HM TREASURY

Public Service Pensions Bill:

impact assessment

September 2012

HM TREASURY

Public Service Pensions Bill:

impact assessment

September 2012

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

Any queries regarding this publication should be sent to us at: public.enquiries@hm-treasury.gov.uk.

ISBN 978-1-909096-03-5
PU1364

Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Evidence base	5
Chapter 3	Policy options	7

1 Introduction

1.1 In the paper *Public Service Pensions: good pensions that last*, published November 2011[1], the Government accepted the view, set out by Lord Hutton in the final report of the Independent Public Service Pensions Commission, that:

> *"it is possible for public service employees to continue to have access for the foreseeable future, to good quality, sustainable and fairer defined benefit pension schemes. For this to happen there will need to be comprehensive reform – reforms that can balance the legitimate concerns of taxpayers about the present and future cost of pension commitments in the public service as well as the wider need to ensure decent levels of retirement income for millions of people who have devoted their working lives in the service of the public[2]."*

1.2 The cost of public service pensions paid out has risen by over a third over the last ten years to £32 billion a year[3]. These additional costs have mostly fallen to the taxpayer[4]. In addition the designs of many of the existing public service pension schemes disproportionately benefit higher earners[5].

1.3 The Government is therefore taking forward reform of these schemes. The Government's stated aims with regard to public service pensions are to:

- ensure a good level of retirement income for public service workers, with a reasonable degree of certainty;
- be affordable and sustainable – with cost risk managed and shared effectively;
- provide a fair balance of cost and benefits between public service workers and other taxpayers;
- protect those closest to retirement;
- have a clear legal framework and governance structure – and be widely understood by workers; and
- stand the test of time – no more reform for at least 25 years.

1.4 Some of these reforms have already been implemented: the measure of annual price increases on which state and public service pension benefits are uprated changed from April 2011 – from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI). Spending Review 2010 set out that members' pension contributions, apart from the armed forces, would be increased by an average 3.2 percentage points[6] phased in over a three year period. However, the Government has recognised that the funded nature of the Local Government Scheme means that alternatives to contribution rate increases can be considered to make the targeted savings.

[1] Public Service Pensions: good pensions that last www.hm-treasury.gov.uk/d/pensions_publicservice_021111.pdf
[2] Independent Public Service Pensions Commission Final Report, page 3. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[3] Public Service Pensions: good pensions that last www.hm-treasury.gov.uk/d/pensions_publicservice_021111.pdf
[4] Independent Public Service Pensions Commission Interim Report, page 20. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[5] Independent Public Service Pensions Commission Final Report, page 27. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[6] Spending Review 2010 cdn.hm-treasury.gov.uk/sr2010_completereport.pdf

1.5 The Public Service Pensions Bill provides the legislative framework for changes to be made to public service pension provision in order to continue to meet these objectives.

1.6 The impact assessment below focuses specifically on the reforms that will be made on the basis of this Bill. The total reform package, including the measures set out above, is larger and is projected to save 40 per cent of net expenditure by 2061-62[7]. The Treasury estimate that this package will deliver more than £430 billion of savings, in constant GDP terms, over the next 50 years[8].

[7] HM Treasury calculations based on Office of Budget Responsibility's Fiscal Sustainability Report 2012

[8] HM Treasury calculations based on Office of Budget Responsibility's Fiscal Sustainability Report 2012

