PENSIONS POLICY INSTITUTE

PPI

PPI Evidence for John Hutton's Independent Public Service Pensions Commission

Introduction

1. The Pensions Policy Institute (PPI) promotes the study of pensions policy and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

2. The Pensions Policy Institute would like to submit two PPI research publications as evidence to the independent review of public service pension provision. Enclosed for the review's attention are:
   - PPI research report on An assessment of the Government's reforms to the public sector pensions (published October 2008)
   - PPI discussion paper on Public sector pensions schemes: policy objectives and options for the future (published March 2010)

   Both research reports have been funded by the Nuffield Foundation and the PPI is grateful for the Foundation's support.

3. For ease of reference this note summarises the key evidence contained in the above reports, however further details on the methodology and assumptions used in the research are contained in the full PPI research reports which can be downloaded from the PPI website at the following link: http://www.pensionspolicyinstitute.org.uk/default.asp?p=12

4. In October 2008, the PPI published a research report, funded by the Nuffield Foundation, which provided an assessment of the Labour Government's reforms to the public sector pensions reforms that were implemented between 2005 and 2008.

5. The research considered the value of the seven main public sector pensions schemes (NHS, Teachers, Civil Service, LGPS, Armed Forces, Fire & Police) to public sector employees before and after the reforms, it considered the comparison between pay and pensions in the public sector and it considered the future affordability and sustainability of the public sector schemes.

What has been the impact of the reforms for public sector employees?

6. The PPI has calculated the "effective employee benefit" rate as a percentage of salary for a typical public sector worker in each of the seven main public sector schemes, before and after, the last labour Government's reforms to the public sector pensions.

7. The calculations show the value to an individual of being a member of a particular public sector pension scheme as a percentage of their salary. The rate of pension accrual, the NPA, survivors' or death-in-service benefits are all factored into the calculation. The future value of these benefits is then discounted back to the present and is presented as the value to a scheme member as a percentage of the individual's salary.

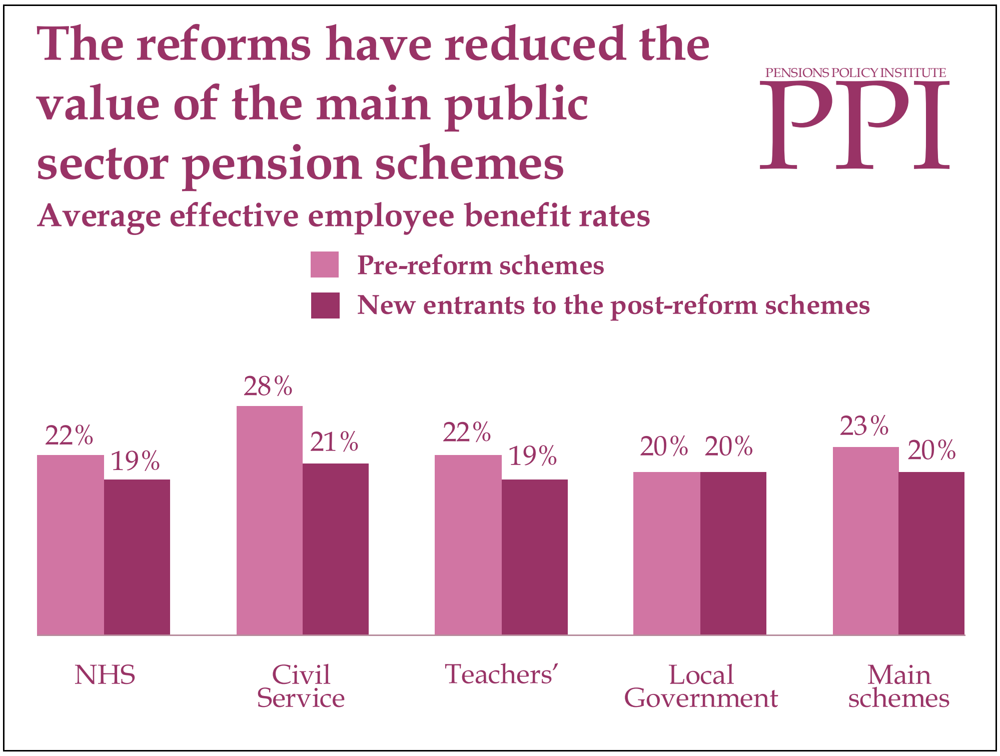
8. The level of the scheme member's own contributions are not factored in to the calculation because the scheme member meets these contributions themselves from their salary, so it is not construed as a benefit that they are receiving on top of their salary.

