PENSIONS POLICY INSTITUTE

PPI

PRESS RELEASE

FOR IMMEDIATE RELEASE
FRIDAY 17 MAY 2013

"The Government's proposed reforms to the four largest public service pension schemes will reduce the average value of the pension benefit for members of these schemes by more than a third, and reduce long-term government expenditure on unfunded public service schemes by around a quarter", says Pensions Policy Institute

The Pensions Policy Institute (PPI) is today publishing an independent assessment of the impact of the Coalition Government's proposed reforms to the four largest public service pension schemes: the NHS, Teachers, Local Government and Civil Service pension schemes. The analysis has been funded by the Nuffield Foundation and covers the potential impact of the Government's proposed reforms on the pension benefit offered to members of schemes and on the affordability and sustainability of the schemes.

Under the Government's proposed reforms to the largest four public service pension schemes the pension benefit will be linked to the member's average salary, the Normal Pension Age is due to increase in line with the State Pension Age and member contributions are set to increase.

Niki Cleal, PPI Director, said: "The PPI's analysis suggests that the combined impact of the Coalition Government's proposed reforms is to reduce the average value of the pension benefit for all members of the NHS, Teachers, Local Government and Civil Service pension schemes from 23% of a member's salary before the Coalition Government's reforms, to 15% of a member's salary after the Coalition Government's reforms, a reduction in the average value of the pension benefit for members of these four schemes of more than a third."

"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."

Chris Curry, PPI Research Director, added: "The impact of the Government's reforms on members of the public service pension schemes will vary for scheme members with different characteristics. High-flyers with fast salary progression may see a larger reduction in the value of their public service pension under the Government's proposed reforms than scheme members with more modest salary progression."

"The reforms will also reduce net government expenditure on unfunded public service schemes from around 1.1% of GDP by 2065 under the current system to around 0.8% of GDP in the reformed system – a reduction of around a quarter."

ENDS

Notes for editors

1. The Pensions Policy Institute (PPI) is an educational research charity, which provides non-political, independent comment and analysis on policy on pensions and retirement income provision in the UK. Its aim is to improve the information and understanding about pensions policy and retirement income provision through research and analysis, discussion and publication. Further information on the PPI is available on our website www.pensionspolicyinstitute.org.uk.

2. The report published today updates a previous report published on 23 October 2012. The new report includes an analysis of the impact of the Government's proposed reforms on the affordability and sustainability of public service pension schemes.

3. The report published on 23 October 2012 estimated the value of a private sector DC scheme to be worth around 10% of salary. This included an allowance for eligibility to the State Second Pension (S2P). The Coalition Government has announced its intention to introduce a Single Tier Pension from 2016, in effect abolishing the S2P. Therefore, the EEBR comparator for a member of a DC scheme used in this report does not take into account the value of the S2P. As a consequence, the overall value of a typical Defined Contribution scheme is now estimated as the average employer contribution rate of around 7% of a private sector worker's salary.

4. The 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.

5. The Coalition Government's proposed reforms to the public service pensions as set out in the proposed final agreements include:
   - Ending the link between pension benefits and final salary. Instead the Government proposes to link pension benefits to the average salary of public sector employees over the course of their careers revalued by an index;
   - Linking the Normal Pension Age to the State Pension Age for members of the four largest schemes and increasing the Normal Pension Age to 60 for members of the uniformed services;
   - Increasing the rate of members own contributions to the schemes, with higher earners seeing the most significant increases in contribution levels.

   The tables in Annex 1 of the report published today summarise the main elements of the four largest public service pension schemes and the Government's proposed reforms. The Government has also proposed reforms to the uniformed service schemes: Policy, Fire and Armed Forces but the PPI has not analysed the impact of those reforms.

6. The Effective Employee Benefit Rate (EEBR) calculations measure the value of the pension being built up each year to an 'average' scheme member expressed as percentage of the scheme member's salary. The calculations take account of the main features of the schemes' design, including the structure of the benefit, the Normal Pension Age, accrual rate, survivors' benefits, ill-health benefits, and death-in-service benefits. Member contributions have been deducted, to show the notional amount that is contributed by the employer and the effective benefit of the pension to the employee as a % of their salary. 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 EEBR would be 15%. The discount rate used in the PPI's calculations is CPI + 3% - the same discount rate that the Government uses to calculate contribution rates to the public service schemes.