2 Evidence base

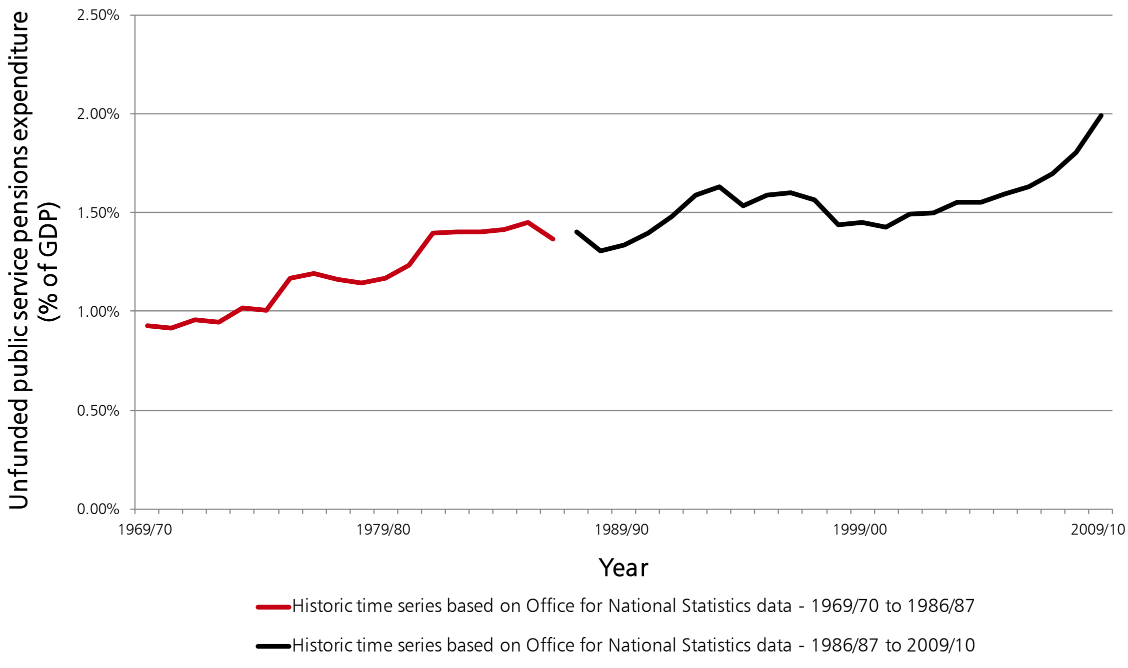
The problem

Costs are increasing as people live longer

2.1 People are living longer and that is good news. However, this means the Government is paying public service pensions for much longer than expected when schemes were designed. Furthermore, improvements in life expectancy have been consistently underestimated. As a result, time spent in retirement and thus the cost of pensions, have been higher than originally expected; the cost of public service pensions paid out has risen by over a third over the last ten years to £32 billion a year[1].

2.2 The chart below shows expenditure on public service pensions doubling as a percentage of GDP over the last 30 years[2].

Chart 2.A: Historic unfunded public service pensions expenditure as a proportion of Gross Domestic Product



[1] Public Service Pensions: good pensions that last www.hm-treasury.gov.uk/d/pensions_publicservice_021111.pdf

[2] HM Treasury calculations based on data from the Office for National Statistics

Lack of effective cost mechanisms to manage future increases in expenditure

2.3 There is no overriding mechanism in place across all schemes to bring costs back to an affordable level should they unexpectedly increase. The current 'cap and share' cost control mechanism applies to some schemes, but not all and has not yet been implemented. The longevity risk is not directly managed at present, so a cost control mechanism is needed to provide additional 'back stop' protection for taxpayers.

2.4 In the context of uncertain and increasing longevity, the current scheme designs are not sufficiently robust to ensure the sustainability of public service pensions; this is unfair to taxpayers, who meet the majority of increased costs of public service pension provision.

Unfairness of public service pension scheme design

2.5 The final salary structure of the majority of the schemes is also unfair. A final salary scheme design is far more beneficial to high flyers than to those with slower salary growth; high flyers can receive almost twice as much in pension payments per £100 of employee contribution[3].

2.6 Greater benefits for high flyers, relative to their contributions, are an inherent feature of final salary pension schemes. Reform of the scheme structure is needed to address this fundamental unfairness and ensure there is an effective balance of risks between scheme members and employers.

[3] Independent Public Service Pensions Commission Interim Report, page 94, Box 5.C. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

3 Policy options

Consideration of options

3.1 In 2010, the Government established the Independent Public Service Pensions Commission (IPSPC), led by Lord Hutton of Furness, to review the long term affordability of public service pensions. The Commission considered a wide range of options for long term reform, based on two extensive consultation / evidence gathering exercises (the Commission's proposals are discussed in detail below).

3.2 This impact assessment considers two approaches to public service pensions:

1. Maintain and implement the switch to CPI uprating of pensions and increases in member contributions announced in June and October 2010 respectively.
2. In addition to these measures, create a legislative framework which will allow for the implementation of key recommendations from the final report of the IPSPC and the reforms set out in agreements reached with trades unions, member representatives and employer representatives, in order to deliver the Government's objectives for public service pension provision.