9. PPI research suggests that the last Labour Government's reforms have reduced the average value of the seven main public sector pension schemes (NHS, Teachers, Civil Service, LGPS, Armed Forces, Fire & Police) by around 3% of salary for new entrants, from 24% to 21% of salary.[1] The precise effects of the reforms, however, vary from scheme to scheme and for individual members of the public sector schemes.

10. The reforms have reduced the average value of the four main public sector pension schemes (for the NHS, Civil Service, Teachers and Local Government) by around 3% of salary for new entrants, from 23% to 20% of salary.[2] (Chart 1) Around half of the impact of rising the normal pension age has been offset by improvements in pension accrual rates. The reforms are likely to have less impact for existing members who retain a normal pension age of 60 (except in the LPGS where NPA is 65).

[1] Pensions Policy Institute, An assessment of the Government's reforms to public sector pensions (2008)
[2] PPI Modelling

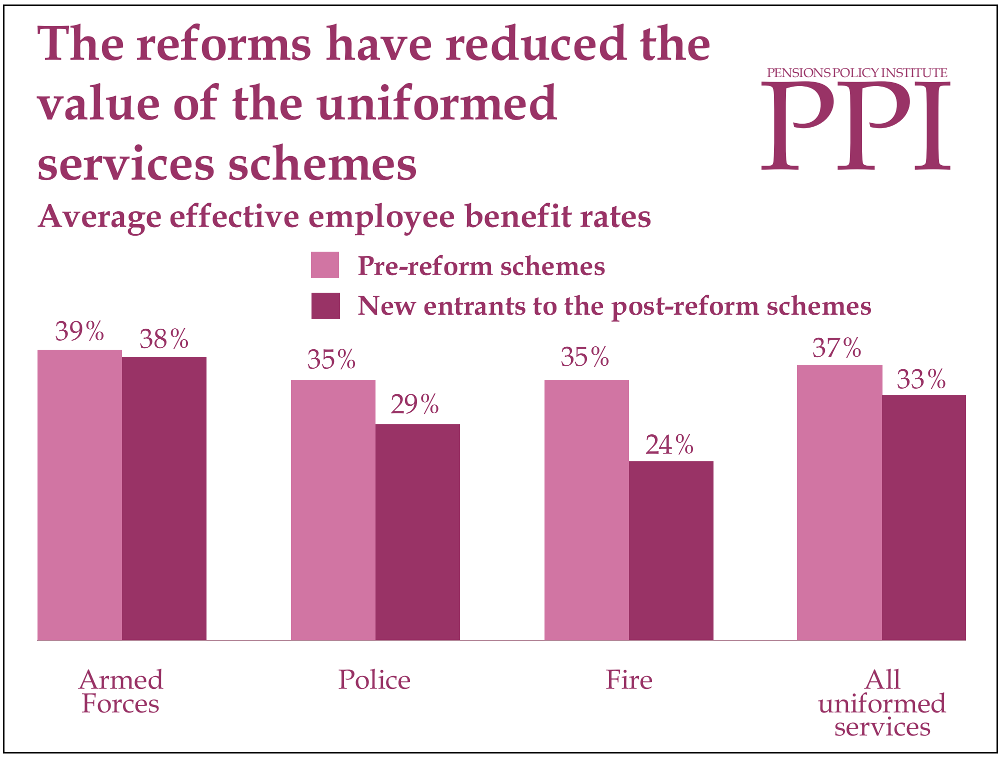
Chart 1[3]



11. The schemes for the Armed Forces, Police and Fire have fewer members than the four main schemes. The reforms to the Armed Forces, Police and Fire schemes have reduced their average value by around 4% of salary for new entrants, from 37% to 33% of salary (Chart 2), although even after the reforms they remain substantially more generous than the four main public sector schemes and many private sector schemes.

[3] PPI modelling

Chart 2[4]



12. For long-serving members of the schemes, the reduction in value can be more significant. Members of these schemes can have an NPA of 55 or 60 provided that they remain in these schemes until retirement, but in future will have their NPA increased to 65 if they leave the scheme early.

