



# The Pensions Apartheid:

The problem, the cost and the tough choices  
that need to be made

written by Corin Taylor, Senior Policy Adviser

IoD POLICY PAPER





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## Executive Summary

*In an ideal world, changes to pension arrangements would not be necessary. But in an age of rapidly rising longevity, pensions will become more expensive unless lasting reform is undertaken. Businesses have had to face up to reality and go through the painful process of scaling back defined benefit pensions. By contrast, recent reforms to public sector pensions have been inadequate, meaning that the gap between public and private pension provision is wider than ever. In the past, lower salaries in the public sector justified more generous pensions, but now that public sector employees are better paid than those in the private sector at all but the highest levels, the pensions apartheid can no longer be defended.*

*90 per cent of public sector employees are members of DB schemes, while the proportion in the private sector has fallen to just 12 per cent. This is after a decade and a half of economic growth. The current recession will lead to even faster falls in private sector DB membership, as pension funds perform poorly and companies no longer have the cash to keep DB schemes going. But at the same time, unless further reform is carried out, taxpayers may have to find up to £335 billion to bailout public sector pensions over the next 50 years.*

*The pensions apartheid needs to be bridged by reducing the costs to taxpayers of unfunded public sector pensions and by increasing private sector pension saving. Increases in the state pension age to 68 will do a lot to mitigate increases in the old age dependency ratio – in fact, if the state pension age was increased to 70 by 2056, the dependency ratio would remain where it is today. Hence, the IoD recommends that the public sector normal pension age should be increased in line with the state pension age as a first step. This would reduce the disparity between public and private pensions, but further consideration needs to be given to overcoming the transition costs of moving to DC in the public sector.*

*The current recession will make the pensions apartheid even greater and the enormous deficits being run intensify the need to reduce long term costs to help bring the public finances back to sustainability. There really is no alternative.*

### Key findings

Rising longevity means that the ratio of workers to pensioners is expected to nearly halve over the next 50 years, putting pressure on all pension arrangements:

- **Today, there are almost 4 people of working age for every person over 65. In 50 years time, it is expected that there will be only 2.**
- 60 years ago, male life expectancy was around 67, with a state pension age (SPA) of 65. Today it is 78, with an unchanged SPA. Increases in the SPA for men and women to 68 by 2046 will provide some mitigation – indeed, if the SPA was increased to 70 by 2056, the state pension age dependency ratio would remain where it is today – but challenges for other forms of pension provision remain.

Over the last decade, a combination of tax rises, increased regulation and simple demographic fact have left many employers with no choice but to close defined benefit (DB) schemes to new members, replacing them with less expensive and less risky defined contribution (DC) arrangements:

- To keep pace with rising costs, employer contributions to final salary schemes in the FTSE 100 alone have increased nearly four-fold – from £3.6 billion in 2002 to £13.1 billion in 2007.
- **As a result, the number of active members of DB schemes in the private sector has fallen by over 40 per cent since the start of the decade.**
- The current recession will lead to even faster falls in private sector DB membership, as pension funds perform poorly and companies no longer have the cash to keep DB schemes going. A survey by the National Association of Pension Funds has found that a quarter of large companies expect to close their DB schemes to new accrual of existing members in the next five years.

Despite recent reforms, relatively generous public sector pensions mean that a public sector worker is on average around 12 per cent better off than a private sector worker on the same basic salary. This may have been acceptable when public sector employees were paid less than their private sector counterparts. But gross annual pay is now higher in the public sector for all but the top 25 per cent, while gross hourly pay is higher for all but the top 10 per cent. Employees in the public sector also benefit from greater job security and in many cases longer holidays. There is now little justification for this pensions apartheid:

- **90 per cent of public sector employees are members of DB schemes, compared with just 12 per cent in the private sector.**
- The public sector normal pension age (NPA) is 65 only for new employees (except for the local government pension scheme). Existing public sector employees will still retire at 60, while the state pension age is set to increase to 68. Already, the NPA for two thirds of active members of private sector schemes is 65, and retirement ages in the private sector will doubtless increase.
- Employer contributions average £4,000 a year per public sector employee, compared with £1,600 a year per private sector employee.
- Post-reform, the average value of a public sector pension for a new entrant is 21 per cent of salary. By contrast, the average value of a private sector DC scheme is around 7 per cent of salary.

Because public sector pension schemes are unfunded (with the exception of the local government pension scheme) taxpayers have to pay twice for the pensions apartheid: firstly for employer contributions and secondly for an annual bailout – the difference between employer/employee contributions and pensions in payment. Liabilities are also building up each year that will need to be paid by taxpayers in the future – either through higher employer contributions and/or through a higher annual bailout. This is especially worrying given the parlous state of the public finances:

- Over the five year period from 2006-07 to 2010-11, according to the Treasury, taxpayers are expected to have to pay a total of £14 billion over and above employer/employee contributions, £2.8 billion each year. Based on the

Treasury data and extrapolated over a 50-year time frame, we would estimate that the bailout could reach £140 billion, £5,500 per household, in total.