3.3 The following discussion sets out the Cost Benefit Analysis of the two options.

Policy option 1 – no further changes

Discussion

3.4 In recent years, there have been several changes made to public service pensions to help mitigate the problems set out in section 2. The IPSPC summarised these in section Chapter 2 of its report[1]. In the 2007-2008 period, the changes included:

- Increases in Normal Pension Age (NPA) for new entrants: The NPA for new entrants increased to age 65 in the NHS, Civil Service and Teachers schemes, age 60 in the fire scheme, and age 55 in the police and armed forces; and provisions in the Local Government Scheme under which unreduced pensions could be taken before 65 was removed for new entrants, with phasing out for existing members[2];
- Tiering of member contribution rates was introduced for teachers and many NHS and Local Government staff with some small increases in average contribution rates; and
- Cap and share, a cost mechanism that applies to just the NHS, Teachers and Civil Service schemes was legislated for, but not implemented. Similar regulations are in place for such a mechanism in the LGPS, but a cap was not set. Increases or reductions in scheme costs, identified in a scheme actuarial valuation, were to be shared between members and employers up to the value of the cap. Above the cap

[1] Independent Public Service Pensions Commission: Interim Report, Page 39. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[2] Public service pension reform – 1997-2010 – Commons Library Standard Note http://www.parliament.uk/briefing-papers/SN05298

the increases or reductions would be borne by members, either by changing contributions or the cost of benefits (or both).

3.5 The cap and share mechanism was designed to prevent new, unforeseen costs falling to the taxpayer; it could not address the historic increased cost of pensions. Cost reductions from this policy would result from limiting future cost increases but would not represent any savings from the current costs.

3.6 Furthermore, at June 2010 Budget the Government announced that the measure of annual price increases on which state and public service pension benefits are uprated would change from April 2011 – from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI).

3.7 Following the clear rationale set out in the IPSPC's Interim Report, Spending Review 2010 set out that members' pension contributions, apart from the armed forces, would be increased by an average 3.2 percentage points[3] phased in over a three year period. The first phase commenced in April 2012; with years two and three to be implemented following further consultation.

3.8 Policy option 1 is to maintain and implement in full the changes outlined above.

Policy option 2 – create a legislative framework which will allow for the implementation of key recommendations from the final report of the IPSPC and the reforms set out in agreements reached with trades unions, member representatives and employer representatives

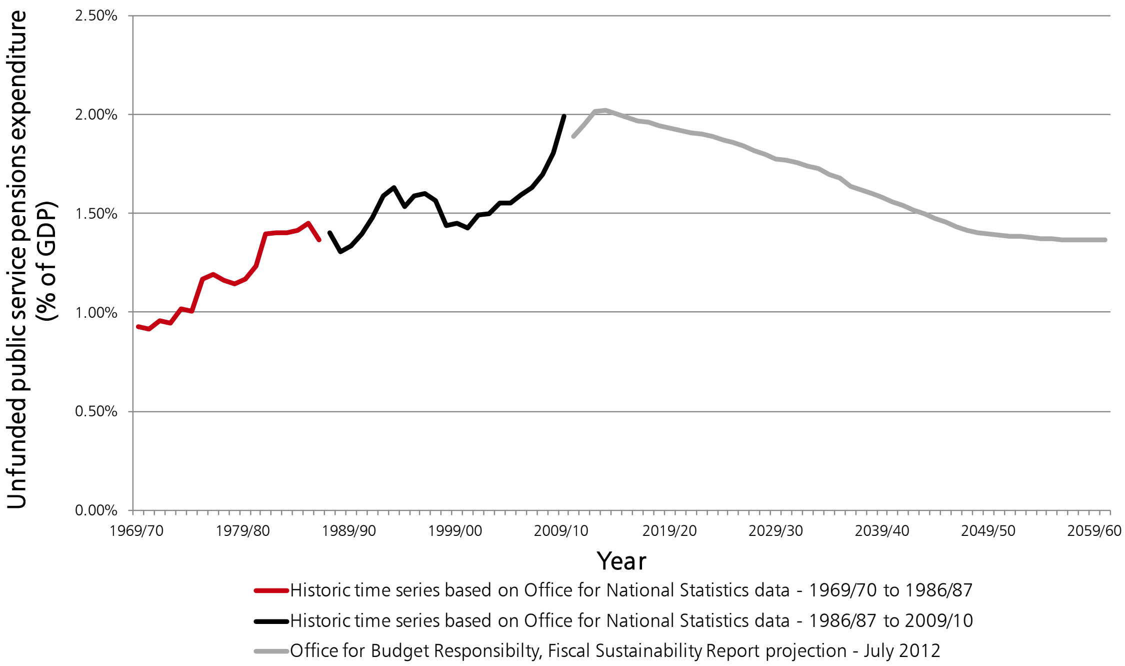
Discussion

3.9 The chart below, an extension of that in Chapter 2, shows the impacts of the reforms to date and that spending on public service pensions has begun to fall. However, despite recent reforms, costs are forecast to remain historically high[4].

