PENSIONS POLICY INSTITUTE PPI

How can we measure adequacy in the context of public sector pensions?

Introduction

In June 2010 the Coalition Government appointed John Hutton to chair an Independent Public Service Pensions Commission (IPSPC) to conduct a fundamental structural review of public service pension provision. The IPSPC has published its final report today, in time for the Budget 2011.

The Commission has consulted widely during the course of its review. In its call for evidence, the Commission noted that a key outcome for public service pensions is that they deliver an adequate level of income in retirement, particularly when people have devoted the majority of their life to public service.

The Commission posed a number of specific questions in relation to the adequacy of public service pension provision, including: a) how to measure adequate levels of resources in retirement?; b) what should be considered an adequate level of resources in retirement?; c) should a full state pension and a full public service pension ensure that people have adequate resources in retirement or should room be left for individuals to make their own arrangements?; d) how should this change where people work part careers?

In January 2011, the Pensions Policy Institute organised a seminar for the IPSPC to discuss these questions with a range of organisations with an interest in pensions policy. This briefing note reports on the main aspects discussed in this seminar, which was hosted by the Nuffield Foundation. None of the concepts discussed here express the particular views of the PPI, the Nuffield Foundation or the PPI seminar speakers.

Chart 1: Comparing measures to assess the adequacy of pensions income

Measure	Single Pensioner (£ per week 2009)
Government's relative poverty line (AHC)[1]	£119
Guarantee Credit (AHC)[2]	£130
Minimum Income Standard (AHC)[3]	£126
Replacement Rate (between 50% - 80% of pre-retirement income) (BHC)[4]	60% high earners - £640 70% median earners - £358 80% low earners - £187

1 DWP(2010) ***Households below average earnings***
2 DWP (2009) ***Benefit Uprating***
3 JRF (2010) ***A minimum income for Britain.***
4 PPI Calculations based on ASHE for 2009. The 10th and 90th deciles of income distribution were used for lower and high earners, respectively.

When assessing the adequacy of the level of income provided by pensions, governments may follow two alternative philosophical approaches. On the one hand, they may try to ensure that the pension benefits paid allow pensioners to have an income level that allows them to fulfil their basic needs. On the other hand, governments may try to ensure that the pension benefits paid are related to what people feel is necessary for them to replicate the standards of living they had while in working life.

If the first approach is preferred, poverty thresholds and minimum income standards measures are useful to assess the adequacy of a given pension system. By contrast, if the second approach is preferred, replacement rates and measures of household resources and income become more appropriate adequacy measures.

Chart 1 shows the value of the different adequacy measures for a single pensioner in 2009 values.

Poverty thresholds and minimum income standards:

Poverty thresholds establish the proportion of the population that are assumed to be in poverty, either in absolute or relative terms.

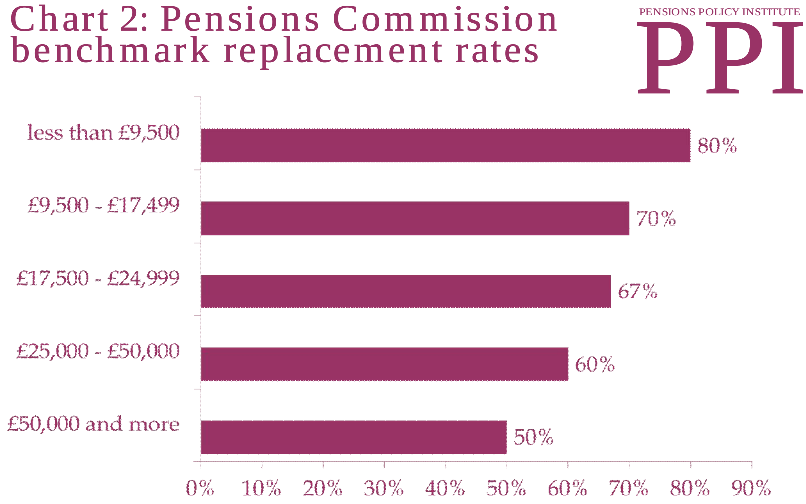
Absolute poverty measures establish the proportion of the population that lives below a certain poverty line that is the same across all countries and does not change; for example, the proportion of people living on under 1.25 or 2 dollars a day reported by the World Bank.[1]

In developed countries such as the UK, the focus is generally on relative poverty measures as it is assumed that everyone is above the absolute poverty threshold.

