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The impact of the 2007-08 changes to public service pensions

Summary

Background

1 This report provides a systematic analysis of the impact on future cash costs to taxpayers of changes made in 2007 and 2008 to pension schemes covering the civil service, NHS and teachers. It builds on our March 2010 report on *The cost of public service pensions* and, like that report, shows pension costs projected over the next 50 years. This report makes recommendations to establish good practice in the programme management of any future changes. It will help inform current consideration, including by Lord Hutton's Independent Public Service Pensions Commission, of the potential need for further changes.

2 The 2007-08 changes affected schemes that account for nearly three-quarters of all United Kingdom public service pay-as-you-go pension payments. In such schemes, contributions from current employees and their employers are used to pay today's pensions, with the Treasury making or receiving balancing payments to cover the difference. The difference arises because pension payments and contributions are driven by different populations and are not designed to balance in any particular year.

3 There were four elements to the changes introduced in 2007-08, which were the first financially significant changes since the 1970s.

- Employee contributions for NHS staff and teachers increased, following earlier increases for civil servants.
- The normal pension age at which employees can take unreduced pensions increased for new staff, from 60 to 65 years in most cases. Negotiations and agreements meant that this change did not apply to existing employees.
- A new cost sharing and capping mechanism was introduced to transfer, from employers to employees, the risk of future additional costs resulting from changes in factors such as pensioners living longer than previously expected. The mechanism is intended to be used at routine actuarial valuations. No valuations have been completed since the mechanism was introduced, so there is no evidence yet of how it will apply in practice.
- Other changes taken together absorbed some of the savings from the first three measures.

4 There have been further developments, outside the scope of our report, since the 2010 general election.

- The new coalition Government asked Lord Hutton to chair an Independent Public Service Pensions Commission, which published interim findings in October 2010 and is expected to report finally before the 2011 Budget. Responding to the interim findings, the Government announced its intention to carry out a public consultation on the discount rate used to set contribution rates in public service pension schemes, and to increase employee contribution rates to most schemes by an average of 3 per cent of pay.
- The Government intends to use the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) for increasing pensions in payment each year, which the Independent Public Service Pensions Commission estimates may reduce the value of a pension by around 15 per cent on average over the whole period in which it is received.
- There is a continuing pay freeze for most of the public sector workforce and the expectation of substantial staff cuts across public services, which should reduce the long-term costs of public service pensions but will increase balancing payments from the Treasury in the short term.
- There are proposed changes to the tax treatment of all pensions, whether private sector or public service.