[3] Spending Review 2010 cdn.hm-treasury.gov.uk/sr2010_completereport.pdf

[4] HM Treasury calculations based on ONS data and projections from the Office of Budget Responsibility's Fiscal Sustainability Report 2012

Chart 3.A: Historic and projected unfunded public service pensions expenditure as a proportion of Gross Domestic Product



The Commission

3.10 The Independent Public Service Pensions Commission's terms of reference were published in June 2010. The Commission's interim report set out the case for reform of public service pensions. It concluded that a fairer balance was needed between public service employees and other taxpayers, and between current and future generations. The interim report further set out the principles for long-term reform[5].

3.11 After extensive consultation and evidence-gathering, the Commission concluded that long term reform was necessary. The Commission's final report made several recommendations for fair and sustainable public service pensions. The key recommendations on scheme reform are discussed below; the Government took forward these recommendations as the basis for discussion with trades unions and member representatives. Discussions have taken place over more than a year to finalise scheme designs.

3.12 The Government also set out the following objectives for reform of public service pensions[6]:

- ensure a good level of retirement income for public service workers, with a reasonable degree of certainty;
- be affordable and sustainable – with cost risk managed and shared effectively;
- provide a fair balance of cost and benefits between public service workers and other taxpayers;

[5] IPSPC Interim Report (2010)

[6] Public Service Pensions: good pensions that last www.hm-treasury.gov.uk/d/pensions_publicservice_021111.pdf

- protect those closest to retirement;
- have a clear legal framework and governance structure – and be widely understood by workers; and
- stand the test of time – no more reform for at least 25 years.

3.13 Primary legislation is required to create the framework necessary to enable changes to public service pensions, in line with the Commission's recommendations and the Government's objectives for reform.

3.14 In particular the proposed Bill's aims are:

1. Enabling the creation of new, fairer, career average public service pension schemes to replace the largest existing final salary schemes.
2. Linking Normal Pension Ages to State Pension Age to manage longevity risk (with the exception of fire service, police and the armed forces).
3. Introducing an employer cost cap to ensure unforeseen changes in cost are controlled to protect the taxpayer.
4. Setting out requirements for scheme governance, regulation and administration to deliver transparency and accountability.
5. Allowing for the provision of transitional arrangements and protections where necessary.
6. Reforming public body and ministerial pension schemes and closing the Great Offices of State pension schemes.

Main recommendations on scheme design set out in the IPSPC final report

CARE design structure

3.15 The Commission identified seven distinct types of possible public service pension scheme and undertook risk analysis for each to produce a short-list of possible scheme designs:

Type of scheme	Who bears the salary risk?	Who bears the investment risk?	Who bears the post-retirement longevity risk?	Conclusion
Final salary	Government ✗	Government ✓	Government ✓	Rejected
CARE	Member ✓	Government ✓	Government ✓	Short-listed
Cash balance with guaranteed conversion terms	Member ✓	Government ✓	Government ✓	Short-listed
Cash balance with open market annuity	Member ✓	Government ✓	Government ✓	Short-listed
Individual defined contribution	Member ✓	Member ✗	Government ✓	Rejected
Notional defined contribution	Member ✓	Both ✗	Government ✓	Rejected
Collective defined contribution	Member ✓	Member ✗	Member ✗	Rejected
Key:	✗ Risk borne by wrong party		✓ Risk borne by correct party	

Source: IPSPC analysis

3.16 The short-listed options were a career average revalued earnings (CARE) design and a cash balance scheme. With a cash balance scheme structure, the pension pot at retirement is defined based on the proportion of salary set aside each year and the guaranteed rate of interest earned. The pot is converted to a pension on guaranteed terms that are set by the scheme at an agreed point before retirement. Once in payment, the amount of pension is guaranteed.

3.17 The Commission found that CARE and cash balance schemes can be set up to provide very similar benefits. The main difference between the two is that in a cash balance scheme, while the 'pension pot' at retirement is defined in the rules, the amount of pension this will buy does not have to be defined. In a CARE scheme it is the pension that is defined.

