Media Briefing
Public Service Pensions
6 October 2010

The Hutton Review

At 8 am on Thursday 6 October Lord (John) Hutton will publish his interim report on the future of public service pensions.

He has been asked by the Government in this first report to identify immediate savings that can be made. It is likely that he will also indicate the changes that he is considering for more fundamental structural change in a further report.

Pensions are highly technical, and surrounded by often misleading statistics. This background brief explains some of the issues and arguments at stake.

Reducing costs

There are only two ways to reduce the immediate cost of pensions:

- **pensions in payment could be immediately cut**, but while this has happened in some other countries, both coalition parties pledged to protect "accrued benefits" before the election. While this term only has clear legal meaning in private sector schemes, it is unlikely that the statement is compatible with immediate cuts in pensions in payment or a reduction in pensions that people have already built up.

  However the switch to indexing public service pensions in payment by the CPI measure of inflation rather than the RPI measure will have a very significant effect on the costs of future public service pensions. The CPI measure of inflation excludes housing and council tax costs, and is calculated on a different basis to RPI (see http://www.touchstoneblog.org.uk/2010/06/the-difference-between-an-arithmetic-mean-and-a-geometric-mean-and-why-it-matters/

  The table shows that the Treasury is predicting a 7.4 per cent cut in pensions by changing the link to CPI over the next five years:

Year of increase	2011	2012	2013	2014	2015	2016	cumulative
CPI	2.7	2.4	1.9	2.0	2.0	2.0	13.7
RPI	3.7	3.2	3.2	3.3	3.4	3.5	22.1
Shortfall	1.0	0.8	1.3	1.3	1.4	1.5	7.4

- **member contributions could be increased** – this would reduce the take-home pay of public sector staff and the Treasury would pocket the savings. But public sector pay is frozen, inflation is already causing a cut in living standards, and the indexing to CPI has already significantly cut the value of public service pensions.

  While most speculation has been that Hutton will recommend a contribution increase, it is unclear whether he will put a figure on it. It has also been suggested that he may recommend some protection for the low paid. While how much in total should be paid by employer and employee in total for a given retirement income is a pensions issue, how you split these contributions between employer and employee is an industrial relations issue.

It has also been suggested that Hutton may recommend **an immediate increase in the pension age** for future pension accruals.

This is often misunderstood. The pension age is not the same as the age at which people retire, but part of the formula used to work out how much pension you receive at the date you choose to retire. The new Government is committed to ending statutory retirement ages so no-one will be forced to go because of their age.

If you retire before your pension age, your pension is reduced. If you defer your pension and retire at a later date then it is increased.

Public servants already have a range of pension ages in their schemes. Everyone in local government has a pension age of 65. The police, firefighters and armed services have lower pension ages that recognise the arduous physical nature of their jobs. In the rest of the public sector changes were negotiated in 2005 that mean that new staff taken on since then have a pension age of 65, while existing staff kept a pension age of 60.

It is perfectly possible for people to have different pensions with different pension ages. If people change employer, it is possible that they may move between schemes with different pension ages. Similarly people can stick with the same employer but move from one scheme to another.

A pension age increase does not make anyone work longer, but effectively reduces the amount of pension someone builds up each year they work as they have to work longer to get their full pension.

Longer term issues

Hutton may set out his thinking on possible structural changes to pensions in future either with a range of options or his favoured alternative. Possible elements include:

- **a move to career average pensions** – most public sector pensions are final salary pensions (however the civil service scheme is already a career average scheme). The pension paid out by a final salary scheme takes into account years of service and what you earn when you leave your job. A career average scheme is based on years of service and your average pay while in employment (updating earlier years by inflation.)

Final salary schemes clearly benefit those who get promoted. In the private sector, it is not unknown for directors to receive a big salary bonus in their final year to bump up their pension. A career average scheme provides much less reward for such promotions and is therefore cheaper to provide.

It is often said that career average schemes are fairer than final salary schemes. But moving from a final salary to a career average pension may not benefit anyone. It may simply hit better off staff harder than lower paid staff. When the civil service scheme moved to a career average, some of the savings were put back into the pension scheme, thus providing a better deal for low paid staff whose pay did not increase by much over their employment. But if none of the savings are put back into the pension, then everyone can lose - though high-flyers lose more.