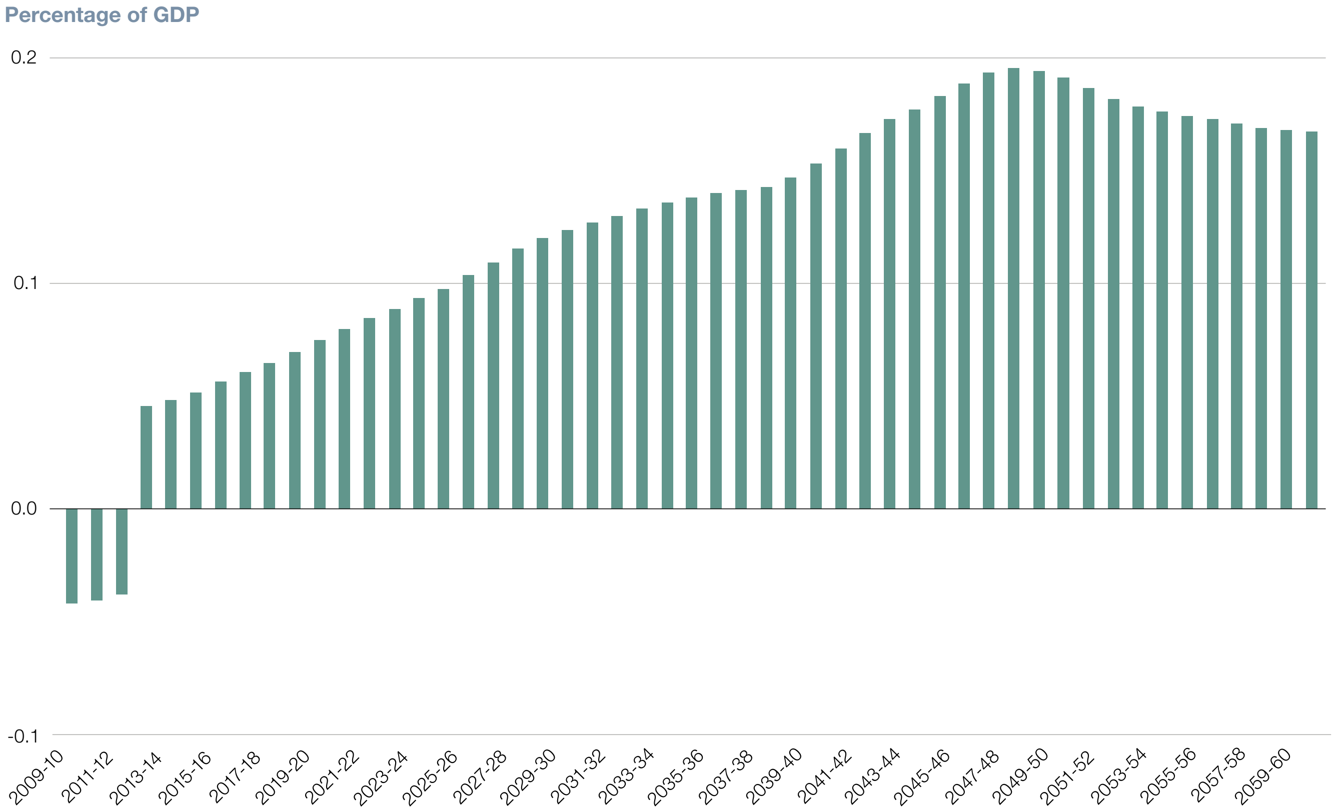
Key findings

Financial impact

5 We estimate that the 2007-08 changes will reduce costs to taxpayers in 2059-60 by 14 per cent compared to what they would have been without the changes. In net present value terms, using the Treasury's discount rate of 3.5 per cent above increases in RPI, aggregate savings over all years in the period to 2059-60 are equivalent to £67 billion in 2008-09 prices. Savings peak at 0.2 per cent of Gross Domestic Product (GDP) in 2047-48, lying between 0.1 and 0.2 per cent of GDP from 2025-26 onwards (**Figure 1** overleaf). The peak occurs because of a temporary reduction in numbers of retirements as the changes start to delay the age at which employees retire. Beyond 2059-60, annual savings will initially remain at 14 per cent, rising slowly from 2065-66. As a consequence of the changes, overall costs to taxpayers will stabilise at around 1.0 per cent of GDP, close to their current levels.

Figure 1

Annual savings to taxpayers from changes to pension schemes for civil servants, NHS staff and teachers lie between 0.1 and 0.2 per cent of GDP from 2025-26 onwards



Source: National Audit Office analysis of Government Actuary's Department pension projections and Treasury GDP projections

6 The size and timing of savings from the cost sharing and capping mechanism, which is designed primarily to prevent costs from changing unexpectedly rather than to reduce them, are subject to particular risk and uncertainty.

- The mechanism gives Ministers discretion in deciding how to implement cost sharing and capping, so it may not have the impact projected in this report. There could be an increased risk of error from administrative complexity if applying the mechanism leads to a growing sequence of different pension calculations for periods between successive actuarial valuations.
- Savings will be smaller if certain cost pressures turn out to be lower than expected, for example if future increases in pensioners' life spans are less than currently projected. Overall costs would, however, stay broadly the same, in line with the design of the mechanism. The reverse applies if cost pressures turn out to be higher than expected.
- The timing of savings depends on the completion of actuarial valuations. Our projections assume that cost sharing and capping will be implemented in 2012-13, as the Treasury currently expects. This accounts for the sudden jump in savings in that year (Figure 1).