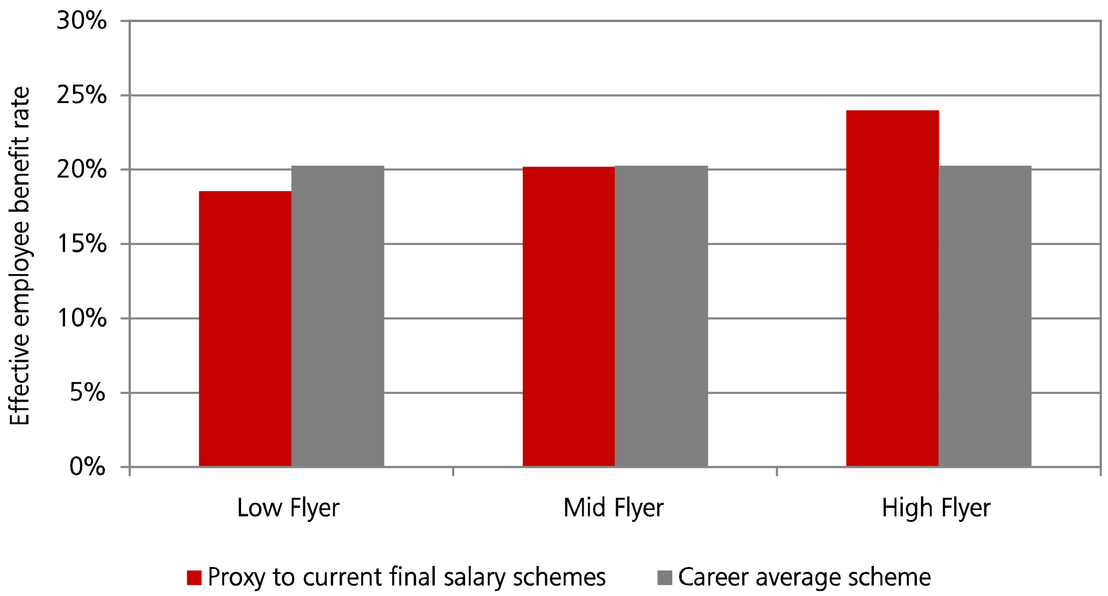
3.18 A cash balance scheme was found to provide additional flexibility for government, as it can vary the pension conversion factor (the factor which converts the cash pot to a pension amount) to reflect changes in the cost of providing pensions. However, the Commission said this flexibility would come at the cost of reduced certainty to members, as they may not be able to predict their pension in retirement.

3.19 The Commission concluded that scheme members should be provided with a good level of certainty when it comes to the amount of their pension and that the initial attraction of a cash balance approach (that it provides greater flexibility for government, which will increase affordability and sustainability) is outweighed by the need for certainty for scheme members (which will help ensure the adequacy principle is met)[7].

3.20 The Commission also found that a cash balance approach is harder for members to understand than a straightforward career average scheme. A CARE scheme design was found to have other benefits; for example the salary risk is borne by members, while the defined benefit arrangement provides a risk structure to the employer after retirement. A scheme design relating to average earnings over the whole of a member's public service career (rather than final salary) was found to be the fairest and most sustainable scheme design[8].

[7] IPSPC Final Report, page 58. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[8] IPSPC Final Report, page 58. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

Chart 3.B: The distributional impact of moving from final salary to CARE



Source: IPSPC analysis drawing on Pensions Policy Institute analysis.

3.21 Although high flyer members are likely to be relatively worse off under a CARE scheme structure, evidence submitted to the Commission suggested that higher earning individuals are better positioned than lower earners to bear some of the risks associated with pension provision, particularly investment risk. Due to their higher disposable incomes, higher earners have a greater capacity for self-provision of pension benefits than lower earners. It is also more likely that they will have additional forms of savings and investments that they can use to provide capital and income in retirement.

3.22 The Commission concluded that while a CARE structure would be the most effective scheme structure for employers in terms of managing cost risk, there is no in-built way of managing longevity risk pre-retirement. Therefore, it recommended that a CARE scheme structure is combined with a longevity risk-sharing mechanism to ensure the affordability, sustainability and fairness of public service pensions.