- **But the actual bailout is likely to be much higher, since the above figure does not include the growing liabilities of the unfunded schemes. Between 2006-07 and 2010-11, according to the Treasury, increasing liabilities are forecast to exceed employer/employee contributions by £33.6 billion, £6.7 billion a year. These increasing liabilities will have to be paid at some point. Based on the Treasury data and extrapolated over a 50-year time frame, we would estimate that the cost could far exceed £140 billion – reaching £335 billion, over £13,000 per household, in total. And this £335 billion would be in addition to the high employer contributions that are already levied.**

Reforms to all the main public sector pension schemes have come into effect since 2005. But they are inadequate:

- For new entrants, the Government has to some extent taken away with one hand and given with the other. A later NPA has been partly offset by more generous accrual rates, for example. The net effect has been to reduce the average value of public sector pensions for new entrants from 24 per cent to 21 per cent of salary, still leaving them three times as generous as average private sector DC schemes.
- For existing employees, the NPA has remained at 60. The Government had originally planned to raise it to 65 for new accrual of existing members from 2013, but backed down in 2005 in the face of a threat of widespread strikes by the public sector unions.
- The Government expects the reforms to the NHS, teachers' and civil service schemes to save just £13 billion over 50 years – a very small amount compared with a bailout that could reach £335 billion. Cost-sharing and cost-capping agreements provide some safeguard against future *unanticipated* increases in longevity, but effectively “lock in” the enormous cost of public sector pensions to taxpayers, now and in the future, that is currently projected.

### **Policy recommendations**

There is a key trade-off that should be remembered. With an ageing population, either public sector pensions will have to be reformed further to reduce their cost, or taxes will have to rise and/or other government spending cut.

Reform is essential to prevent long term pressure on the public finances and damaging increases in tax. It should focus on bridging the pensions apartheid, by both reducing the cost to taxpayers of public sector pensions and increasing private sector pension saving. This will lead to a more sustainable pensions system in the UK. The scale of the demographic challenge means that doing nothing is not an option, however attractive it might appear to be:

- Any changes to public sector pension arrangements should not affect past accrual. However, the arrangements for new accrual of existing members, in addition to those for new members, can and should be changed.

- **The IoD's central recommendation is that the public sector normal pension age for new members and for new accrual of existing members should be increased in line with increases in the state pension age.<sup>1</sup> This means that the NPA for new accrual of existing members should increase in stages to 65 by 2020 (in line with the increase in the SPA for women) and then for both new members and new accrual of existing members to 68 by 2046 (in line with the SPA for both men and women), removing a key unfairness of the present system. It is a first step in bridging the pensions apartheid.**
- Although we have concerns that saving in Personal Accounts will deliver negative returns (through withdrawal of means-tested retirement benefits) for certain lower income households and those with a short time to go to retirement, they should help increase private pension saving overall. In addition, the trend towards saving in more flexible instruments such as ISAs should be encouraged, potentially through a new form of workplace ISA.
- Ultimately, the only way to manage longevity risk is to move away from pension arrangements where current contributions by employees pay for current pensions paid to retirees, to funded provision, where each scheme member's retirement pot grows throughout his or her working life. Businesses have had to bow to this reality, and in the long run, the only way of bridging the pensions apartheid and ensuring the sustainability of the public finances may be for the public sector to move to DC arrangements. In that context there will need to be a greater consideration of how to manage transition costs, which may be considerable.

**Pension reformers should not be deterred. The pensions apartheid is real, unfair, unsustainable and urgently in need of change. The current recession will make the divide even greater and the enormous deficits being run intensify the need to reduce long term costs to help bring the public finances back to sustainability. There really is no alternative.**

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<sup>1</sup> For the armed forces, police and fire services, we are referring to the NPA for early leavers only

## 1 The context: the demographic challenge

The reason why pension arrangements need to be looked at again is quite simple. People are living longer. This is clearly a good thing, but in the absence of any reform makes pension provision far more expensive.

As Table 1 shows, the demographic change will be stark:

- People born in 50 years time are expected to live between 6 and 8 years longer than people born today.
- People retiring in 50 years time are expected to live between 5 and 7 years longer than people retiring today.
- As a consequence, the ratio of workers to pensioners is expected to nearly halve. Today, there are almost 4 people of working age for every person over 65. In 50 years time, it is expected that there will be only 2.

60 years ago, male life expectancy was around 67, with a state pension age (SPA) of 65. Today it is 78, with an unchanged SPA.<sup>2</sup> The SPA, however, is set to increase for women to 65 by 2020 and then for both men and women to 68 by 2046, mitigating to some extent the alarming rise in the old-age dependency ratio. The change in the “state pension age dependency ratio” is therefore less stark:

- There are currently 3 people of working age for every person over the SPA.<sup>3</sup> Under current government policy to increase the SPA, in 50 years time there will be around 2.6 people of working age for every person over the SPA.
- If the SPA was increased to 70 rather than 68, in 50 years time there would be 3 people of working age for every person over the SPA – exactly the same ratio as today.

This provides us with two lessons for public and private sector pensions. Firstly, in the absence of reform, expected demographic changes would be likely to bankrupt defined benefit schemes in the private sector and lead to unsustainable levels of taxpayer subsidy for public sector schemes. Secondly, increases in the SPA show how reform can mitigate the impact of demographic changes.<sup>4</sup>

Pension reform has never been more necessary. It's not something to celebrate, as tough choices will have to be made about the generosity of retirement benefits in the future, but the task is not impossible.