7 Within the current spending review period, we estimate savings with a present value of £5 billion in 2008-09 prices between 2010-11 and 2014-15, almost entirely absorbed by additional short-term costs with a present value of £4 billion. The costs are consequences of changes in tax rules that allow employees to take more of their pensions as lump sums on retirement, and are more than offset by longer-term savings through pensions being lower than they would have been without the lump sum exchanges.

8 Our estimate of savings is new information because the Treasury, while it projects and monitors overall spending on public service pensions, has not monitored the specific impact on overall spending of the different elements of the 2007-08 changes. In November 2005, the Treasury set a financial target, or 'cost envelope', which it used to secure savings in employer contribution costs over 50 years. By 2008, the Treasury regarded the 2005 target as 'obsolete'. It has not produced revised estimates of long-term savings to be able to assess for itself, or demonstrate to others, the success or otherwise of the first major changes to public service pension schemes for over 30 years. The results we describe here are distinct from further savings that the Independent Public Service Pensions Commission has estimated as a result of developments in 2010.

Sustainability

9 The Treasury set three criteria for sustainability in introducing the changes: financial affordability and stability in employer costs; fitness for purpose in staff recruitment and retention; and, setting the right example to private sector employers.

10 We do not comment on whether public service pension schemes are financially affordable because that is a political judgement rather than an audit assessment. However, our analysis of savings is relevant to that judgement. Financial stability is about managing risks that costs might turn out to be higher than projected because factors about which assumptions have been made behave differently from what is currently expected, or because those factors are not well enough understood. We found that the changes improve the management of the key financial risk related to longevity, but not the risk related to any permanent change in GDP growth, while three other areas of uncertainty were not considered by the Treasury's sensitivity analyses.

- The cost sharing and capping mechanism, if it is implemented as envisaged in the light of much subsequent change, will transfer from taxpayers to employees most of the financial risk arising if pensioners live longer, on average, than the schemes' actuaries have previously projected. Employees could have to pay substantially larger proportions of their salaries into the pension schemes if projected life spans rise or, alternatively, accept substantially reduced future pension accumulation.
- The cost sharing and capping mechanism does not manage the risk that the cost of public service pensions, as a proportion of GDP, will rise if GDP growth is permanently lower than expected. The focus in this area is, instead, on managing the risk of public sector salaries growing faster then the wider economy. While pensioners were already living longer than previously expected at the time of the 2007-08 changes, there was then no equivalent cause for concern about GDP growth. Nevertheless, the potentially substantial impact of differing GDP growth rates was known at the time, so it would have been reasonable for the Treasury to have investigated means to manage the risk.
- Other uncertainties remain, which could mean that overall costs to taxpayers differ from current projections. The Treasury has not modelled the potential impact of different workforce growth rates on public service pension costs, although the Independent Public Service Pensions Commission has included variants from the Treasury's assumption of an unchanging workforce size in its own modelling, or the potential impact of changes to public service pensions on means-tested benefits and tax receipts.

11 The Treasury and public service employers did not agree a long-term strategy for the role of pensions in recruitment and retention, including what variations might be appropriate among schemes, to underpin the 2007-08 changes. They did not identify the types of employee behaviour they wished to encourage and support through pensions, for example the balance between staff retention and mobility or the flexibility to stress one or the other at different times. Focus group research, carried out in 2004 for the civil service and NHS, indicated that employees did not have a clear financial understanding of the value of their public service pensions.

12 Evidence of the impact of the pensions package on recruitment and retention is not yet clear, largely because it will take time for the changes in pension schemes to have an impact but also because of inadequate understanding among employers of how employees perceive the value of their pensions.