Relative poverty measures employ a poverty line that is related to an average income level. In the UK and other OECD countries, the current relative poverty line is set at 60 per cent of the median income. The main advantage of absolute and relative poverty measures is that they are relatively easy to establish and that they allow comparisons among different groups or countries. Yet, critics argue that they are not based on the true income needs of people but rather on how their income compares to an arbitrarily set poverty line. Furthermore, critics argue that such measures are sensitive to fluctuations in the economy.[2]

Minimum income standards have been developed in the UK by some scholars as an alternative to poverty thresholds.[3] They are based on feedback from a sample of the population on the types of goods and services they deem necessary to stay out of poverty. The value of this standard "basket" of goods and services is then used to assess whether people's income is above or below this level. Some observers argue that such measures are very sensitive to the specific type of elements selected and they also highlight that these measures do not account for the increased income needs of those who are frail, disabled or long term ill.[4] Chart 1 shows that the values of both the Government Poverty line and the Minimum income Standard are quite close to the Government Guarantee Credit, which is the income level that the government guarantees to every pensioner by topping up their Basic State Pension.

Chart 2: Pensions Commission benchmark replacement rates



*2004 earnings terms
Source: Pensions Commission (2004) p.143

Replacement rates and Measures of Household incomes:
Replacement rates are defined as the ratio of pension benefits to working life earnings. There are two different ways of applying this measure: as a ratio to average earnings or as a ratio to pre-retirement earnings. Both approaches are used in the academic literature.[5] However, if the purpose is to assess how adequate pension income is compared to pre-retirement income levels, the second option may be preferred.

The UK Pensions Commission adopted this second option.[6] Professor John Hills presented the Pensions Commission's approach to adequacy at the seminar. He explained that the Commission agreed on using replacement rates as a measure of adequacy for private sector pensions, establishing different benchmark levels for specific income brackets (Chart 2).

The estimated levels of income for an individual pensioner at different income levels following different benchmark replacement rates, are consistently above the minimum income standard and the Government's poverty line (Chart 1).

Measures of household incomes and resources aim to measure pensioner's resources not only in terms of their income but also in terms of their access to financial resources. Thus, as well as income, these measures typically include benefits in kind, assets and investments, goods and services, etc.[7]

Critics highlight that some assets may be more volatile and illiquid than others (e.g. property vs.

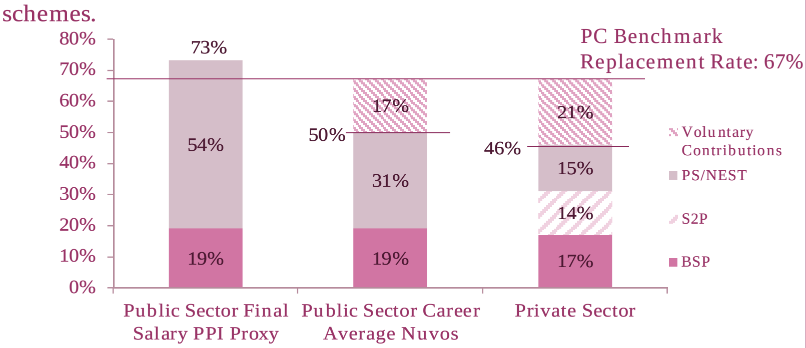
savings). Also, they argue that it is hard to assume that households remain stable over time and that assets and income are not shared equally across households.[8]

Conclusion: towards an appropriate adequacy measure for public service pensions

After discussing the different adequacy measures, it was generally agreed among the seminar participants that the Pensions Commission benchmark replacement rates are an appropriate way for the IPSPC to assess the adequacy of public service pensions.

Chart 3: Comparing gross replacement rates in the public and in the private sector under NEST

Gross replacement rates for a worker that joins at age 25 in 2016 and retires at age 68 on a median salary in the different modelled schemes.



Source: PPI individual modelling and Pensions Commission (2005), p.283

There was a general agreement that, in the context of public service pensions, poverty thresholds and minimum income standards may be useful to ensure that the income of low-earning pensioners does not fall below an unacceptable minimum level. There was some discussion as to whether the tax-free lump sum should be included or excluded in the calculation of the replacement rates. Some attendees pointed out that the lump sum could be used to provide pension income and, as such, should be included in the calculation of the replacement rate. Other participants pointed out that the lump sum should not be included as pensioners may use it to pay down debt or for other purposes. The UK Pensions Commission did not include the lump sum in its estimated benchmark replacement rates.

Chart 3 compares the gross replacement rates and its components modelled by the PPI for a median earner member of a typical public service final salary scheme and for a member of a career average scheme with benefits that mirror the Nuvos scheme in the Civil Service, but with higher levels of contributions.[9] It also compares these estimates to the ones published in the Pensions Commission's final report for a private sector worker member of NEST.[10] For comparability purposes, these estimates exclude the tax-free lump sum in the calculation of the replacement rates.