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<sup>2</sup> English Life Tables; Government Actuary's Department, period expectations of life 1981-2056, principal projections, 2006

<sup>3</sup> The state pension age for women is currently 60, which is why there are only 3 people of working age for every person over the state pension age, compared with 4 people under 65 for every person over 65

<sup>4</sup> The basic state pension will also revert to increasing in line with earnings, which will offset some of the savings from increasing the SPA. State pensions will still be more expensive in the future, which perhaps illustrates that reform has not gone far enough

Table 1: The demographic challenge explained<sup>5</sup>

	2006	2056	Change, years	Change, %
<b>Life expectancy at birth</b>				
<i>Period projection</i>				
Men	77.2	85.5	+8.3	+10.8%
Women	81.5	88.7	+7.2	+8.8%
<i>Cohort projection</i>				
Men	88.1	94.4	+6.3	+7.2%
Women	91.5	97.0	+5.5	+6.0%
<b>Life expectancy at age 65</b>				
<i>Period projection</i>				
Men	17.2	23.9	+6.7	+39.0%
Women	20.0	26.0	+6.0	+30.0%
<i>Cohort projection</i>				
Men	20.6	25.5	+4.9	+23.8%
Women	23.1	27.7	+4.6	+19.9%
<b>Dependency ratio</b>				
Old-age dependency ratio (population aged 20-64 / population aged 65+) <sup>6</sup>	3.7	2.1	n/a	-43.2%
State pension age dependency ratio under current government policy (population aged 20-SPA / population aged above SPA) <sup>7</sup>	3.0	2.6	n/a	-13.3%
State pension age dependency ratio if SPA raised to 70 by 2056 <sup>8</sup>	3.0	3.0	n/a	0.0%

<sup>5</sup> Government Actuary's Department, period and cohort expectations of life 1981-2056, principal projections, 2006

<sup>6</sup> IoD calculations based on Government Actuary's Department, population projections 2006-2081, principal projection, 2006

<sup>7</sup> Ibid. Given the changes to the SPA between 2010 and 2046 (increasing the SPA for women to 65 between 2010 and 2020 and increasing the SPA for men and women to 68 by 2046) the state pension age dependency ratio calculation is as follows: 2006: male population aged 20-64 plus female population aged 20-59 / male population aged 65+ plus female population aged 60+; 2056: population aged 20-67 / population aged 68+. Given that the GAD population projections only use 5-year age bands, for 2056 it is assumed that the number of people in each year of the 65-69 age band is equal. This will slightly overstate the number of people aged over 68, but will only make a negligible difference to the final result

<sup>8</sup> Ibid. The 2006 state pension age dependency ratio calculation is as in the previous footnote; the 2056 calculation is simply: population aged 20-69 / population aged 70+

## 2 The pensions apartheid

Private sector pension provision has undergone major changes in the past decade. A combination of tax rises on pension fund dividends, increasingly onerous regulation of defined benefit (DB) schemes (from a number of bodies, including the DWP, HMRC, FSA and the new Pensions Regulator), higher Pension Protection Fund levies and simple demographic fact has left many employers with no choice but to close DB schemes to new members in favour of less expensive defined contribution (DC) arrangements, including a growing number of employer-sponsored personal pensions:

- The reduction and abolition of repayable tax credits on dividends in the 1990s is estimated to have cost pension funds £150-£225 billion in lost dividends and growth.<sup>9</sup>
- To keep pace with rising costs, employer contributions to final salary schemes for the FTSE 100 companies have increased nearly four-fold in the past five years, from £3.6 billion in 2002 to £13.1 billion in 2007. Greater regulatory requirements mean that it costs private sector employers around twice as much as public sector employers to fund equivalent DB pension provision.<sup>10</sup>
- The resulting collapse of DB provision in the private sector has been remarkable. Since 2000, there has been a 41 per cent fall in the number of active members of occupational DB schemes. The current recession is likely to accelerate this trend, as pension funds perform poorly and companies no longer have the cash needed to keep the schemes going.
- At the same time, there has been a 0.4 million increase in DC scheme membership, largely through a doubling of the membership of employer-sponsored stakeholder pensions.
- Overall, though, the membership of private sector pensions sponsored by an employer (DB and DC) has fallen by around 1.6 million, or 20 per cent, since the start of the decade.

A recent survey found that only 16 per cent of smaller firms (those employing less than 250 people) provided DB schemes – of these schemes, 91 per cent were closed to new members and 48 per cent were also closed to new accrual.<sup>11</sup> A second survey found that a quarter of large companies expect to close their DB schemes to new accrual of existing members in the next five years.<sup>12</sup> In many cases, paying index-linked percentages of final salary from the age of 60 is quite simply unsustainable when, on average, people are living to 80 rather than 70.

It is often assumed that DB pensions are risk free and that a move to DC schemes represents a transfer of risk to the employee. This assumption is not entirely accurate. Employees in DB schemes run the considerable risk of the company they work for going bankrupt, as has occurred on numerous occasions over the past decade, and which the Pension Protection Fund may not fully

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<sup>9</sup> Calculation by Terry Arthur, Fellow of the Institute of Actuaries: Arthur, T. and Taylor, C., The UK Pensions Crisis, The TaxPayers' Alliance, November 2008

<sup>10</sup> CBI, Clearing the Pensions Fog, December 2008

<sup>11</sup> Association of Consulting Actuaries, 2008 Smaller Firms Pension Survey, Figure 4

<sup>12</sup> National Association of Pension Funds, January 2008

resolve. When transferring to DC schemes, employees no longer have to bear this risk, but do of course have to bear the investment risk.