13. There is much debate about the appropriate discount rate to use in such calculations. In these calculations the PPI has used the same discount rate that the Government assumes in calculating the total liabilities of the public sector pension schemes – a AA corporate bond rate[5].

14. Private sector pension schemes are required to use a AA corporate bond discount rate in preparing FRS17 valuations. The use of the same discount rate in both the private and the public sector pensions means that direct comparisons are possible between the fundamental differences of value of pensions in the public and private sectors that are not driven by different discount rate assumptions.

[4] PPI modelling
[5] As at 31 March 2008 the Government was assuming a real discount rate of 2.5%

15. Some commentators have argued that because public sector pension promises are backed by the Government, a discount rate that is linked to index-linked gilts is more appropriate.[6] Using this alternative methodology the value of the four main public sector pension schemes (NHS, Teachers, Civil Service and LGPS) would be around 40% of salary rather than around 20% of salary when calculated using an index linked gilt discount rate.[7]

16. It should be stressed that the selection of the discount rate assumption will alter the perceived value of the public sector pensions but the nature and timing of the payments to be paid by the public sector pension schemes to scheme members is not affected by the choice of discount rate.

17. As a result, PPI analysis tends to focus on Government expenditure (net of employee contributions) as a percentage of GDP to gauge the overall affordability and sustainability of the public sector pension schemes rather than the employee benefit calculations.

Will the reforms improve the financial sustainability of the schemes?

18. Figures which focus on the level of the liabilities of the public sector schemes will be heavily determined by the discount rate that is assumed. Such estimates provide no information on the extent to which the Government can afford to meet these future obligations from growth in the economy/ general taxation (or from the underlying assets in the case of the LGPS.) Neither do liability figures take account of the extent to which public sector employees are themselves meeting a share of these future costs through their own contributions.

19. An alternative measure of the future affordability and sustainability of the public sector pension schemes is to consider what proportion of the economy's GDP will need to be dedicated to meeting the costs of the public sector pensions, after netting off the contributions that will be made by public sector employees themselves.

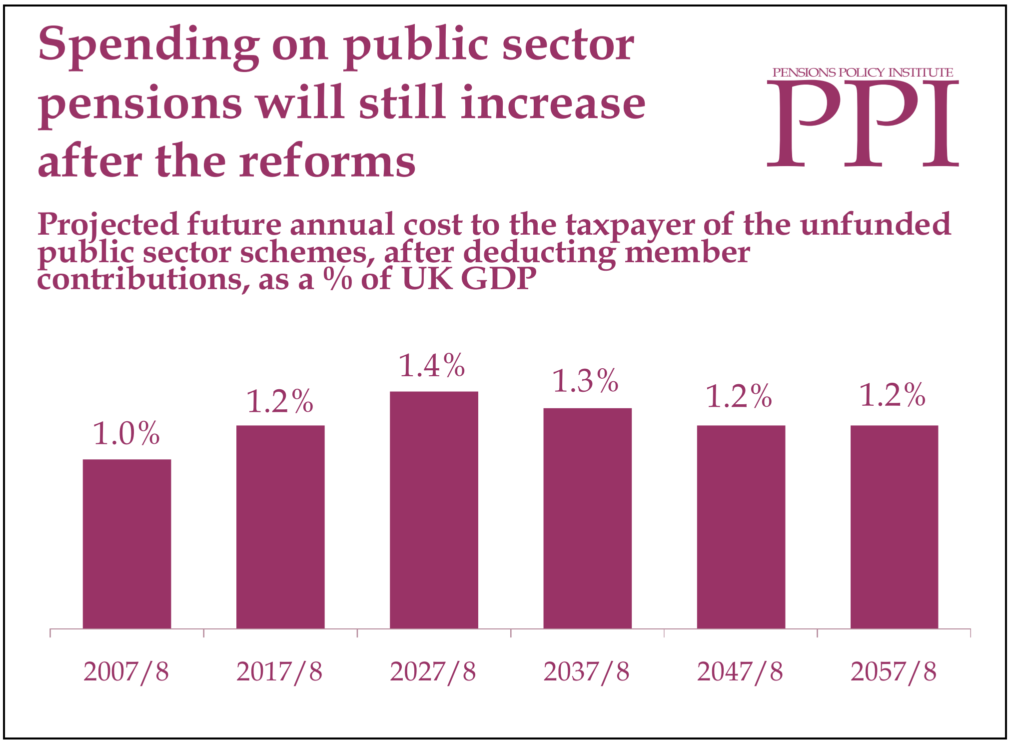
20. On this basis, spending on unfunded public sector pensions (net of employee contributions) is projected to grow from 1.0% of GDP in 2007/8 to 1.4% of GDP in 2027/8 before falling back to 1.2% of GDP by 2047/48[8], after allowing for the savings from the recent reforms. (Chart 3)