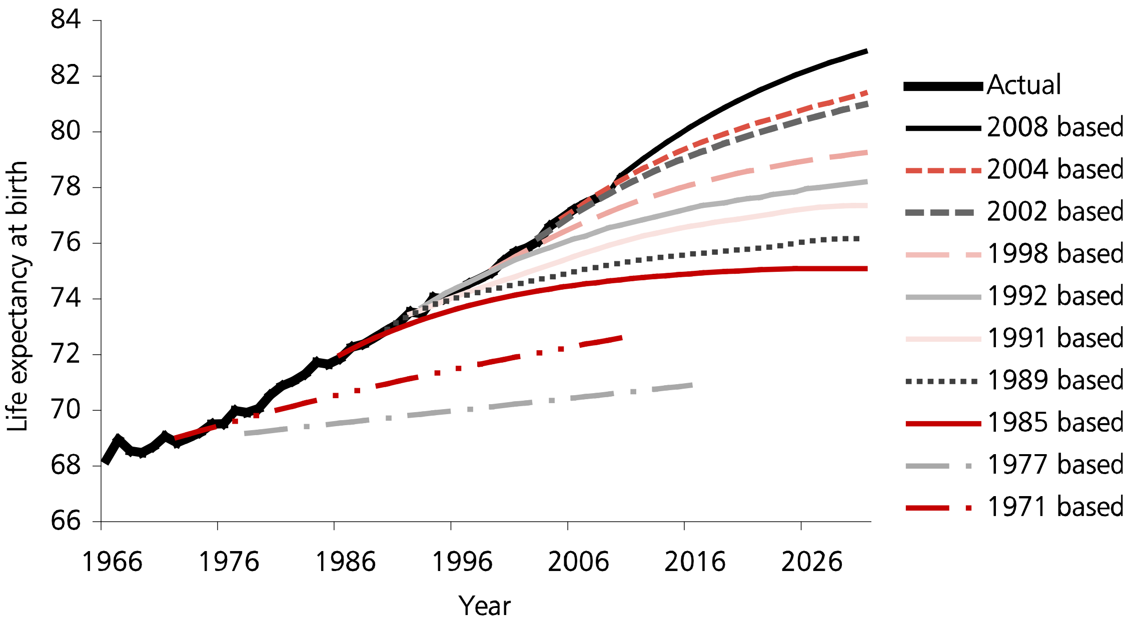
Linking Normal Pension Age with an individual's State Pension Age

3.23 It is generally assumed that longevity will continue to increase in the future, but there is significant uncertainty about the scale of any future changes.

3.24 The Commission found that increases in life expectancy have historically been recognised in future projections, but the rate of improvements has been consistently underestimated. The below chart highlights actual and projected period life expectancy at birth for UK males[9]:

[9] IPSPC Final Report, page 89. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

Chart 3.C: Actual and projected period life expectancy at birth for UK males



Source: IPSPC analysis drawing on C Shaw, 2007 and ONS 2008 population projections

3.25 It is not possible to be confident about what the longevity experience will be in the future. The Commission concluded that the most effective way to manage the longevity risk is to link members' Normal Pension Age (NPA), for most schemes, so that it is in line with their State Pension Age (SPA).

3.26 Members will be able to take an unreduced pension at their NPA, but there would be nothing to prevent them retiring earlier and taking an actuarially reduced pension. Likewise, people could continue to work beyond their NPA and may benefit from an enhanced pension as a result.

3.27 The Commission believed this approach should help to keep NPA within the public service pension schemes generally in line with developments in longevity, ensuring sustainability and managing risk to the taxpayer.

Controlling costs

3.28 Moving to CARE scheme structure from final salary will remove much of the cost risk associated with final salary pensions. Adjusting NPA in line with longevity increases through an automatic SPA link will also remove much of the risk of costs of future increases in longevity.

3.29 However, the Commission recommended that consideration should also be given to an overriding mechanism to ensure that public service pensions remain affordable and sustainable. It suggested a mechanism be introduced to act as a safety valve should costs within the new scheme increase due to factors not taken account of in the new scheme design.

3.30 The Government has accepted this recommendation and is proposing to introduce a fixed employer cost cap, i.e. the proportion of pensionable pay that the taxpayer will contribute to employees' pensions over the long term. A periodic assessment will be made of whether scheme costs have breached the cap. The cap will include a 'buffer' or floor and ceiling either side of the cap, so that if costs rise above the ceiling, member representatives would be consulted on how to reduce the costs and if no agreement could be reached a default mechanism would reduce them automatically. Similarly, if costs reduced below the floor scheme benefits could be improved or member contributions reduced.

3.31 This process and automatic mechanism will ensure that public service pensions remain affordable to the Exchequer and private employers with access to the schemes. It will mean that the costs are distributed more fairly between members, employers and taxpayers.