Table 2.1: Membership of private sector pension schemes<sup>13</sup>

Year	Number of active members of private sector pension schemes, millions					Total*
	Occupational DB	Occupational DC	Occupational hybrid	Employer-sponsored personal pension	Employer-sponsored stakeholder pension	
2000	4.6	0.9	0.1	-	-	7.9*
2001	-	-	-	1.8	0.5	-
2002	-	-	-	1.8	0.6	-
2003	-	-	-	1.7	0.8	-
2004	3.6	1.2	-	1.8	0.8	7.4
2005	3.7	1.0	-	1.9	0.9	7.5
2006	3.0	1.0	-	1.9	1.0	6.9
2007	2.7	0.9	-	1.7	1.0	6.3
<b>Change 2000-2007</b>	<b>-1.9</b>	<b>No change</b>	<b>-0.1</b>	<b>-0.1</b>	<b>+0.5</b>	<b>-1.6*</b>
<b>% change 2000-2007</b>	<b>-41%</b>	<b>No change</b>	<b>-100%</b>	<b>-6%</b>	<b>+100%</b>	<b>-20%*</b>

NB: Figures rounded to nearest 100,000; data for employer-sponsored personal and stakeholder pensions refers to financial year; gaps in the table refer to unavailable data.

\* Total for 2000 assumes membership of employer-sponsored personal and stakeholder pensions equal to actual 2001 data.

In an ideal world, pension reform would not be necessary. Employers have unfortunately had to face up to reality: people living longer means that pensions will have to become less generous – either through higher contributions, later retirement ages or less generous retirement benefits. But there has been no such realism in the public sector. Section 4 will show how the reforms to public sector pension schemes enacted since 2005 are inadequate – even after the Government's reforms, the pensions apartheid is very real. The current recession will only increase the divide:

- **Membership of final salary schemes.** At the same time as final salary provision has collapsed in the private sector, the number of active members of final salary schemes in the public sector has actually increased, from 4.1 million in 1995 to 5.2 million in 2007.<sup>14</sup> 90 per cent of public sector employees are members of final salary schemes, compared with just 12 per cent in the private sector.<sup>15</sup>
- **Retirement ages.** The normal pension age (NPA) for new employees in most public sector schemes has now risen to 65. But, with the exception of the local government pension scheme, it remains at 60 for existing employees. This means that if, for example, a 21-year-old joined the civil service in 2006, he or she would retire in 2045 at age 60, at a time when the

<sup>13</sup> Government Actuary's Department, Occupational pension scheme survey 2000, Table 3.1; Office for National Statistics, Occupational Pension Schemes Annual Report 2007, September 2008, Table 3.3; HMRC, Tables 7.4 and 7.5

<sup>14</sup> Office for National Statistics, Occupational Pension Schemes Annual Report 2007, September 2008, Table 3.4

<sup>15</sup> Office for National Statistics, Public Sector Employment Q3 2008, December 2008, Table 5 (comparison with 2007 levels of public and private sector employment)

state pension age will be 67 rising to 68. As Table 2.2 shows, even when the majority of public sector workers are retiring at 65, there will still be a three-year gap between the age at which they retire and the SPA. Already, the NPA for two thirds of active members of private sector schemes is 65, and private sector employees are likely to be retiring later in the future.<sup>16</sup>

*Table 2.2: The gap between the public sector normal pension age and the state pension age*

Year	Public sector normal pension age		State pension age	Difference	
	Existing employees	New employees		Existing employees	New employees
2006	60	60	65/60	5/0	5/0
2020	60	65	65	5	0
2026	60	65	66	6	1
2036	60	65	67	7	2
2046	60 (virtually no existing employees)	65	68	8 (virtually no existing employees)	3

*NB: The NPA for existing local government pension scheme employees is already 65. For the armed forces, police and fire services, the NPA shown above applies to early leavers only.*

- **Employer contribution rates.** Employer (i.e. taxpayer) contribution rates generally far exceed employee contribution rates. Even these, however, are not enough to meet annual payments to retirees, meaning that further taxpayer subsidy is required (see Section 3). Table 2.3 provides an illustration for some of the main public sector schemes. Overall, public sector employers contribute an average of £4,000 a year per employee, compared with an average of £1,600 a year for each private sector employee.<sup>17</sup>

*Table 2.3: Employer and employee contribution rates compared<sup>18</sup>*

Public sector pension scheme	Employee contribution rate	Employer contribution rate
NHS	5% - 8.5%	14%
Teachers	6.4%	14.1%
Civil service	1.5% - 3.5%	17.1% - 26.5%
MPs	10%	26.8%

<sup>16</sup> Pensions Policy Institute, An assessment of the Government's reforms to public sector pensions, October 2008, Chart 12

<sup>17</sup> Ibid., Table 6

<sup>18</sup> NHS pension scheme and new NHS pension scheme guides, April 2008, <http://www.nhsbsa.nhs.uk/Pensions/Documents/Pensions/sdguide.pdf>, <http://www.nhsbsa.nhs.uk/Pensions/Documents/Pensions/SDNG.pdf>; Teachers pensions guide, September 2008, <http://www.teacherspensions.co.uk/resources/pdf/User%20Guide/TP%20Member%20User%20Guide.pdf>; Civil service pensions, [http://www.civilservice-pensions.gov.uk/scheme\\_information.aspx](http://www.civilservice-pensions.gov.uk/scheme_information.aspx); Office of the Leader of the House of Commons, <http://www.commonleader.gov.uk/output/Page1626.asp>

- **Value of pensions.** Post-reform, the average value of a public sector pension for a new entrant is 21 per cent of salary. By contrast, the average value of a private sector DC scheme is around 7 per cent of salary.<sup>19</sup> Although private sector DB schemes are worth considerably more than 7 per cent, for an increasing number of private sector employees in DC or employer-sponsored personal pensions, the reality is that their public sector counterparts are receiving a pension three times as valuable.