7. One feature of the Coalition Government's proposed reforms to the four largest public service pension schemes is that the Normal Pension Age (NPA) has been set to increase in line with future changes to the State Pension Age (SPA) for men. The modelling in this project assumes increases in SPA approximating a combination of current legislation and announced Government policy. Since April 2010 women's State Pension Age has been increasing in a series of steps to equalise with men's SPA, and will reach age 65 by November 2018 when SPA will be equal for men and women. According to current legislation, both men and women's SPA will then rise to 66 by 2020. The NPA for each scheme under the Government's proposed reforms is therefore 65 until 2018 (which is consistent with the current SPA for men), increasing to 66 by 2020. Scheme NPAs are then assumed to increase in line with the Government's announced intention that SPA for both men and women will rise to 67 between 2026 and 2028. In the longer term, SPA and NPA are then modelled as increasing to 68 between 2044 and 2046 as stipulated in current legislation.

For further information please contact:

Chris Curry, PPI Research Director, on 020 7848 3731 or 07970 254940
email: niki@pensionspolicyinstitute.org.uk

Martin Campbell, Beacon Strategic Communications: 07802 634695
email: martin@beaconstrategic.com

The PPI has today published a report on the implications of the Coalition Government's public service pension reforms. The report sets out the full analysis and can be downloaded from the PPI's website www.pensionspolicyinstitute.org.uk.

The Executive Summary of the report follows on the next page

Executive Summary

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 Coalition Government's proposed reforms include linking the pension benefits for public service workers to average salary rather than to final salary, linking the Normal Pension Age (NPA) to the State Pension Age (SPA) 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 an NPA of 60 is proposed.

The proposed reforms apply to all members except members within ten years of their NPA on 1 April 2012, who will have their pension calculated according to the rules in place prior to the introduction of the proposed reforms.

Purpose of this report

This report sets out the PPI's independent assessment of the potential impact of the Coalition Government's proposed reforms to the public service pension schemes, based on the Government's Proposed Final Agreements. The report considers the impact on the value of the 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).

Previous reforms to the public service pension schemes

The Coalition Government's proposed reforms are the latest in a series of reforms to 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 Revalued Earnings scheme (CARE) for new entrants to the Civil Service from 30 July 2007. In addition, the Normal Pension Age for the NHS, Teachers and Civil Service schemes was increased from 60 to 65 for new entrants, and the rates of accrual in the final salary schemes were amended. The Local Government Pension Scheme (LGPS) already had an NPA of 65 although the rule of 85 which enabled retirement before age 65 in some circumstances was abolished in these reforms.

Higher rates of member contributions were introduced for all four of the main 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.

It is important to frame the analysis in such a way that the estimated impact of the reforms on scheme members is comparable to the way in which scheme members and their employers currently think about how much they pay for their schemes. The most appropriate way of doing this is to make the EEBR calculation consistent with the current framework for setting contributions.[1]

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%.

[1] The EEBR calculation requires making an assumption on the discount rate employed to discount future pension payments back to a present value. Following a consultation in 2011, the discount rate used by HM Treasury for calculating contribution rates to unfunded public service schemes is linked to GDP growth, approximated by CPI growth plus 3%. This discount rate has therefore been used in the EEBR calculations. For more discussion about the appropriate discount rate for this analysis see Annex 8.

Assessing the Impact of the Coalition's proposed reforms on scheme members

The Coalition Government's proposed reforms to the public service pensions include:

- 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.

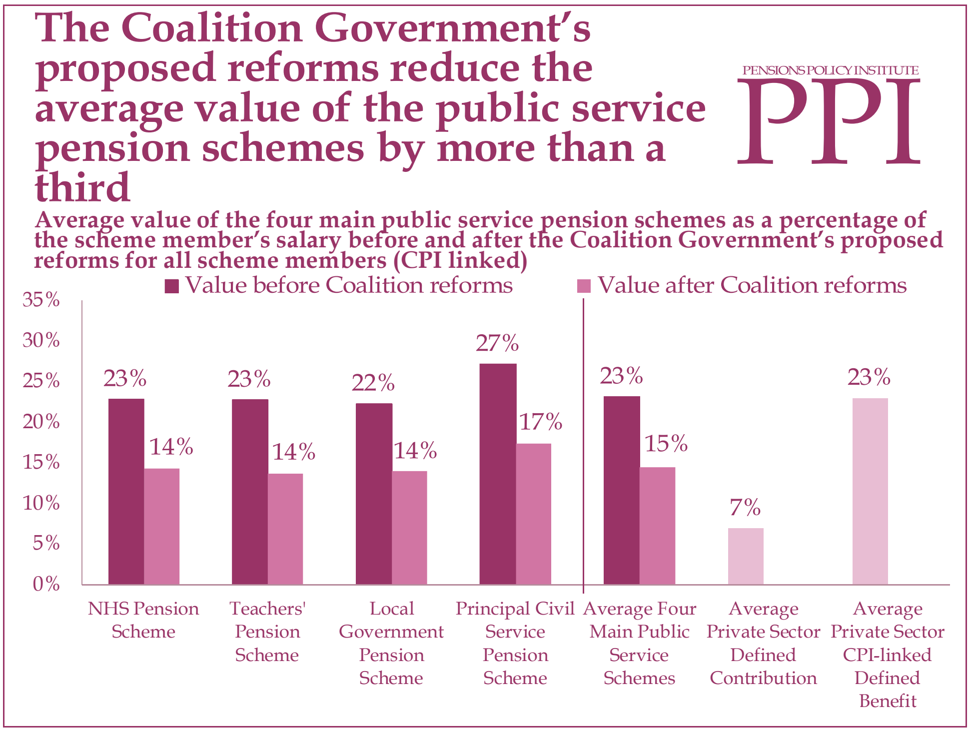
We have assumed in the baseline used in this report that from 1 April 2011 all public service pensions in payment and pensions accrued are uprated in line with changes in the Consumer Prices Index (CPI), instead of the Retail Prices Index (RPI) as had been the previous policy. In Annex 3 we have also 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 A).

