civil Service schemes are published in the full report.

Chart 3[3]



- The increase in average member tiered contributions, under which higher earners pay higher contributions than lower earners, reduces the average value of the pension benefit offered by the scheme by 3% of salary.

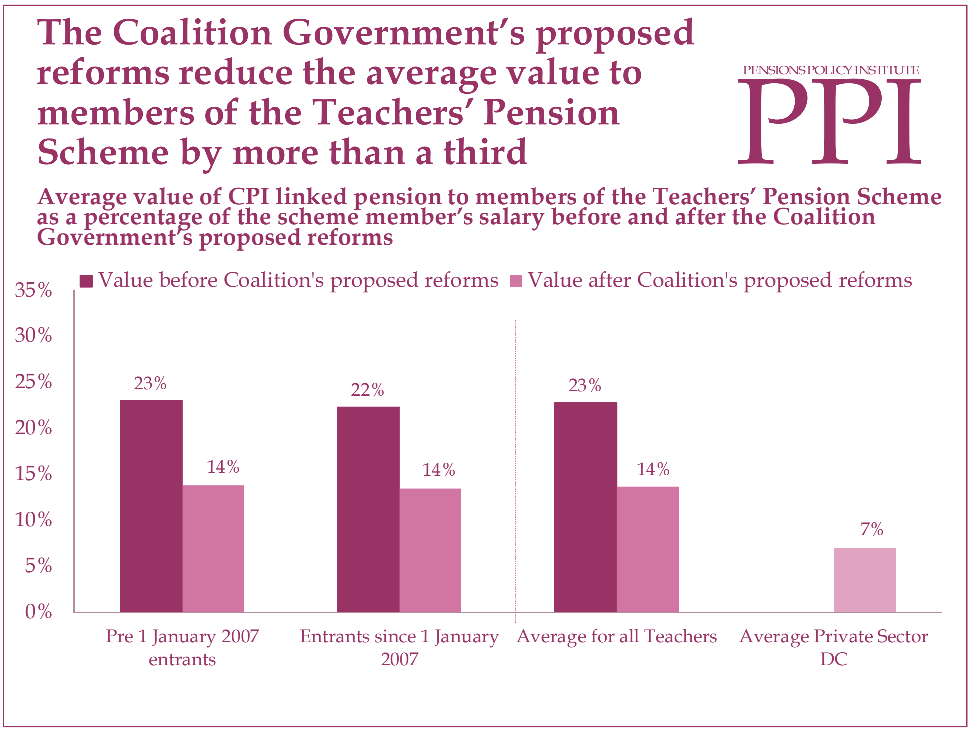
- The switch from a final salary scheme with a 1/80th accrual rate with a 3/80th lump sum to the new NHS Career Average Revalued Earnings scheme reduces the average value of the pension benefit being offered by the scheme by 3% of salary.

- Linking the Normal Pension Age to the State Pension Age instead of having an NPA of 60 reduces the average value of the pension benefit by a further 3% of salary.

[3] PPI EEBR analysis using scheme designs as set out in the Proposed Final Agreement for the NHS Pension Scheme. Figures rounded to the nearest 1%.

Teachers Pension Scheme

Chart 4[4]



- For members of the Teachers' scheme who joined the scheme <u>before</u> 1 January 2007 the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 23% of a member's salary before the proposed reforms, to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- For members of the Teachers' scheme who joined the scheme <u>since</u> 1 January 2007 the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 22% of a member's salary before the proposed reforms, to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- The impact across <u>all members</u> of the Teachers' scheme is to reduce, on average, the value of the pension benefit from 23% of a member's salary before the proposed reforms, to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- Nevertheless, even after the reforms the value of the Teachers' pension scheme remains more valuable than an average private sector Defined Contribution, into which employers typically contribute around 7% of a DC scheme member's salary.