Overall, generous public sector pension arrangements are worth a considerable salary premium. The Institute for Fiscal Studies has calculated that they add around 12 per cent to the salary of public sector employees, over and above private sector employees. As the IFS concludes:

*“Relatively generous public sector pensions mean that a public sector worker is on average around 12 per cent better off than a private sector worker on the same basic salary. This gap has grown over the past decade as a result of private sector retrenchment. The government has made modest progress on reform, but unfunded public pension liabilities continue to grow. The gap between public and private sectors does not look sustainable. The case for further reform is strong.”<sup>20</sup>*

In the past, lower salaries in the public sector justified more generous pensions – the overall package was a fair deal. But in recent years pay growth has outstripped the private sector, meaning that gross annual pay is now higher in the public sector for all but the top 25 per cent of full-time employees, while gross hourly pay is higher for all but the top 10 per cent.<sup>21</sup> Employees in the public sector also benefit from greater job security and in many cases longer holidays.

The fact that at almost every level public sector employees now earn more than their private sector counterparts removes the justification for such a large degree of taxpayer subsidy of public sector pensions. It is quite simply unfair for businesses and individuals to pay, through taxes, for pensions that they cannot afford for themselves.

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<sup>19</sup> Pensions Policy Institute, An assessment of the Government’s reforms to public sector pensions, October 2008. These are average figures and vary for different schemes and for individual employees in the same scheme. Note that the PPI measure “is calculated as the amount that would be needed to ‘buy’ the benefits of the scheme, as if it were a funded scheme. Member contributions have been deducted, to show the notional remaining amount that is contributed by the employer.”

<sup>20</sup> IFS Green Budget, January 2008, p.4

<sup>21</sup> Office for National Statistics, Annual Survey of Hours and Earnings, 2008, Tables 13.5a and 13.7a

### 3 The unsustainable cost of the pensions apartheid

Most public sector pension schemes are unfunded, which means that contributions from today's employees and employers pay today's pensioners. But despite the high employer contribution rates described in Section 2, employee and employer contributions are not sufficient to pay today's retirees.

This means that taxpayers are having to pay twice: firstly for *employer contributions*, and secondly for an *annual bailout* – the difference between employer/employee contributions and pensions in payment.

Table 3.1 shows how the annual bailout of unfunded public sector pensions is growing. Over the five year period from 2006-07 to 2010-11, taxpayers are expected to have to pay a total of £14 billion over and above employer/employee contributions, £2.8 billion each year. Based on the Treasury data shown in Table 3.1 and extrapolated over a 50-year time frame, we would estimate that the bailout could reach £140 billion, £5,500 per household, in total. This is likely to be an underestimate as the annual bailout is growing.

*Table 3.1: The annual cost of unfunded public sector pensions<sup>22</sup>*

£ billion	Unfunded public sector pensions in payment	Employer + employee contributions	Difference: annual bailout
2006-07	19.1	17.9	1.2
2007-08	21.3	19.0	2.3
2008-09	22.0	19.1	2.9
2009-10	23.2	19.6	3.6
2010-11	24.2	20.2	4.0
<b>Total</b>	<b>109.8</b>	<b>95.8</b>	<b>14.0</b>
<b>Average</b>	<b>22.0</b>	<b>19.2</b>	<b>2.8</b>

*NB: Figures rounded to nearest £100 million. Figures may not sum to totals due to rounding. As explained above, most of the cost of the employer/employee contributions column will also be borne by taxpayers, as contribution rates for employers are higher than for employees. Unfortunately, the Treasury does not provide a split. Final column refers to Treasury "Contribution to TME" figure.*

But the actual bailout is likely to be much higher, since the above figure does not include the growing liabilities of the unfunded schemes. Because of changing demographics, liabilities in excess of what is paid out to today's retirees are building up each year. Table 3.2 shows that over the period 2006-07 to 2010-11, increasing liabilities are forecast to exceed employer/employee contributions by £33.6 billion, £6.7 billion a year.

These increasing liabilities will have to be paid for by taxpayers at some point in the future, either through higher employer contributions, and/or through a higher annual bailout. Based on the Treasury data shown in Table 3.2 and extrapolated over a 50-year time frame, we would estimate that the actual cost could far exceed £140 billion – reaching £335 billion, over £13,000 per household, in total. *And this £335 billion would be in addition to the high employer contributions that are already levied.*

<sup>22</sup> HM Treasury, Public Expenditure Statistical Analyses 2008, Table D.1

Table 3.2: The build up of unfunded public sector pension liabilities<sup>23</sup>

£ billion	Increase in unfunded public sector pension liability	Employer + employee contributions	Increase in liability in excess of employer + employee contributions
2006-07	21.1	17.9	3.3
2007-08	29.0	19.0	10.1
2008-09	25.4	19.1	6.4
2009-10	26.2	19.6	6.7
2010-11	27.2	20.2	7.1
<b>Total</b>	<b>128.9</b>	<b>95.8</b>	<b>33.6</b>
<b>Average</b>	<b>25.8</b>	<b>19.2</b>	<b>6.7</b>