PENSIONS POLICY INSTITUTE

Chart A[2]



The impact across all members 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.

The impact across all members 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.

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.

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 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

[2] PPI EEBR analysis using scheme designs as set out in the proposed final agreements for each scheme. Figures are weighted averages based on the relative membership of each scheme. Figures rounded to the nearest 1%.

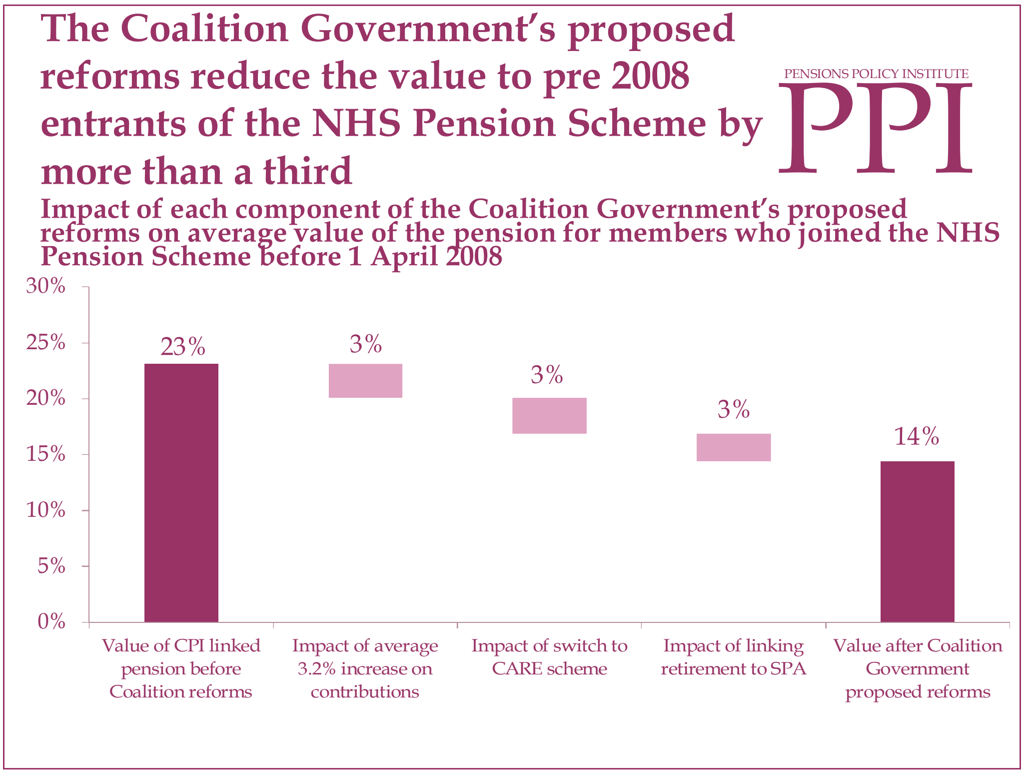
which employers typically contribute around 7% of a DC scheme member's salary.[3]

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 would have an average pension benefit value to public sector workers 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 a typical private sector Defined Benefit scheme linked to RPI the average value of the pension benefit to public sector workers would be 27% of a member's salary.

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 <u>before</u> 1 April 2008 Chart B shows 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 Annexes 4, 5 and 6.

Chart B[4]



[3] See Annex 2 for details on the calculation of the private sector DC comparator.
[4] 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 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.

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 report analyses the potential impact of the proposed reforms on members who joined the NHS Pension Scheme <u>before</u> 1 April 2008 for individuals with fast and slow salary progression (high-flyers and low-flyers), with high and low earnings, and those who leave after a short period of time (early leavers) or who stay until Normal Pension Age (long-stayers). This analysis suggests 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 under the pre-reform schemes, 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 high earner.

