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What do we mean by adequacy in the context of the public sector pensions?

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Adequacy Seminar for the Independent Public Sector Pensions Commission

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The IPSPC questions on adequacy

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- How should the Commission think about measuring adequate levels of resources in retirement?
- What should be considered an adequate level of resources in retirement?
- Should a full state pension and a full public service pension ensure people have adequate resources in retirement? Or should room be left for individuals to make their own arrangements?
- How should this change where people work part careers in public service?

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Measuring adequate levels of resources in retirement

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Individual objectives of pensions

- Consumption smoothing: to ensure that a person transfers consumption from working to retired years. A system's replacement rate reflects how well this is achieved.

- Insurance: to protect people against the risk of outliving their own savings. In DC systems this risk is mitigated through the purchase of an annuity. In DB systems employers make a promise to cover such a risk

How to approach adequacy?

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- From a philosophical point of view, the state may want to provide a minimum income level in retirement ***or*** a desired income level related to people needs in retirement
- Minimum income measures: poverty thresholds, minimum income standards
- Desired income levels: replacement rates; measures of household income / resources

Poverty thresholds

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- Absolute poverty: the number of people below a fixed real poverty threshold.
- UK government absolute poverty line: 60% of the 1998-1999 median income constant in real terms
- UK government relative poverty line: 60% of median income
- Relatively straightforward measures
- Yet, they are not based on what people need. Most useful to make comparisons between groups and across countries

Minimum income standards measures

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- Developed by JRF* based on a selection of components that are deemed necessary to avoid poverty
- The UK has never formally accepted their use for policy-making
- These measures do not include expenditure for those with ill health, frailty or disability
- May be most relevant for lower income households

* JRF (2008) ***A Minimum Income Retirement for Britain***

Pension commission benchmark replacement rates

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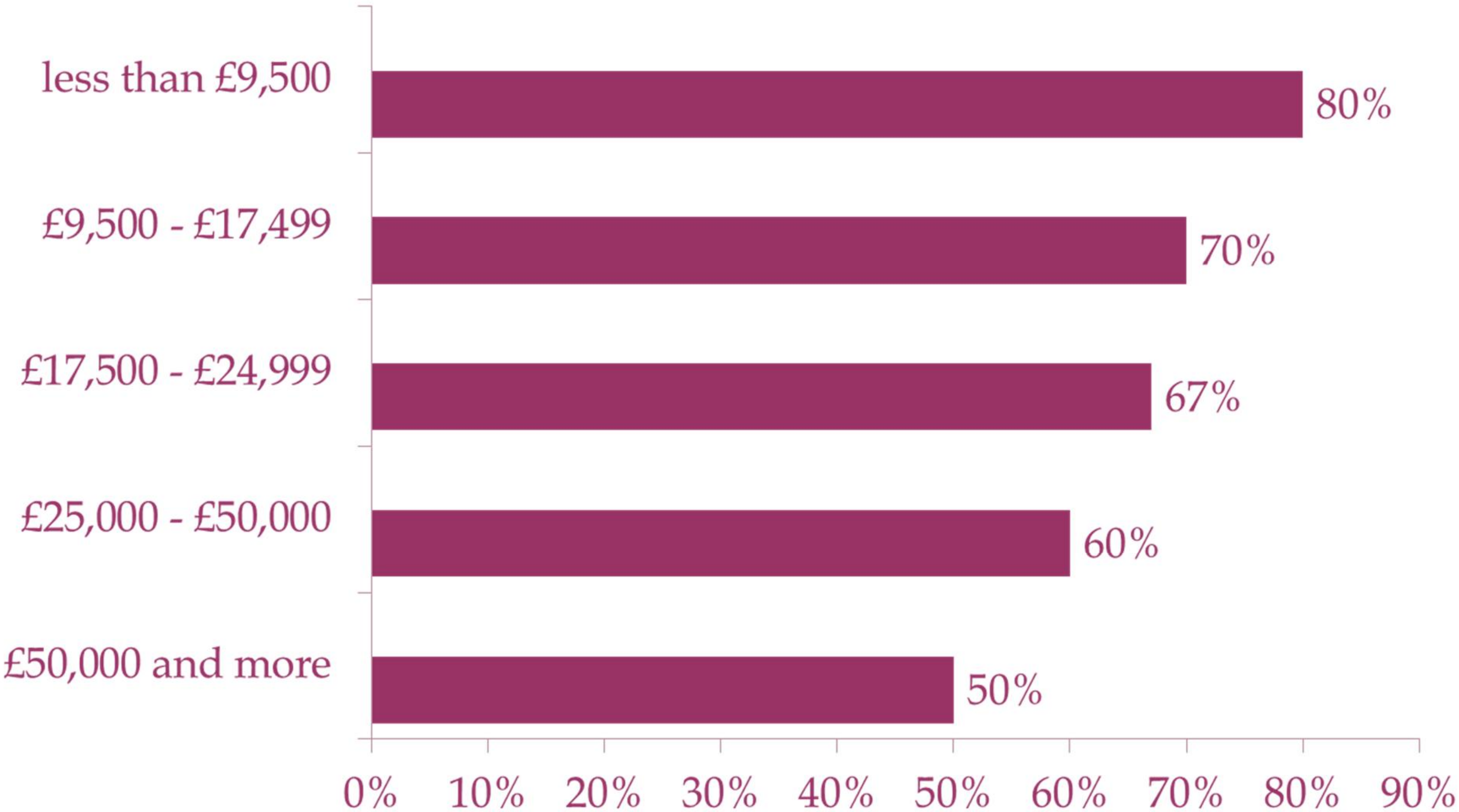