NB: Figures rounded to nearest £100 million. Figures may not sum to totals due to rounding. Final column refers to Treasury "net public service pensions" figure, which also includes around £100 million each year of "cash payments in OCS not covered by release of provision"

The local government pension scheme is a funded scheme, and so is not included in Table 3.1 or Table 3.2, but it suffers from similar problems. Employer contributions have to make up the difference between fixed employee contributions and the final salary pension promises. Not surprisingly, the employer contribution rate in most local authority schemes has increased rapidly in recent years.<sup>24</sup> Local government pensions are already equivalent to around £1 in every £5 of council tax paid.<sup>25</sup>

Another way of looking at future costs is to examine the official estimates of the overall annual cost of unfunded public sector pensions to taxpayers (i.e. employer contributions plus bailout). Post-reform, these costs are estimated to increase from 1 per cent of GDP last year to 1.4 per cent of GDP by 2027 – a 40 per cent increase as a share of national income.<sup>26</sup> But this figure does not include the local government pension scheme and is based on the Treasury's estimate of unfunded liabilities, which is at the lower end of the range of estimates in Table 3.3. If the unfunded liabilities are larger than the Treasury's projection, then the overall annual costs to taxpayers will also be larger.

These estimates suggest that public debt in the UK could be over 100 per cent of GDP, compared to the official numbers putting it at less than 50 per cent (including the financial sector interventions).<sup>27</sup> Whichever estimate is used, the bill to taxpayers over the next few decades will be enormous.

<sup>23</sup> HM Treasury, Public Expenditure Statistical Analyses 2008, Table D.1

<sup>24</sup> Employer contribution rates vary by local authority, but to give some illustration, the employer contribution rate in Hounslow increased from 8.8 per cent of pensionable pay in 1996 to 21.5 per cent of pensionable pay in 2006. Source: annual accounts of Hounslow council. Increases of similar magnitude have occurred across local government, creating further pressure for council tax increases

<sup>25</sup> CBI, Clearing the Pensions Fog, December 2008; TaxPayers' Alliance, Council Spending Uncovered: No.3 – Pension Contributions', February 2008

<sup>26</sup> Annual taxpayer cost = total cost less employee contributions. Pensions Policy Institute, An assessment of the Government's reforms to public sector pensions, October 2008, Chart 8. HM Treasury puts the total cost at 1.5 per cent of GDP rising to 2 per cent of GDP: HM Treasury, Long Term Public Finance Report 2008, Table 4.1

<sup>27</sup> Office for National Statistics First Release, Public Sector Finances December 2008, 21 January 2009

Table 3.3: Estimates of unfunded public sector pension liabilities<sup>28</sup>

Estimate	Unfunded liabilities		
	Total	Percentage of 2007-08 GDP	Total per household
Treasury	£650 billion	46%	£26,000
CBI	£915 billion	64%	£36,000
Watson Wyatt	£960 billion	68%	£38,000
IEA	£1,071 billion	75%	£43,000

<sup>28</sup> HM Treasury, Long Term Public Finance Report 2008; CBI, Clearing the Pensions Fog, December 2008; Watson Wyatt press release, 8 March 2006 <http://www.watsonwyatt.com/news/press.asp?ID=15784>; Neil Record, Sir Humphrey's Legacy: An Update, Institute of Economic Affairs, January 2008

## 4 The Government's failure to enact meaningful public sector pension reform

Reforms to all the main public sector pension schemes have come into effect over the last three years (between 2005 and 2008).<sup>29</sup> But they have been quite inadequate. As explained in Sections 2 and 3, even after the reforms, the pensions apartheid – and its cost – has not gone away.

The reforms of the last few years have not affected everyone uniformly. Existing members have experienced far fewer changes to their pension arrangements than new entrants:

- For *new entrants*, the precise changes vary, but in general, the NPA has risen to 65, employee contribution rates have increased slightly and lump sum payments have generally declined. At the same time, however, the schemes have generally remained final salary and the accrual rates have actually become more generous, usually from 80ths to 60ths. The civil service scheme has moved to career average for new entrants, but the accrual rate has increased from 60ths to around 43rds.
- To some extent, the Government has taken away with one hand and given back with the other. For example, for the NHS scheme, half of the impact of the increase in the NPA has been offset by changes to accrual rates. The net effect of the reforms has been to reduce the average value of a public sector pension for new entrants from 24 per cent to 21 per cent of salary,<sup>30</sup> an insufficient change given that taxpayer costs are still projected to increase as a share of GDP by 40 per cent over the next 20 years.
- *Existing employees*, however, have not experienced a great deal of change to their pension arrangements. The key reform – increasing the NPA to 65 – only applies to new employees.<sup>31</sup> The Government had originally planned to raise the NPA to 65 for new accrual of existing members from 2013, but backed down in 2005 in the face of a threat of widespread strikes by the public sector unions.<sup>32</sup> Hence the reduction of the average value of a public sector pension to 21 per cent of salary, cited above, does not apply to existing employees.

The Government expects the reforms to the NHS, teachers' and civil service schemes to save £13 billion over a 50 year period, which is very small when compared with a bailout that could reach £335 billion (see Section 3).

In addition to the savings cited above, cost-sharing and cost-capping agreements have been made with respect to the NHS, civil service and teachers' schemes, with the local government pension scheme expected to follow suit. These

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<sup>29</sup> For a comprehensive description of the reforms, see Pensions Policy Institute, An assessment of the Government's reforms to public sector pensions, October 2008, from which figures in this section are based, except where otherwise stated

<sup>30</sup> These are average figures and vary for the different public sector pension schemes and for individual employees in the same scheme. Note that the PPI measure "is calculated as the amount that would be needed to 'buy' the benefits of the scheme, as if it were a funded scheme. Member contributions have been deducted, to show the notional remaining amount that is contributed by the employer."