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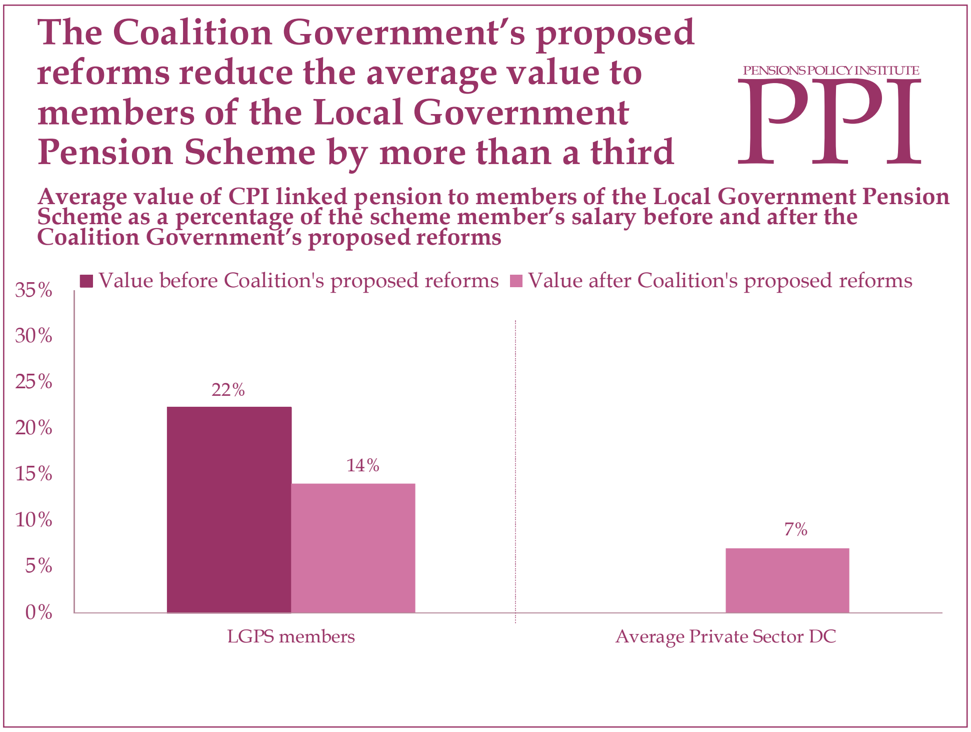
[4] PPI EEBR analysis using scheme designs as set out in the Proposed Final Agreement for the Teachers' Pension Scheme. Figures rounded to the nearest 1%.

Local Government Pension Scheme

Chart 5[5]



- As the 2008 reforms to the Local Government Pension Scheme applied to all members, all members of the LGPS are now in the post 1 April 2008 reformed scheme.

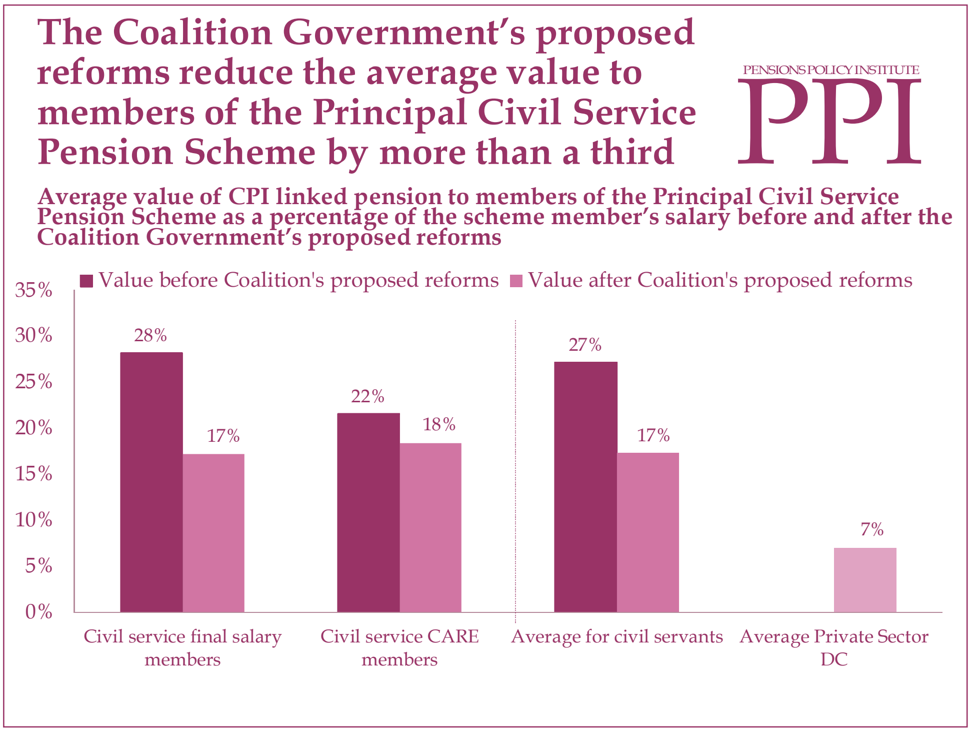
- For members of the LGPS scheme the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 22% of a member's salary before the proposed reforms to 14% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- Nevertheless, even after the reforms the value of the Local Government pension scheme remains more valuable than an average private sector Defined Contribution scheme, into which employers typically contribute around 7% of a DC scheme member's salary.

[5] PPI EEBR analysis using scheme designs as set out in the LGPS 2014 proposals. Figures rounded to the nearest 1%.

