PENSIONS POLICY INSTITUTE

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PRESS RELEASE

EMBARGOED TO 00.01 THURSDAY 16th October 2008

"Public sector pensions are still more valuable than most private sector pensions even after the Government's reforms" says Pensions Policy Institute

On average public sector pensions are now worth 21% of salary compared to a typical private sector defined benefit scheme worth 20% of salary and a typical private sector defined contribution pension worth 7%.

The Pensions Policy Institute (PPI) will today publish new research that assesses the impact of the Government's reforms to public sector pensions.

The Government has introduced a number of reforms to the main public sector pension schemes in recent years. These reforms include increasing the normal pension age to 65 for new entrants to the public sector, increasing the level of contributions made by members to some of the schemes and improving the rate at which members accrue pension rights.

Many commentators have argued that, even after the reforms, the public sector pensions are too generous and too expensive. With this report, the PPI aims to set out the factual background to this important debate without making any such judgements.

Niki Cleal, Director of the PPI, said:

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

"Even after the Government's reforms, there are still significant differences between pensions in the public and private sectors. Public sector employees are more than twice as likely as private sector employees to be a member of an employer-sponsored pension scheme."

"The majority of public sector employees have a defined benefit pension linked to their final salary. In the private sector two-thirds of employers have closed their defined benefit schemes and many now offer less valuable, defined contribution pensions."

"After the reforms, public sector employees will receive, on average, a pension worth around 21% of salary. This is similar to a typical private sector defined benefit pension worth 20% of salary, but substantially higher than a typical private sector defined contribution scheme worth 7%."

"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, the evidence suggests that the picture is more complex than this. 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."

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Notes for editors

1. The Pensions Policy Institute (PPI) is an independent research organisation. Its aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue, but works to make the pension policy debate better informed.

2. This research has been funded by the Nuffield Foundation. The Foundation is a charitable trust established by Lord Nuffield. Its widest charitable object is 'the advancement of social well-being'. The Foundation has long had an interest in social welfare and has supported this project to stimulate public discussion and policy development. The views expressed are however those of the authors and not necessarily those of the Foundation.

3. The research will be presented at a seminar on Thursday 16th October chaired by Matthew Annable, the PPI's Chairman, and attended by around 50 attendees with an interest in pensions policy. The speakers at the seminar will include Jenny Willott MP, the Liberal Democrat Spokesperson on Work and Pensions, Neil Carberry from the Confederation of British Industry and Kay Carberry from the Trades Union Congress. The Nuffield Foundation will host the seminar.

4. The Government's reforms to the public sector pensions include increasing the normal pension age from 60 to 65 for new entrants to the main public sector pension schemes and increasing the level of contributions made by members to the schemes. There are other changes to the accrual rates and the amount of lump sum that individuals can take and to ill-health benefits. Table 1 summarises the Government's main reforms.

5. The calculations included in the PPI's report measure the value of pensions being built up each year to an 'average' member. They take account of the main features of the schemes' designs, including their 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 salary. If the effective employee benefit rate in Scheme A is 20% of salary and in scheme B is 15% of salary, then the members of Scheme A are in effect receiving benefits worth 5% of salary more than those in Scheme B.

6. In a defined benefit pension scheme, a member's pension entitlement is calculated using a set formula, usually based on some measure of final salary and length of service. All of the main public sector pension schemes remain defined benefit in nature, although the Civil Service scheme is now based on average salary over the member's career rather than on his or her final salary. In a defined contribution, or money purchase, scheme, employees and/or employers contribute and the final pension depends on the accumulated value of the investments as well as on annuity rates. Average employer contributions to defined contribution schemes have been less on average than to defined benefit schemes.

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A summary of conclusions from the research follows on the next page.

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 four main unfunded 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.

Table 1: Summary of the main elements of the reforms to public sector pension schemes (all reforms are for new joiners only unless otherwise stated)

	NHS[1]	Teachers'	Civil Service[2]	LGPS (reformed for all members)	Armed Forces	Police	Fire
Normal Pension Age (NPA)	60 à 65	60 à 65	60 à 65	Remains 65; Rule of 85 abolished for new service with transitional protection	No change from 55	50 with 25 years' service (below 50 with 30 years); 55 (57 or 60 for higher ranks) à 55	55 (from 50 after 25 years' service) à 60
NPA for early leavers	Same as NPA	Same as NPA	Same as NPA	Same as NPA	60 à 65 (all members for future service)	60 à 65	60 à 65
Basic design	Remains final salary	Remains final salary	Final salary à Career average	Remains final salary	Remains final salary	Remains final salary	Remains final salary
Accrual rate	80ths à 60ths	80ths à 60ths	60ths à 2.3%	80ths à 60ths	69ths (91ths after 22 years)[3] à 70ths	60ths (30ths after 20 years) à 70ths	60ths (30ths after 20 years) à 60ths
Additional lump sum?	3 x pension à commutation	3 x pension à commutation	Commutation only	3 x pension à commutation	No change from 3 x pension	Commutation à 4 x pension	Commutation only
Late retirement enhancement?	No à Yes	No à Yes	No à Yes	No à Yes	No	No	No
Draw-down option?	Yes	Yes (all members)	Yes (all members)	Yes	No	No	No
Rate of e'ee contributions[4]	6% (5%) à 5-8.5% (for all members)	6% à 6.4% (for all members)	No change from 3.5%	6% (5%) à 5.5-7.5%	Remains non-contributory	11% à 9.5%	11% à 8.5%
Cost sharing?	Yes	Yes	Yes	Expected to apply	No	No	No
Eligibility for survivor's pension	Now includes non-legal partners and payable for life (but only for new joiners in the Police and Fire schemes)						
Survivor's pension on death in retirement	Remains a 160ths pension	Remains a 160ths pension	160ths à 3/8ths of member's pension	Remains a 160ths pension	50% à 62.5% of member's pension	Remains 50% of member's pension	Remains 50% of member's pension
Ill-health benefit	1-tier à 2-tier	1-tier à 2-tier	Remains 2-tier	1-tier à 3-tier	1-tier à 2-tier	1-tier à 2-tier	Remains 2-tier
Timescale	1 April 2008	1 January 2007	30 July 2007	1 April 2008	6 April 2005	6 April 2006	6 April 2006

[1] The scheme for salaried staff is illustrated. Self-employed members, such as GPs and Dentists, have a career-average scheme that is not shown
[2] The Premium section of the Civil Service scheme is illustrated here, since the Classic section has been closed to new members from 2002.
[3] For other ranks. Officers have higher accrual rates.
[4] If a range is shown then employee contributions depend on pay. Figures in brackets denote special provisions for certain categories of workers.