<sup>31</sup> Although the retirement age for the local government pension scheme is already 65

<sup>32</sup> For a discussion, see Pensions Policy Institute, Briefing Note 25

agreements mean that additional costs arising in the future will be shared 50:50 between employers (taxpayers) and scheme members. They also include an overall cap on employer contributions, meaning that employees may have to bear more than 50 per cent of cost increases, either through increases in employee contributions or reductions in benefits.

These agreements are an important way to cap the total taxpayer liability, but are incomplete in a number of respects.

- Firstly, they generally only apply to cost increases that are the result of changes to *demographic assumptions*, i.e. people living longer than previously predicted. They will generally not apply to cost increases resulting from changes to financial assumptions (such as the discount rate) or from changes to the actuarial valuation methodology.
- Secondly, they only refer to *unanticipated* increases in costs. The cost increases resulting from the demographic time-bomb described in Section 1 will not be subject to cost-sharing or cost-capping, as the demographic changes have already been predicted.
- Thirdly, the agreements work both ways. If there are cost *decreases* as a result of unanticipated demographic changes, i.e. people not living as long as previously predicted, they will also be shared between employees and employers (taxpayers).

The agreements do make the future taxpayer cost more predictable, but they also effectively “lock in” the enormous cost of public sector pensions to taxpayers, now and in the future, that is currently projected. A further reform effort is urgently needed.

## 5 The unavoidable choice

Before setting out our suggestions for reform, there is an unavoidable trade-off which is worth setting out. The implication of various decisions and concessions to unions that have been made needs to be clearly understood.

The key assumption behind this is that the population will age as described in Section 1. Clearly, if the population ages to a lesser extent, the trade-off described below would be eased, but not eliminated. Conversely, if the population ages to a greater extent than predicted by the Government Actuary's Department, the trade-off would be even more important, although in this case cost-sharing and cost-capping agreements for some of the public sector pension schemes would provide some mitigation.

With an ageing population:

- Either public sector pensions will have to be reformed further to reduce their cost.
- Or taxes will have to rise and/or other government spending cut to pay for higher employer contributions and/or higher annual bailouts.

Given that even after the recent reforms, the annual cost of public sector pensions to taxpayers is estimated to increase as a share of national income by 40 per cent – from 1 per cent to 1.4 per cent of GDP by 2027 – there is unfortunately no magic way around this problem (see Section 3 for more details on the cost to taxpayers of current policy).<sup>33</sup>

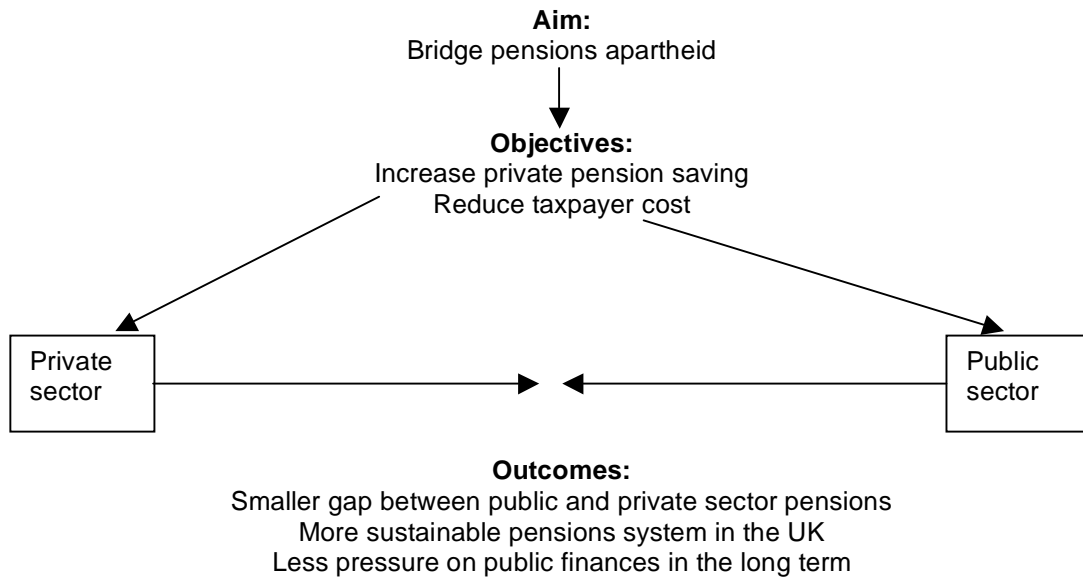
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<sup>33</sup> A smaller public sector workforce would save money in the long term, as there would be fewer benefits to fund

## 6 Reform objectives and possible solutions

The aim of reform should be to bridge the pensions apartheid, by both reducing the cost to taxpayers of public sector pensions and increasing private sector pension saving, as shown in Figure 6. This will lead to a more sustainable pensions system in the UK and reduce the long term pressure on the public finances.

Figure 6: Aims and objectives of reform



As Section 4 showed, public sector pensions have been reformed in the last few years, but the reforms were inadequate. They do not prevent escalating taxpayer costs, nor do they close the gap between public and private sector pension provision. A further reform effort is urgently needed.