*2004 earnings terms

Source: Pensions Commission (2004) p.143

Measures of household resources/income

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- Recent efforts to measure assets and debts as part of total household income: ONS Wealth and Assets Survey; IFS ELSA
- Yet, no clear consensus exists on what financial resources to include in a measure of household resources for pensioners
- Some assets are more liquid and volatile than others (e.g. savings accounts vs. property)
- Some assets may be used for other purposes (eg. to fund long-term care)
- Households can dissolve and assets may not be equally shared between individuals

Comparing adequacy measures

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Measure	Single Pensioner (£ per week 2009)
Government's relative poverty line (AHC)	£119
Guarantee Credit (AHC)	£130.0
Minimum Income Standard (AHC)	£126.08
Replacement Rate (between 50% - 80% of pre-retirement income) (BHC)	60% high earners - £640.38 70% median earners - £358 80% low earners - £186.60

Source PPI(2009) ***Retirement Income and Assets, Do Pensioners Have Sufficient Income to Meet their Needs?***

What should be considered an adequate level of resources in retirement?

Should a full state pension and a full public service pension ensure people have adequate resources in retirement?

Or should room be left for individuals to make their own arrangements?

Pensioner spending varies during retirement as needs and preferences change

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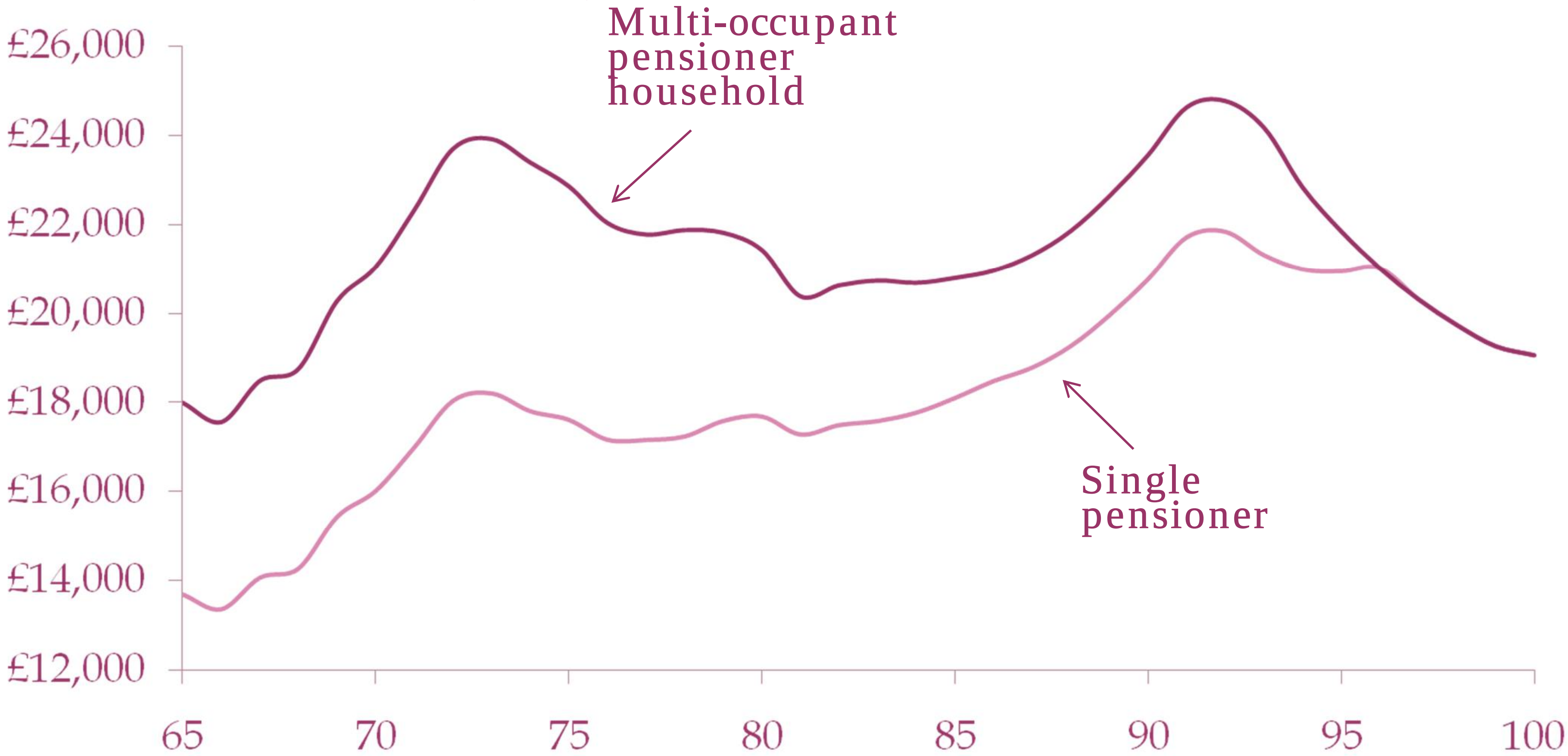
Annual household spending on different categories for pensioner households retiring at 65 in 2008 in current (cash) terms