Accrued rights and Final Salary Link

3.32 The Commission also recommended that the Government must honour in full the pension promises that have been earned by scheme members (their accrued rights). It also said the final salary link for past service for current members should be maintained. The Government proposes to take these recommendations forward; the benefits already earned by public service workers will be protected. Current workers will earn benefits in the new schemes for future service, but can be assured that:

- they will be entitled to all they have already earned – their "accrued rights"; and
- in addition, for those in final salary schemes, the Government will calculate entitlement for pensions already earned using the final salary when the person retires or leaves the scheme, not their salary when the scheme closes.

Fair Deal

3.33 Although not a formal recommendation, the Commission also said there was a case for reviewing the Fair Deal policy[10]. The policy is a non-statutory code of practice that protects the pension provision of public service workers who have their employment compulsorily transferred out of the public sector. The transferring organisation is required to ensure that the pension provision for future service is broadly comparable after the transfer.

3.34 The Government established a review of the Fair Deal policy and decided to retain the principal of broad comparability; this will in future be met through access to the new public service schemes to transferring staff. By offering transferred staff the right to remain members of the public service scheme private, voluntary and social enterprise providers will no longer be required to take on the risks of their own defined benefit pension schemes. The new schemes will be more affordable than the cost of equivalent provision purchased in the market. This may increase competition for public service contracts for smaller organisations.

Governance and administration

3.35 The Commission identified a great variety of governance arrangements in the public service schemes. They flagged that the position contrasts with that of the trust based schemes in the private and public sector, which are required to have pension boards that are responsible for operation of the schemes. The Pensions Regulator in turn plays an active role in overseeing the operation of trust based schemes and ensuring their compliance with pensions legislation.

3.36 The Commission recognised that there are valid reasons for the different governance models, but considered that lessons can be learned from the trustee model. They recommended that every public service pension scheme (and individual Local Government Pension Scheme fund) should have a properly constituted, trained and competent pension board, with member nominees, responsible for meeting good standards of governance, including effective administration. The Commission also recommended that a framework should be established to ensure independent oversight of the governance, administration and data transparency of the public service pension schemes.

3.37 The Government accepted these recommendations. The Government's intention is that every public service scheme with two members or more will be required to establish a pension

[10] IPSPC Final Report, page 27. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

board to ensure that the schemes are managed and administered effectively and efficiently. The Pensions Regulator will be given a more active role in defining and regulating good standards of governance and administration in the public service pension schemes. Where the Pensions Regulator's existing powers relating to the administration and governance of pensions do not currently apply to the public schemes, they will be given equivalent powers.

3.38 We do not envisage that the cost of administering the schemes will increase as a result of these changes. Schemes should already be compliant with legislation and achieving good standards of administration. The changes are concerned with providing members and other taxpayers with assurance that those standards are being met across all schemes. There will be new costs for the Pensions Regulator's role, but we expect these to be insignificant compared to the other costs considered in this assessment.

Future policy

3.39 As set out above, the Government took forward the IPSPC's recommendations as the basis for discussion with schemes, trades unions, member representatives and employer representatives. Discussions have taken place for over a year to finalise scheme designs. The main objective is to provide fair and sustainable public service pension schemes under a common UK framework. Most scheme designs have now been finalised on the basis of the Commission's recommendations.

3.40 **Policy option 2 is to implement the key recommendations of the Commission, and the reforms set out in agreements reached with trades unions and employer representatives.**

3.41 The changes would affect all scheme members, except those within 10 years of retirement who will be protected from any changes. The Commission estimated that there are around 12 million members of public service pension schemes (including deferred and pensioner members and those who receive pensions as dependants of deceased members). There are around three hundred public service pension schemes, but more than 95 per cent of the members of these schemes are members of the six largest categories of scheme – local government, NHS, teachers, civil service, armed forces and police.

Policy options – costs and benefits

3.42 Present Value figures throughout this assessment have been rounded to the nearest £10 billion given the inherent uncertainty in forecasting pension expenditures.

3.43 A discount rate based on the Office for Budget Responsibility's (OBR) nominal GDP growth forecasts in their Fiscal Sustainability Report (FSR), to proxy the growth of the tax base from which unfunded pension liabilities are met, has been used to calculate net present values. This is consistent with the SCAPE discount rate used to set contribution rates for the unfunded public service pension schemes.

3.44 Average annual figures below have been expressed to the nearest £5 billion, as they are of a significantly smaller magnitude. These figures are a simple average of the annual costs over the forecast period, expressed in 2012 prices.