Civil Service Pension Scheme

Chart 6[6]



- For members of the Civil Service scheme who joined the scheme before 30 July 2007 and are still in the Civil Service Classic Final Salary scheme the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 28% of a member's salary before the proposed reforms, to 17% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- For members of the Civil Service scheme who joined the scheme since 30 July 2007 and have joined the Civil Service Nuvos Career Average scheme the impact of the Coalition's proposed reforms is to reduce, on average, the value of the pension benefit from 22% of a member's salary before the proposed reforms, to 18% of a member's salary after the Coalition's proposed reforms, a reduction of less than a fifth.

- The impact across all members of the Civil Service scheme is to reduce, on average, the value of the pension benefit from 27% of a member's salary, before the proposed reforms to 17% of a member's salary after the Coalition's proposed reforms, a reduction of more than a third.

- Nevertheless, even after the reforms the value of the Civil Service pension scheme remains more valuable than an average private sector Defined Contribution scheme, into which employers typically contribute around 7% of a DC scheme member's salary.

[6] PPI EEBR analysis using scheme designs as set out in the Proposed Final Agreement for the Principal Civil Service Pension Scheme. Figures rounded to the nearest 1%.

The above figures show the **average impact of the reforms across all members of each of the schemes. The individual impact of the reforms on the value of the pension benefit available to a particular scheme member will be influenced by a wide range of factors** including: the member's age and salary when the reforms are introduced, their salary progression and whether they leave public service early or stay in the scheme until they retire.

The impact of the reforms for an individual scheme member could therefore be substantially different to the average impacts presented here. To illustrate this point the PPI's report published today provides some examples of the potential impact of the reforms on members who joined the NHS Pension Scheme before 1 April 2008 for individuals with fast and slow salary progression (high-flyers and low-flyers), with high and low earnings and for early leavers and long stayers. Headline findings from this analysis suggest that:

- The Coalition's proposed reforms will remove the different outcomes for high-flyers and low-flyers which exist in final salary schemes. If two median earning 40-year-old men had joined the NHS scheme before 1 April 2008, the high-flyer would have had a pension benefit of 29% of salary, compared to 11% of salary for the low-flyer. Under the Coalition Government's proposed reforms high-flyers and low-flyers have a pension benefit worth the same percentage of salary, with the average value of the pension offered being worth 15% of salary for both members.

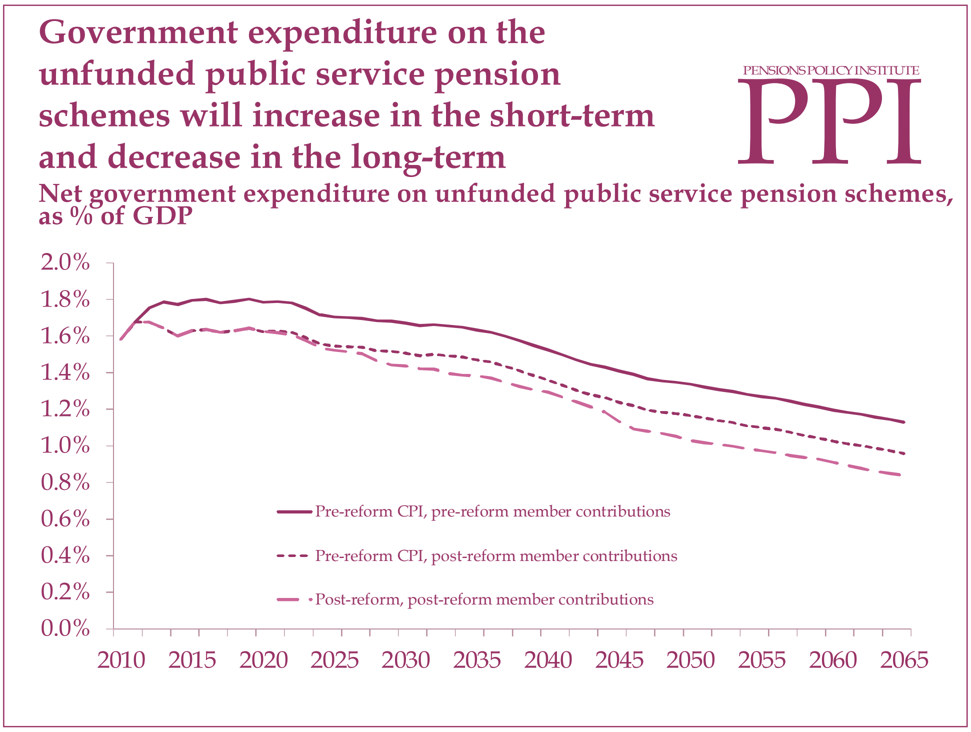
- After the Coalition's proposed reforms the value of the pension received by lower earners will be higher as a percentage of their salary than that of higher earners, as higher earners must pay higher contributions for the pension they receive, compared to lower earners. For example, a 50-year-old member of the NHS Pension Scheme who joined the scheme before 1 April 2008 earning up to £15,000 will have a pension benefit worth 21% of salary. By contrast, a 50-year-old member of the NHS Pension Scheme who joined the scheme before 1 April 2008 with earnings above £110,274 will have a pension benefit worth 11% of salary. This does not mean that a higher earner gets a lower pension in absolute terms than a lower earner, but that a lower earner accrues a pension per year that represents a higher percentage of their salary, compared to a higher earner.