Source: Life Trust, cebr (2008) ***Life Trust Cost of Retirement Report***

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

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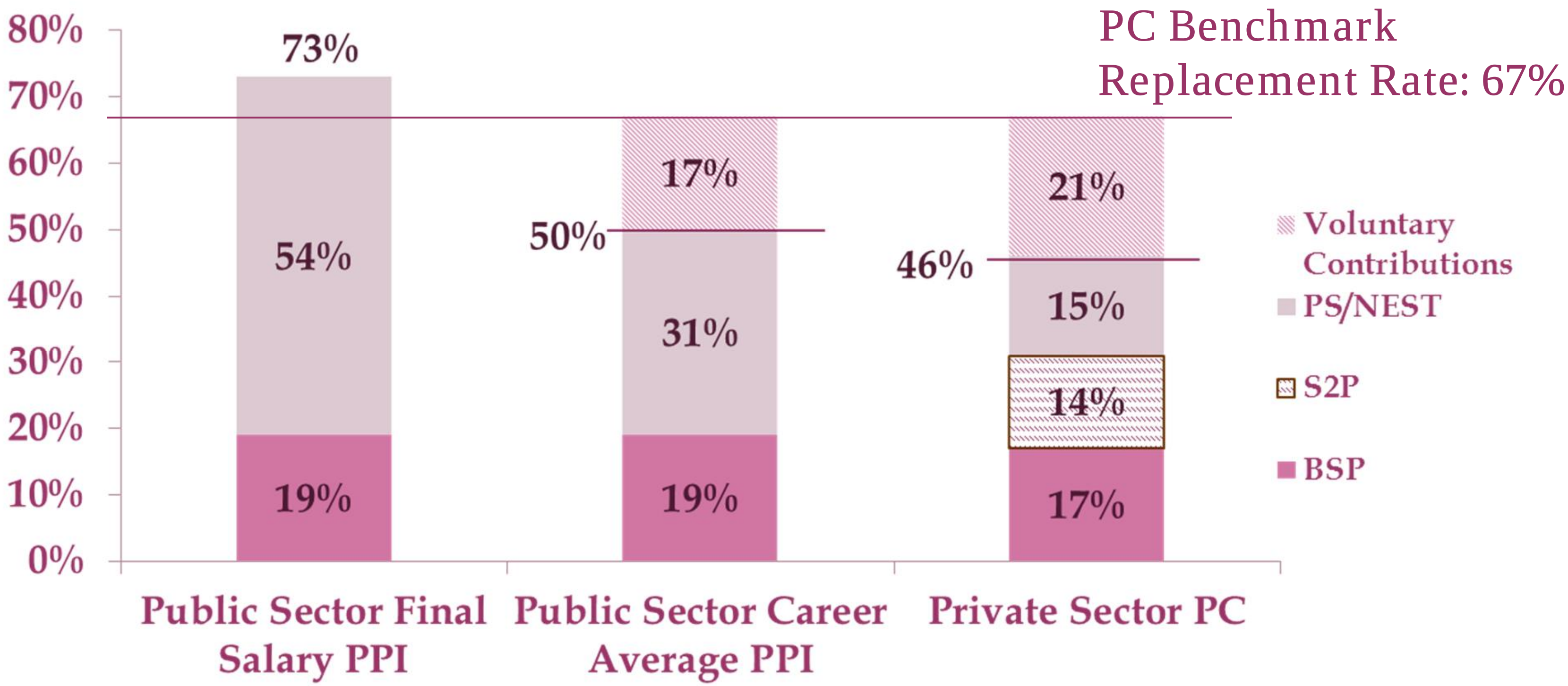
Gross replacement rates for a worker that joins at age 25 in 2016 and retires at age 68 on a median salary in the different modelled schemes.



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

Typical public sector pension scheme replacement rates compared to uprated PC benchmarks