[6] Public Sector Pensions Commission, Reforming Public Sector Pensions: solutions to a growing challenge, July 2010

[7] Pensions Policy Institute, An assessment of the Government's reforms to public sector pension (2008) Table 8 p.41

[8] Source: PPI Calculations. Note that these figures were calculated before the Government's switch to CPI indexation for public sector pensions. The use of CPI rather than RPI for indexation is likely to reduce the costs to the Government.

Chart 3[9]



21. These projections were calculated by the PPI in its research published in 2008. They are based on HMT long-term projections for Government Expenditure on public sector pensions adjusted by netting off member contributions. The HMT projections assumed a constant public sector workforce at 2008 levels. The NAO highlighted that any change to this assumption would affect the projections.[10] A contraction of the public sector workforce would reduce Government expenditure on public sector pensions, an expansion would increase expected Government expenditure.

22. The original HMT projections assumed that the public sector pensions would be indexed in line with RPI. The Coalition Government announced in the emergency budget that public sector pensions will be indexed to the Consumer Prices Index, instead of the Retail Prices index from April 2011. As CPI is typically lower than RPI over the long-term this policy change would reduce projected Government expenditure. The PPI will be updating these projections in the light of these changes in the next phase of its research.

[9] PPI calculations based on HMT (2008) Table 4.1 and ONS Pension Trends Table 8.12. In the absence of detailed projections of aggregate member contributions, the figures assume they will increase as a proportion of GDP from 0.5% to 0.6%, in line with the recent increases to member contribution rates.
[10] National Audit Office, The cost of public service pensions, March 2010

23. Although the rate of growth of expenditure on public sector pensions is currently projected to be fairly rapid, state spending on public sector pensions will, however, still be lower in absolute terms than state spending on health, education and state pensions.

24. The savings from the Labour Government's recent reforms are likely to be relatively modest. Over the next 50 years, the Government expects the reforms to save a total of £13 billion in the NHS, Civil Service and Teachers' schemes. This compares to the total amount contributed by public sector employers to these three schemes of around £10 billion every year. The reforms to the Local Government scheme could save taxpayers £340 million a year, a 7% reduction. No data are available for the Armed Forces, Police and Fire schemes.

25. Cost sharing and cost capping agreements have been made in the NHS, Civil Service and Teachers' schemes, and Local Government is expected to follow. These agreements mean that unanticipated future increases in costs will be shared between public sector employers and the members of the schemes, rather than passed automatically onto public sector employers, as was the former situation.

26. The agreements could limit employer contributions in future, particularly as employer contributions will be subject to an overall cap. For example, if estimates of life expectancy increase by 1 year more than expected, this could cost employers in these schemes an extra £200 million a year in the absence of the cost sharing and cost capping agreements. Now the extra costs may be met almost entirely by the members of these schemes.

