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An assessment of the Government's reforms to public sector pensions

Summary of conclusions

The Government announced reform of the public sector pension schemes in 2002. Most contentiously, the final set of reforms include an increase in the Normal Pension Age (NPA) from 60 to 65 for new entrants to the NHS, Civil Service and Teachers' schemes. Existing members of the schemes have retained an NPA of 60. The reforms also include benefit improvements, reforms to ill-health and flexible retirement benefits, and a new cost sharing agreement between public sector employers and individual members of the schemes.

Despite the reduction in benefits for new entrants to the public sector pension schemes, the Government argued that increasing the NPA would:

- Redirect resources to finance greater flexibility and benefit improvements for public sector employees.
- Improve the financial sustainability of public sector pension schemes.
- Reflect the practice in the majority of private sector pension schemes.

This paper considers to what extent the reforms have met these aims.

What will be the impact of the reforms on public sector employees?
Public sector schemes are pension schemes run and paid for by the Government for the benefit of public sector employees and are an important part of the remuneration package for the five million public sector employees who are members of them.

The Government's reforms have reduced the average value of public sector pension schemes by around 3% of salary for new entrants, from 24% to 21%. The precise effects of the reforms, however, vary from scheme to scheme and for individual members of the public sector schemes.

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%. 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.

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%. 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.

Will the reforms improve the financial sustainability of the schemes?
Public sector pensions are projected to grow more quickly over the next twenty years than any other area of state spending for which long-term projections are available. Over this period, spending on unfunded public sector pensions is projected to grow from 1.0% of GDP to 1.4% of GDP in 2027/8, after allowing for the savings from the recent reforms. This is an increase of 40%, which compares to an increase of 17% for long-term care, 16% for health and 14% for state pensions over the same period. In 2027/8, state spending on public sector pensions will, however, still be lower in absolute terms than state spending on health, education and state pensions.

The savings from the 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.

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. 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.

Will the reforms close the gap between public and private sector pension provision?
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. 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.

The value of the four main public sector schemes (for the NHS, Civil Service, Teachers and Local Government) for new entrants will be similar to a medium private sector Defined Benefit scheme, at around 20% of salary on average. The average value of a private sector Defined Contribution scheme is around 7% of salary, however, which is significantly lower than the value of the reformed public sector schemes.

The schemes for the Armed Forces, Police and Fire are worth on average 33% of salary for new entrants. They remain more valuable than medium private sector Defined Benefit scheme and are significantly more valuable than private sector Defined Contribution schemes. If the shift from DB to DC continues in the private sector, and contribution rates in DC schemes do not increase, the difference between the average pension provision of public and private sector employees may continue to grow.

Taking account of both the higher coverage of pensions in the public sector and the value of pensions in the public and private sectors, significantly more is contributed each year to pensions in the public sector than in the private sector. Employers contribute around £4,000 per year per employee in the public sector, compared to £1,600 per employee in the private sector. However, employees in the public sector also contribute more than their counterparts in the private sector.

Do public sector pensions make up for lower pay?

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 in the public than the private sector. High-skilled male workers are paid more in the private than the public sector.

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.