The estimates show that the typical final salary scheme provides a replacement rate for a median earner that is above the Pensions Commission benchmark of 67 per cent of earnings. Meanwhile, a member of a career average scheme with benefits similar to the Nuvos scheme would achieve a total replacement rate of 50 per cent. Therefore, this member would have to make additional voluntary contributions to reach the benchmark in this scheme.

However, it should be noted that a career average scheme could be designed to deliver any desired level of adequacy.

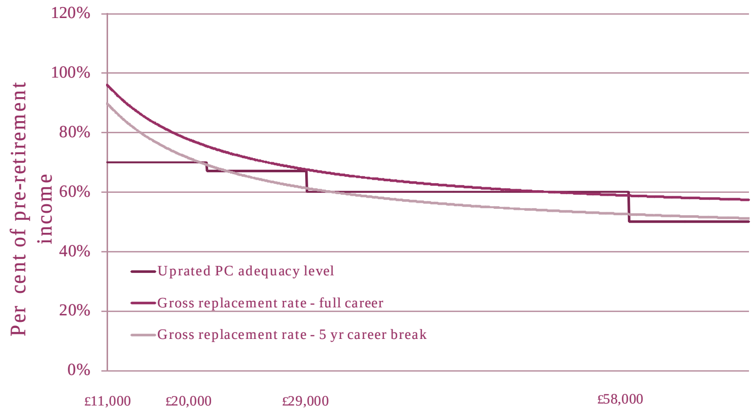
In comparison, the Pensions Commission estimated that a member of NEST making the minimum level of total contributions (8 per cent of a band of salary), would reach a replacement rate of around 46 per cent. It is worth noting that in this case the worker accrues rights to the Second State Pension (S2P), unlike public sector workers, who are contracted out of S2P. The Pensions Commission had further estimated that if contributions were doubled (16 per cent of a band of salary) a median earner would be able to reach a total replacement rate of between 60 and 66 per cent of pre-retirement earnings.

Comparing these estimates, and following the recommendations of the IPSPC, the Government will need to establish whether public sector pensions should provide an income close or above the Pensions Commission benchmark (as happens now) or somewhere in-between the current level and the minimum replacement rate level estimated by the Pensions Commission for private sector workers (46 per cent of pre-retirement earnings). In the second option, public sector workers would need to make additional voluntary contributions if they wanted to reach their target replacement rate.

The seminar participants agreed that income from the basic state pension and the public service pension scheme should allow workers to be somewhere close to the Pensions Commission's benchmark replacement rate. However, it was acknowledged that the Government will need to assess the affordability of any reform option; therefore, additional voluntary contributions may play a role.

The last aspect discussed by the seminar participants was how to ensure that people who take career breaks are not penalised in any future reform option. Chart 4 shows estimates from the Independent Public Service Pensions Commission's interim report on the replacement rate for a range of earnings compared to the uprated Pensions Commission target replacement rate.[11]

Chart 4: Typical public sector pension scheme replacement rates compared to uprated Pensions Commission benchmarks



Source: IPSPC calculations

Workers with a full career are consistently above their Pensions Commission benchmark. However, workers with a five year career break, especially those with earnings between £22,000 and £58,000 fall consistently below their benchmark.

This is an aspect that any future reform should consider as some people are more likely than others to take a career break or work part-time (e.g. women).

The participants agreed that any reforms should be designed to provide an adequate retirement income on the assumption of a full career. However, they also agreed that those who work part-time or take career breaks should not be unnecessarily penalised.

Finally, it was highlighted that any future reform may want to consider what is a fair assumption of a full career in the public sector.

1 See World Bank methodology at: data.worldbank.org/indicator/SI.POV.DDAY
2 See Price, D. (2008) ***Measuring the Poverty of Older People,*** p. 97 to 102.
3 See Bradshaw et al (2008) for a discussion of the Minimum Income Standards measures developed by the Joseph Rowntree Foundation. Available at: www.jrf.org.uk/publications/minimum-income-standard-britain-what-people-think
4 See Fisher, G. (2007) ***An overview of recent work on budget standards in the United States and other Anglophone countries.*** York: Family Budget Unit.
5 Binswanger, J. and D. Schunk. (2009) ***What is an Adequate Standard of Living during Retirement?***, CESifo Working Paper 2893
6 Pension Commission (2004) ***Pensions: Challenges and Choices,*** p.143.
7 See for example the ONS Wealth and Assets Survey and the English Longitudinal Survey of Ageing developed by the Institute of Fiscal Studies.
8 Westaway J and McKay S (2007) ***Women's Financial Assets and Debts*** London: Fawcett Society
9 PPI individual modelling.
10 Pension Commission (2005) ***A New Pension Settlement for the Twenty-First Century***, p.283.
11 IPSPC (2010) ***Interim Report,*** p.89

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