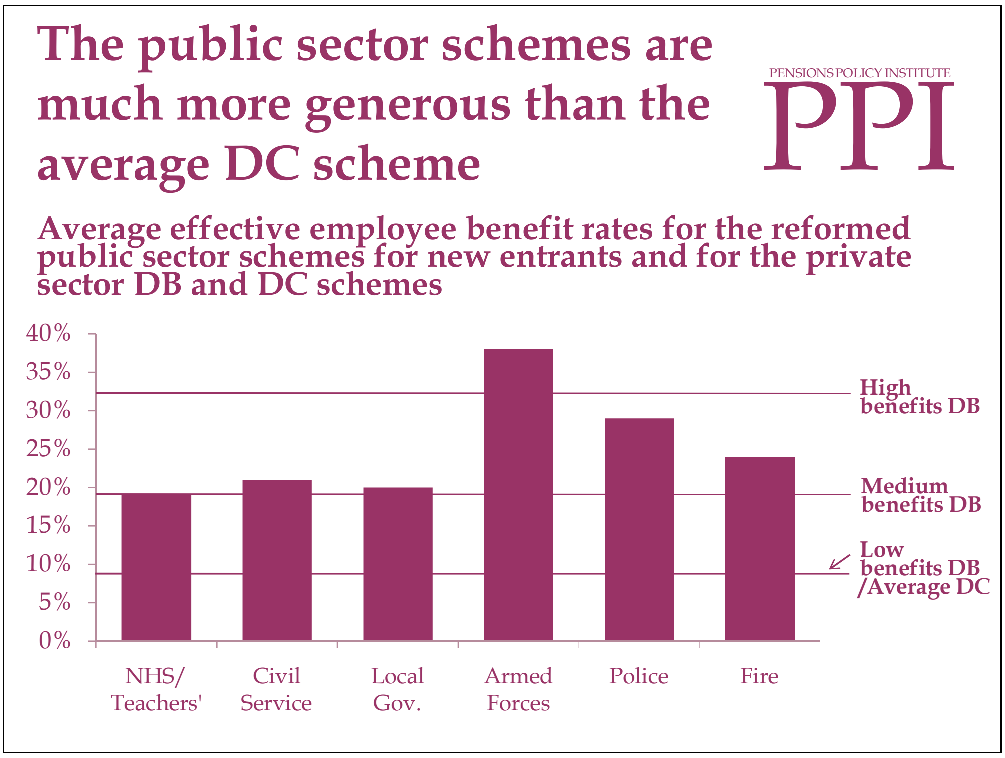
27. The PPI is undertaking further work on the future of the public sector pension schemes during 2010. This research will consider whether there is a case for further reform of the public sector pensions, and if so what might be the appropriate policy objectives of any further reform. The final stage of the research will assess a number of reform options against the policy objectives (forthcoming in 2010.)

How do pensions and pay in the public sector compare with pensions and pay in the private sector?

28. Public sector employees are more than twice as likely to be a member of an employer-sponsored pension scheme as private sector employees: around 85% of public sector employees are members of a scheme, compared to only 40% of private sector employees.[11] Most of the members of public sector schemes have a Defined Benefit scheme, but only around 15% of private sector employees are active members of a Defined Benefit scheme.

29. The value of the four main unfunded public sector schemes (for the NHS, Civil Service, Teachers and Local Government) for new entrants will be similar to a typical private sector Defined Benefit scheme, at around 20% of salary on average. However, a typical public sector DB scheme is around twice as valuable as the average value of a private sector Defined Contribution scheme, which is worth around 10% of salary on average, once the value of state second pension is included. (Chart 4)

Chart 4[12]



[11] ONS 2007 Annual Survey of Hours and Earnings Pensions Analysis. 'Employer-sponsored pension scheme' means a pension scheme that is arranged through an employer. Includes people with a group personal pension but not people who only have a personal pension that they arranged individually with a pension provider. Includes schemes that do not receive contributions. Figures are based on numbers of jobs and so some individuals with more than one job may be counted more than once. Group personal pensions include group stakeholder pensions.

[12] PPI modelling. Does not include any allowance for the impact of cost sharing/cost capping agreements

30. It is often assumed that better pensions in the public sector make up for lower pay. Although a job-for-job type comparison of pay is difficult to make between the private and public sectors, women and low-skilled male workers seem to be paid relatively more on average given their levels of skill and qualifications in the public than the private sector. High-skilled male workers are paid more in the private than the public sector given their levels of skill and qualifications.[13]

31. The problem of lower paid employees having no employer-sponsored pension provision is less acute in the public than the private sector. For example, around 20% of private sector employees who earn between £100 and £200 a week are members of an employer-sponsored pension scheme, compared to around 70% of similarly paid public sector employees.

32. This evidence does not suggest that more valuable pensions in the public sector compensate for lower pay across the board in the public sector.

Is there a need for further reform of the public sector pensions?

33. Calls for further reforms to the public sector pension schemes have been voiced by a number of organisations. Some of the political parties, business lobby groups and trade unions have publicly discussed possible options for the future of public sector pension schemes.