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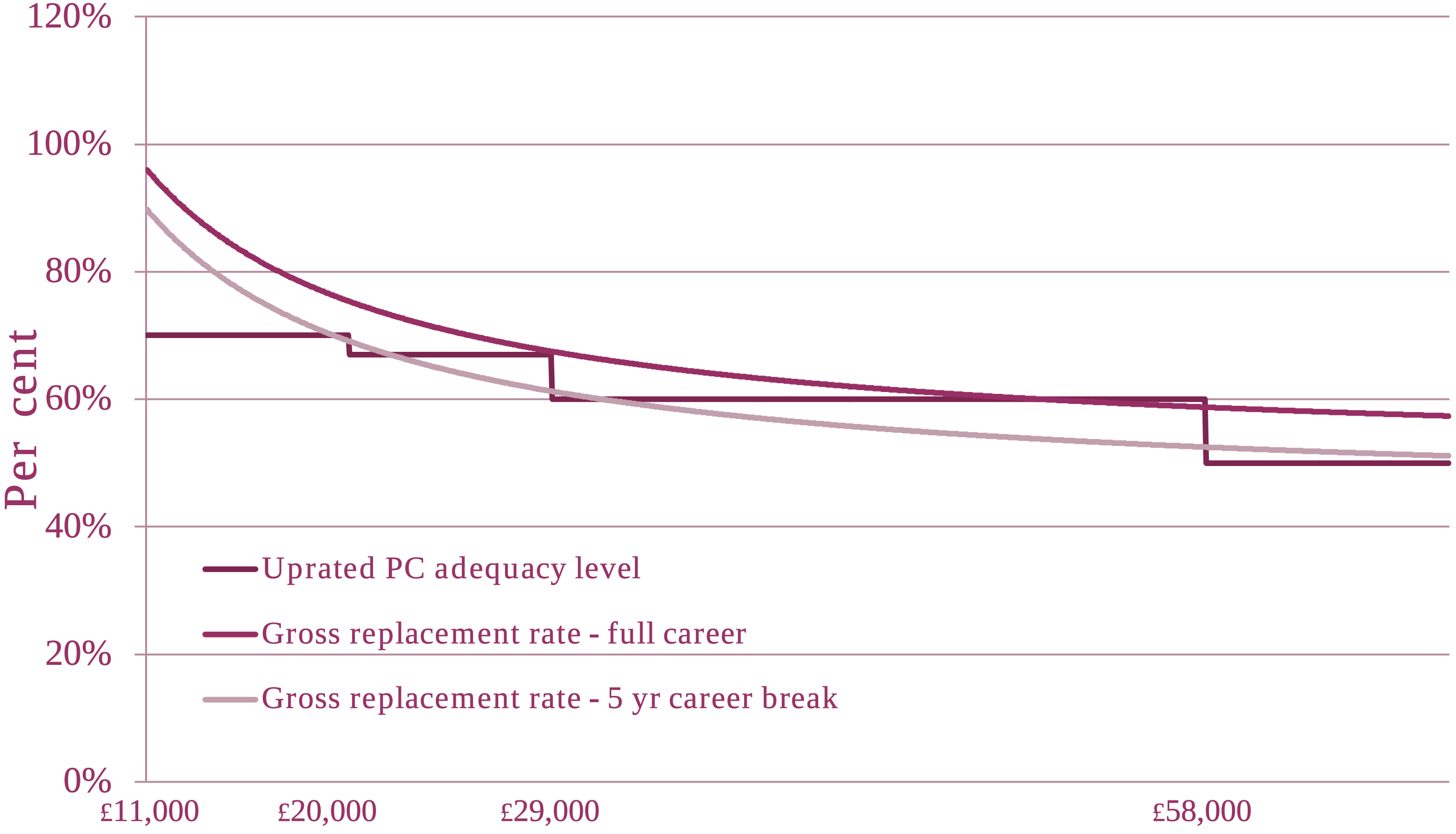

Source: IPSPC calculations

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How to ensure that career-breakers are not penalised?

Career-breakers and part-timers

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- Any reform option should be judged on the assumption of a full working career
- However, women are more likely to make a career break or to work part-time
- Scheme design should not unfairly penalise them
- What should be considered as a full career: 30 years, 40 years?

Questions for Discussion (1)

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- What measures should the IPSPC use to assess adequacy: replacement rates, minimum income standards or poverty thresholds?
- If using replacement rates, should they be linked to pre-retirement income levels rather than to career-average levels?
- Should the tax free lump sum be included or excluded in the calculation of the replacement rate?

Questions for Discussion (2)

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- What should be the respective roles of the state pension, the public sector pension and individual voluntary saving in enabling individuals to reach target replacement rates?
- How should career breakers and part-timers be treated?
- What should be the standard assumption of a full career in the public sector?