The impact on the affordability of the unfunded public service pension schemes

Chart 7 shows the impact of the Coalition Government's proposed reforms on net government expenditure on unfunded public service schemes (so excluding the LGPS) under three different scenarios:

- If the unfunded public service pension schemes had remained as after the 2008 reforms but with pension benefits indexed to the CPI, as announced by the Coalition Government in 2010.
- If the unfunded public service pension schemes had remained as after the 2008 reforms but with pension benefits indexed by the CPI and higher post-reform levels of member contributions.
- Under the Coalition Government's proposed reforms, including the move to Career Average and the change in Normal Pension to align it with the State Pension Age and higher post-reform levels of member contributions

Chart 7[7]



If the unfunded public service pension schemes had remained as after the 2008 reforms but with pension benefits indexed by the CPI, net government expenditure on the unfunded public service schemes would have peaked at around 1.8% of GDP in 2016, before falling to around 1.1% by 2065.

If the unfunded public service pension schemes had remained as after the 2008 reforms but with pension benefits indexed by the CPI but and higher post-reform levels of member contributions, net government expenditure would have fallen to around 1% of GDP by 2065.

[7] PPI Aggregate Model. Estimates include the NHS, Civil Service and uniformed services pension schemes.

The impact of the recent Coalition Government reforms (including the changes in the benefit structures and the increase in employee contributions) is to reduce net government expenditure on the unfunded public service pension schemes further. After implementation of the reforms net government expenditure is estimated to fall to around 0.8% of GDP by 2065 – a reduction of around a quarter compared to the pre-reform system.

One area of uncertainty surrounding the impact of the reforms is on the opt-out rate of public service pension schemes. Future net government expenditure on public service pensions will depend on the opt-out rate assumed. Around 15% of public service employees opt-out of public service pension schemes, although the opt-out rate varies on a scheme by scheme basis. A 15% opt-out rate has therefore been used as a baseline for this analysis.

A higher opt-out rate would increase net government expenditure on public service pension schemes in the short-term as the Government must pay existing pensions while collecting a lower amount of contributions. However, in the long-term, a higher opt-out rate reduces net government expenditure on public service pensions as fewer pensions must be paid. A lower opt-out rate would have the exact opposite effect.

If the opt-out rate increased to 25%, net government expenditure on the unfunded public service pension schemes could decrease to around 0.7% of GDP by 2065. Conversely, if the opt-out rate decreased to 5%, net government expenditure could increase to around 0.9% of GDP by 2065.

Cost and affordability issues for the funded Local Government Pension Scheme (LGPS) are different from those for the unfunded public service pension schemes. As the contributions from employers, employees and Government (implicitly through tax relief) are paid into a fund which is invested, there is not the same direct implication for future government expenditure on this scheme.

However, looking at the relative gap between pensions in payment and employer contributions can give an idea of the relative level of strain that may be placed on investment returns and employer contributions to fill the gap.

The Coalition Government reforms, including the changes to the benefit structure and the Normal Pension Age contained in the Public Service Pension Act, will reduce excess of pensions in payment above employee contribution in the future. After the implementation of the reforms, the excess of pension payments over employee contributions in the LGPS is projected to fall to around 0.35% of GDP by 2065, compared to 0.4% before the reforms.

As in the unfunded schemes, different levels of opt-out rates will have an impact on the future level of the gap between pensions in payment and employer contributions to the LGPS.

If the opt-out rate increased to 25%, the gap between pensions in payment and member contributions could decrease to around 0.3% of GDP by 2065, compared to 0.35% under the central opt-out rate scenario of 15%. By contrast, if the opt-out rate decreased to 5%, the gap between pensions in payment and member contributions could increase to around 0.4% of GDP.

The differences in pay in the public and private sector

Comparisons between public and private sector pay that use unadjusted averages of pay in both sectors are misleading. There are significant differences in experience, qualifications, gender and regional location between the workforce in both sectors that will lead to differences in pay between the public sector and private sector employees. Membership of a pension scheme is much higher among low paid workers in the public sector than in the private sector.

The full report underlying this analysis can be downloaded from the PPI's website www.pensionspolicyinstitute.org.uk.

Nuffield Foundation

This analysis has been funded by a grant from the Nuffield Foundation, an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at www.nuffieldfoundation.org.

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