- Under the Coalition's proposed reforms there is a smaller difference between the value of the pension earned for each year of service by a long-stayer and an early leaver than before the Coalition's proposed reforms for members of the NHS and Teachers' Pension Schemes. For example, before the Coalition Government's proposed reforms, a median earning 40-year-old member of the NHS Pension Scheme whose earnings increase in line with average earnings growth, who joined before 1 April 2008 and stays in the scheme until they retire at their NPA - a long-stayer - would have a value of the pension benefit earned in a year worth 26% of a member's salary. This compares to a value of the pension benefit earned in a year of 14% of a member's salary for an early leaver who has the same earnings and earnings growth but leaves the scheme after 5 years of membership.

- By comparison, after the Coalition Government's proposed reforms, the value of the pension earned in a year for a long-stayer in the NHS Scheme would be 14% of a member's salary, compared to 9% of a member's salary for an early leaver. After the Coalition's proposed reforms there is a smaller difference between the value of the pension earned for each year of service by a long-stayer and an early leaver in the NHS scheme. The impact on members of the Teachers' Pension Scheme would be similar.

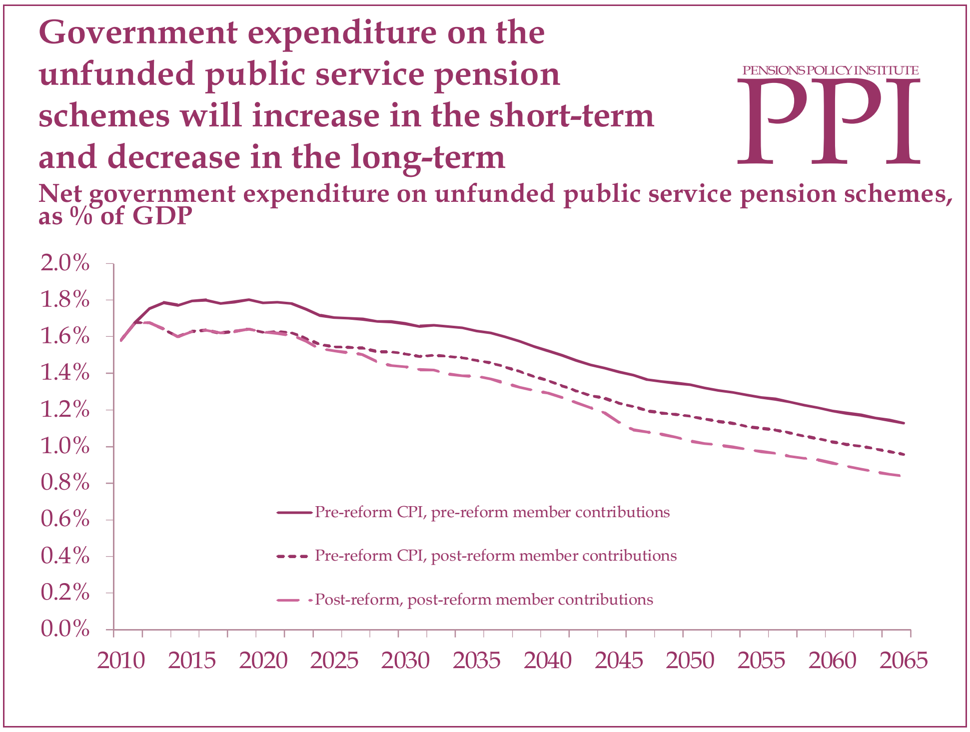
- For members of the Civil Service Pension Scheme and the Local Government Pension Scheme, under the Coalition's proposed reforms the amount of pension earned in a year would be the same percentage of salary for members with similar characteristics who leave the scheme early and for members who stay in active service until they retire. In both the LGPS and the Civil Service schemes after the Coalition's reforms the value of the pension earned in a year is not affected by whether the pension was earned at the beginning of a member's career or over their whole career.

The impact of the proposed reforms on the affordability and sustainability of public service pension schemes

The Coalition Government's proposed reforms are expected to have an impact on how much the Government spends on public service pension schemes. Government expenditure on unfunded public service pension schemes represents how much the Government needs to pay out each year to meet its unfunded public service pension obligations. Gross government expenditure on public service pension schemes only includes government expenditure on paying unfunded public service pensions in payment. Net government expenditure deducts members' contributions. Net government expenditure could reduce in the long-term as a consequence of the Government's proposed reforms (Chart C).

PENSIONS POLICY INSTITUTE

Chart C[5]



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 and with higher post-reform levels of member contributions, net government expenditure would have fallen to around 1% of GDP by 2065.

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.

[5] PPI Aggregate Model. Estimates include the NHS, Teachers, Civil Service, uniformed services pension schemes and other unfunded public service pension schemes.

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 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.

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.