- The civil service adopted a career average salary scheme for new entrants. It is intended to support greater employment flexibility, diversity and mobility and provide a fairer outcome for staff in general, as staff with shorter or flatter career paths should receive better pensions than they would receive on a final salary basis. Other schemes chose to stay with a final salary basis.
- There is poor understanding among staff of the real value of public service pensions, and widespread disagreement about it among experts. There is a risk that frequent changes to pensions, which are inherently long-term assets, will degrade their perceived value to employees and prospective employees. The Office for Budget Responsibility also expects increases in employee contributions to cause some, particularly those on lower incomes, to opt out of their pensions.

13 The continuing closure of defined benefit schemes in the private sector suggests that the use of public service pension schemes to set a wider example is not working.

Conclusion on value for money

14 By making changes in 2007-08 to pension schemes for civil servants, NHS staff and teachers, the Treasury and departments overseeing the schemes acted to tackle potential future growth in costs to taxpayers. As a result of the changes, which are on course to deliver substantial savings, long-term costs are projected to stabilise around their current levels as a proportion of GDP. The changes are also set to manage one of the most significant risks to those costs, by transferring from taxpayers to employees additional costs arising if pensioners live longer than is currently projected.

15 Despite these achievements, the value for money of the changes cannot be demonstrated because the Treasury and employers did not agree a long-term strategy for the role of pensions in recruitment and retention and the Treasury has not monitored the ongoing impact of the changes against a long-term financial objective. In particular, the savings are being provided by public service employees in the form of increased contributions or reduced future pension accumulation, and there has been no assessment of long-term impact on staff motivation and retention.

Recommendations

16 We make the following recommendations so that omissions in the way the 2007-08 changes were introduced are not replicated in any future changes.

a **The Treasury's focus in overseeing the 2007-08 changes was on meeting its 'cost envelope' and its approach was not underpinned by a longer-term strategy and analysis, developed with employers, of what features are desirable in a modern public service pension scheme.** The Government has since established the Independent Public Service Pensions Commission. In the light of the Commission's recommendations, the Treasury, Government departments and public service employers should agree and communicate a clear view of the purpose of public service pensions, including their role in recruitment, retention and mobility, and what aspects of scheme design are delegated and what characteristics are not.

b **Public service employers may not be optimising the use of pensions as recruitment and retention tools.** Building on research carried out for the civil service and NHS schemes in 2004, public service employers, Government departments and the Treasury should improve their understanding of how employees view a pension within an overall pay package and how it influences their employment decisions. They should use this understanding to inform their future decisions about pension arrangements.

c **Before it approved the pension scheme changes, the Treasury conducted sensitivity analyses on longevity and GDP growth, the two main risks to taxpayer costs, but not on three other areas of uncertainty.** The Treasury should improve its understanding of the financial impact of changes to public service pensions by undertaking sensitivity analyses of different workforce size projections and by assessing interactions with the tax and benefits systems.

d **The Treasury set a financial target which it regarded as obsolete after the 2007-08 changes were agreed, and it has not devised an alternative measure to monitor the financial impact of the changes.** The Treasury should set clear long-term financial objectives for any further changes to public service pensions and put in place mechanisms to monitor their achievement.

e **The cost sharing and capping mechanism does not manage the risk that the cost of public service pensions, as a proportion of GDP, will rise if GDP growth is permanently lower than expected.** The Treasury, in reviewing recommendations from the Independent Public Service Pensions Commission, should consider and communicate the extent, if any, to which it can and will manage GDP risk.

f **Despite the potential benefit to taxpayers of the flexibility to change public service pensions further in the future, there is a risk that uncertainty from an impression of constant change may reduce their perceived value to employees and prospective employees.** The Treasury should make clear its intentions on this issue in its response to recommendations from the Independent Public Service Pensions Commission.