In some public sector schemes – such as the NHS – higher paid staff already pay a higher percentage contribution than lower paid staff. Hutton may recommend this extends to other schemes.

- **a cap on pensionable pay** – one suggestion is that Hutton may limit the pay on which people can build up a salary-related pension. This would mean that only pay below a certain figure (£50,000 has been mentioned) would build up a pension based on their salary. Above this, staff would contribute to a new notional DC scheme (with or without an employer contribution as well). DC schemes (defined contribution schemes) in the private sector invest money on behalf of their members. When they retire their pension depends on how their investments have performed and how big an annuity they can buy with their pension pot. In a notional DC scheme the money is not invested but kept by the Treasury who add a return to it each year. The member then gets this pension pot when they retire as if it has been invested.
- **reduced accrual rates** – this is a simple reduction in how much pension you build up each year. Different public sector schemes have different accrual rates but 1/50 is common.

Can John Hutton satisfy the public sector pensions critics?

Lord (John) Hutton's initial report on public sector pensions is likely to recommend that public servants should pay higher pension contributions at a time when their pay is frozen and inflation is busting Bank of England targets. That is unlikely to be popular.

The more interesting question is whether he will satisfy the right wing critics of public sector pensions in the TaxPayers' Alliance and their allied network of small state think tanks.

The most frequent complaint made against public sector pensions by their right wing critics is that they are more generous than private sector pensions and should be bought into line.

But this is an imprecise complaint. Are the critics saying that public sector pension provision should mirror provision in the private sector? Or are they saying that public sector pensions should be like private sector pensions where they exist?

These are two very different tests.

In the private sector there are stark differences in pensions provision. Two out of three private sector workers get no employer pension contribution. At the top end a small minority of top directors have pensions that are not so much gold-plated as solid platinum.

To make pension provision in the public sector mirror the private sector, you would therefore need to take away the pensions from two in three public sector staff, concentrating on women, the low-paid and part-time workers. Senior public servants would need to be given huge increases in their pensions to mirror those of top boardrooms.

This, to put it mildly, is unlikely.

So what would Hutton have to do to bring public sector pensions in line with private sector pensions? This is not an easy question to answer, as even this test can be defined in different ways.

But we do have some recent research from ONS that can guide us (press release and full article on page 23 of the September 2010 issue of Economic and Labour Market Review.

Pensions are deferred pay, so a helpful way of comparing pension provision is to look at total reward – the sum of pay and the contribution that the employer is making towards a pension. If we exclude employers' NI and other benefits such as private medical insurance, this is the cost of employing someone.

Total reward (pay plus employer pension contribution (£ per week)		
	mean	**median**
Private sector		
Total	814	666
Men	873	712
Women	658	542
Public sector		
Total	718	644
Men	808	708
Women	645	589

As the table shows private sector staff with pensions get higher mean and median total reward than public sector staff. The average reward package in the private sector for staff with pensions is £814 – £96 higher than the public sector figure of £718 per week. The difference is most marked for men, while lower paid women do better in the public sector.

The cost of public sector pensions

There are various ways of examining the cost of public sector pensions:

- **The proportion of GDP** – pay-as-you-go public sector pensions are paid out of tax income, and therefore the Treasury, in an approach endorsed by the NAO and the Office of Budget Responsibility, say that the best way to estimate future costs and affordability of public sector pensions is to look at the proportion of GDP future pensions payments will require. Treasury estimates show a modest increase from 1.5 per cent to 1.9 per cent by 2027 and then remaining stable.
- **The net cost of public sector pensions** – this is the difference in cost between pensions in payment and income from staff pension contributions each year. While it is a straightforward number and important for Treasury planning, there should be no expectation that this figure is in balance each year. This is because the pensions in payment reflect contributions made in the past, and the contributions paid in are for pensions in the future. The Government is reducing the number of public servants and freezing public sector pay. This *reduces* public spending, but *increases* the net cost of public sector pensions as there will be fewer smaller contributions paid.
- **Big scary numbers** – many of those hostile to public sector pensions produce huge numbers for their future cost. These are an attempt to work out how much it would cost today to put aside enough cash to fund all the pensions that have already been built up across the public sector. How you cost in today's money a commitment that will last for decades time is extremely controversial – and depends on what discount rate you choose to do this. (A discount rate is a kind of interest rate.) But as the NAO says, this provides no indication of the affordability or sustainability of public sector pensions as this is not how they are paid for.