34. It is useful to determine a set of desirable policy objectives for any reforms to the public sector pensions. The effectiveness of suggested reforms can then be measured against these objectives.

35. Potential objectives for reform of the public sector pensions could be:
    - 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.

[13] See Pensions Policy Institute, An assessment of the Government's reforms to public sector pension (2008) Chapter 5, p45 for a full discussion of these issues.

36. There are clearly tensions between some of the policy objectives. For example, ensuring that public sector pensions provide adequate pensions for public sector workers may conflict with an objective to address concerns that public sector pension schemes are unaffordable. So policymakers will need to make trade-offs between policy objectives. A reform option which appears to be very affordable in the short-term, may not be sustainable in the long-term if it implies that public sector workers will have inadequate pensions in the future.

37. In the long-run, reform options that mean that public sector workers have inadequate pensions may lead to increased Government expenditure in the future if public sector employees end up falling back onto state benefits.

38. There are two policy objectives listed above that relate to fairness: to address perceptions that public sector pension schemes offer higher levels of benefits than private sector pension schemes, and to address unfairness between members within the same public sector pension scheme.

39. The issue of perceived fairness with pensions in the private sector is an important one. There are a number of bodies who represent private sector organisations (e.g. IoD, CBI) who have argued that private sector workers (as taxpayers) should not have to pay for the more generous pensions of their public sector counterparts.

40. The issue here may not be so much about ensuring direct parity of the value of pensions in the public and private sectors, as ensuring that if public sector pensions continue to be more valuable than the pensions widely available in the private sector, then public sector workers should expect to contribute more to help to meet the costs of these pensions, such that private sector taxpayers are not expected to disproportionately bear the cost.

41. The second policy objective that relates to fairness relates to fairness within the public sector schemes. Final salary pension schemes tend to favour high fliers with fast salary progression. As a result public sector workers with slower salary progression end up cross subsidising these high earners. There is a reasonable public policy question as to whether or not this benefit structure is fair within the public sector schemes. Reform options which link pensions to average salary, or which cap the level of final salary benefits are likely to lead to fairer outcomes between public sector workers with high and slow salary progression.

42. A pension is also a recruitment and retention tool which forms a part of the total package of remuneration. The review should seek evidence on the extent to which public sector employers are having recruitment or retention difficulties and should factor this into its thinking.

Options for the future of the public sector pension schemes

43. There have been a number of calls for reform or specific policy proposals made for future reform of the public sector pensions. These have fallen into a number of different broad categories of proposals. These are:
    - *Continue current policy*, and implement the already agreed reforms for new entrants with no further change. In particular it assumes that the already agreed cost sharing and cost capping agreements are implemented.
    - *Make changes to existing final salary schemes* such as increasing normal retirement ages in line with changes to the state pension age, placing a cap on the benefit accrued or capping pensionable salary or increasing member contributions further.
    - *Risk sharing measures* such as moving schemes to career average arrangements such as the civil service scheme or implementing a hybrid scheme with a defined benefit scheme on a base salary with a defined contribution top up.
    - *Move to defined contribution arrangements* such as looking at the impact of moving to a funded defined contribution system or a notional defined contribution system such as the one used in Sweden.

44. The PPI will publish an assessment of these policy options against the policy objectives set out above later in 2010 and we will be happy to keep the review team informed as our work progresses and to feed into the second phase of the review's evidence gathering.

The case for short-term savings

45. The review has been asked to provide an interim report that will consider the case for delivering savings on public service pension provision ahead of the Government's spending review.

46. The decision about the appropriate level of public spending on public sector pay and pensions is a matter for the Government of the day. However, it should be noted that of the reform options listed above the only reform option that is likely to deliver substantial savings in the short-term are increases to the level of public sector employees' contributions to the schemes.

47. Some of the options listed above would actually increase Government expenditure in the short-term, such as moving to a funded defined contribution arrangement. Other reform options such as moving to a career average or hybrid basis are likely to deliver expenditure reductions only over the longer-term.

48. Ultimately whether to make short-terms savings from making changes to the public sector pensions is a political judgement that will have to be driven by the overall affordability of public sector pay and pensions in the context of the wider Government spending review.

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30 July 2010