Any changes to public sector pension arrangements should not affect past accrual. Although this principle has been broken by government with respect to the basic state pension in the past – the move from earnings to prices and increases in the state pension age – the accrual principle has to remain sacrosanct. However, the arrangements for new accrual of existing members, in addition to those for new members, can and should be changed.

There are four principal ways to reduce the cost of public sector pensions to taxpayers:

- Increase the normal pension age;
- Reduce accrual rates;
- Increase employee contribution rates;
- Move from final salary to career average.

There are also other options, such as changing lump sum benefits and indexation rules. While it is not necessary to exercise every one of these options, there will need to be reform in at least one area. The scale of the demographic challenge

means that doing nothing is not an option, however attractive it might appear to be.

The IoD's central recommendation is that the public sector normal pension age for new members and for new accrual of existing members should be increased in line with increases in the state pension age.<sup>34</sup> This would lead to phased increases in the public sector retirement age, and would help to reduce costs to taxpayers considerably. It is a first step in bridging the pensions apartheid:

- Between 2010 and 2020, the NPA for new accrual of existing members should be increased from 60 to 65, in line with the increase in the SPA for women.
- Between 2024 and 2026, the NPA for new accrual of existing members and for new members should be increased from 65 to 66, in line with the increase in the SPA for men and women.
- Between 2034 and 2036, the public sector NPA should be increased to 67, in line with the SPA increase.
- Between 2044 and 2046, the public sector NPA should be increased to 68, again in line with the SPA increase.

In addition, there is a strong argument that final salary pensions are no longer the most suitable pension arrangements for today's more flexible labour market. In a world where people now change job on average every 7.5 years,<sup>35</sup> and where an important objective is to increase employment rates among the older workforce, final salary schemes may make it harder for people over 50 to find new jobs, both by making them more reluctant to leave their current position and more expensive to hire than younger people.<sup>36</sup>

In this context, the move to career average pensions for new entrants to the civil service is welcome, and should be followed by the other public sector schemes. The accrual rate, however, has been increased to 43rds, which is excessively generous, meaning that new civil servants can earn a pension worth half their career average salary after just 22 years of employment. Indeed, for some civil servants, the new scheme will actually be more generous than the old.<sup>37</sup> The accrual rate should have remained at 60ths, and should remain at 60ths should other public sector schemes move to career average.

But reform doesn't stop with the public sector. It is also essential to increase private pension (and other) saving. Although we have concerns that saving in Personal Accounts will deliver negative returns (through withdrawal of means-tested retirement benefits) for certain lower income households and those with a

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<sup>34</sup> For the armed forces, police and fire services, we are referring to the NPA for early leavers only

<sup>35</sup> Mean job tenure was 90 months in 2001, although *median* job tenure was only 48 months (4 years). Office for National Statistics, Job mobility and job tenure in the UK, Labour Market Trends, November 2003

<sup>36</sup> Actuarial costs of final salary pensions are higher for older than younger people, which makes them both less attractive to hire and more reluctant to leave existing positions

<sup>37</sup> Pensions Policy Institute, An assessment of the Government's reforms to public sector pensions, October 2008, Chart 5

short time to go to retirement, they should help to increase pension saving overall.

In addition, people are increasingly making the choice to save in alternative vehicles such as ISAs. In 2005, the latest year for which comparative data is available, £31.1 billion was invested in ISAs, compared with £22.3 billion of individual and employee contributions to private sector occupational and personal pensions.<sup>38</sup> Much of the ISA saving was undertaken by lower income households. Of the 12.4 million people investing in ISAs in that year, 7.5 million had incomes below £20,000 and 3.7 million had incomes below £10,000.<sup>39</sup> This trend should be encouraged, perhaps by increasing the ISA limit, which has risen by only £200 since ISAs were introduced in 1999. Consideration should also be given to introducing workplace ISAs.

In the long run, however, with an ageing population, it is clear that DB pensions will be increasingly risky and expensive for employers and taxpayers. Ultimately, the only way to manage longevity risk is to move away from pension arrangements where current contributions by employees pay for current pensions paid to retirees, to funded provision, where each scheme member's retirement pot grows throughout his or her working life.

Although this is not something to celebrate, businesses have had to bow to reality, and private sector DB schemes may soon be a thing of the past. The challenge for the private sector is to increase saving for retirement. For the public sector, the retirement age reform proposed above will help to keep a lid on taxpayer costs. But in the long run, the only way of bridging the pensions apartheid and ensuring the long term sustainability of the public finances may be for the public sector to move to DC arrangements.

The main obstacle is that in moving from unfunded pension schemes to funded arrangements, there will be a period of time when payments have to be made twice. This is because at present, current contributions pay for current pensions. Under reformed arrangements, current contributions will go into a fund to be built up for the member's future pension, meaning that current pensions will have to be paid by some other means for several decades. In the long run, such a shift will hugely reduce liabilities and therefore taxpayer exposure, but the transition costs (which are likely to fall on taxpayers) may be great. The next stage of our work will be to investigate the practicalities and the transition costs of moving public sector pension schemes for new accrual over to DC.

The pensions apartheid is real, unfair, unsustainable and urgently in need of change. The current recession will make the divide even greater and the enormous deficits being run intensify the need to reduce long term costs to help bring the public finances back to sustainability. There really is no alternative.

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<sup>38</sup> HMRC Table 9.4; Office for National Statistics, Pension Trends, Table 8.12

<sup>39</sup> HMRC Table 9.7