3.45 No sensitivity analysis has been undertaken, as the data used to monetise costs and benefits has largely taken from other sources.

3.46 Public service pension provision affects three main groups: the exchequer, scheme members, and employers. For each group there are costs and benefits as summarised in the following table.

Table 3.A: Summary of costs and benefits

	Costs	Benefits
Exchequer (on behalf of public)	Payment of pension benefits.	Services provided by public servants.
Scheme members	Pension contributions.	Accrual of pension benefits.
Employers	Pension contributions.	Labour inputs in return for total remuneration (including pension provision).

3.47 At any moment in time the costs and benefits in the table are distinct. However, there are elements of double counting since scheme members' contributions and employers' contributions (indirectly funded by the Exchequer) are used to offset the Exchequer payment of benefits to public service employers, and both also go towards scheme members' accrual of pension benefits. Furthermore, over time some of the costs and benefits transfer from one group to another. For example, the accrual of pension benefits (scheme member benefit) flows into the payment of pension benefits (Exchequer cost) when the member retires. This is an inherent feature of unfunded pension provision, which are transfer payments between groups and across time.

3.48 For these reasons, a cost-benefit analysis of public service pension provision which does not consider the complete lifespan of pension schemes can be misleading. Instead, the cost-benefit analysis for this Impact Assessment has been carried out on an Exchequer basis, isolating the effects on state finances and the services provided by public servants over the next 50 years.

Costs

3.49 As set out above, the main cost to the Exchequer of public service pension provision is the gross expenditure on providing pension benefits. Forecasts of expenditure for both policy options have been taken from the OBR's July 2012 Fiscal Sustainability Report.

Table 3.B: Monetised costs

Cost category	Policy option 1	Policy option 2
Costs of the payment of public service pensions falling to the Exchequer[11]	£1,300 billion present value terms. £55 billion as an annual average (2012 prices).	£1,240 billion in present value terms. £50 billion as an annual average (2012 prices).

3.50 Compared to policy option 1, option 2 gives a present value saving to the Exchequer of £65 billion[12]. This is due to the overall scheme designs providing benefits which are approximately 10 per cent less expensive in the long-term, although the cost impact does not fully flow through in the forecast period. These costs are only in respect of the unfunded public service pension schemes. They do not account for the funded Local Government Pension Scheme. Pensions in this scheme are met from the Local Authority Pension Funds, which receive employer and employee contributions and seek investment returns.

3.51 Under option 2 we expect there to be small additional costs to employers (indirectly funded by the Exchequer) due to changes to administration systems, but cannot assess this until the policy is developed further. They are therefore excluded from this analysis.

[11] Based on projections in the Office for Budget Responsibility's July 2012 Fiscal Sustainability Report. These extend to 2060, giving a 50 year period from 2012 over which to calculate a Present Value of costs.
[12] Apparent differences between this figure and that in the table are due to rounding.

Benefits

3.52 As set out above, the main benefits to the Exchequer of public service pension provision are services provided by public servants in return for total remuneration package (including pension provision)[13].

3.53 The IPSPC's interim report noted that in the last few decades pension provision in the public and private sectors has diverged, in response to pressures around longevity, changes in the business environment and investment risk. This has led to a sharp decrease in the provision of defined benefit schemes and an increase in the number of employees without any provision at all. Defined benefit pension provision by public sector employers remains, and would remain under policy option 2, near universal. By comparison, only 28 per cent of private sector employers offer a pension at all. Only 1 per cent of private sector employers offer an open defined benefit scheme.

3.54 On pay, the Commission observed that, while comparison can be difficult, "private sector pay does not seem to be systematically higher. If anything, public sector pay seems usually to be higher for employees with low or medium education". This was set out in Chart 6.B within the Commission's interim report[14]. The IFS also estimates an overall public sector pay premium of 8.3 per cent between 2009 and 2011.

3.55 On the basis of the evidence above, a more affordable and sustainable public service pension provision would, all else being equal, leave total remuneration in the public sector above market levels. Two of the Government objectives were to develop reforms that "are affordable and sustainable – with cost risk managed and shared effectively", and "provide a fair balance of cost and benefits between public service workers and other taxpayers". So although the benefits of public services provided by public service employees are non-monetised, we would not expect that they would be diminished under policy option 2.

Net present value

3.56 The costs to the Exchequer of both policy options are monetised, but the benefits to the Exchequer are not. It is therefore not possible to carry out a full cost-benefit analysis for either option.

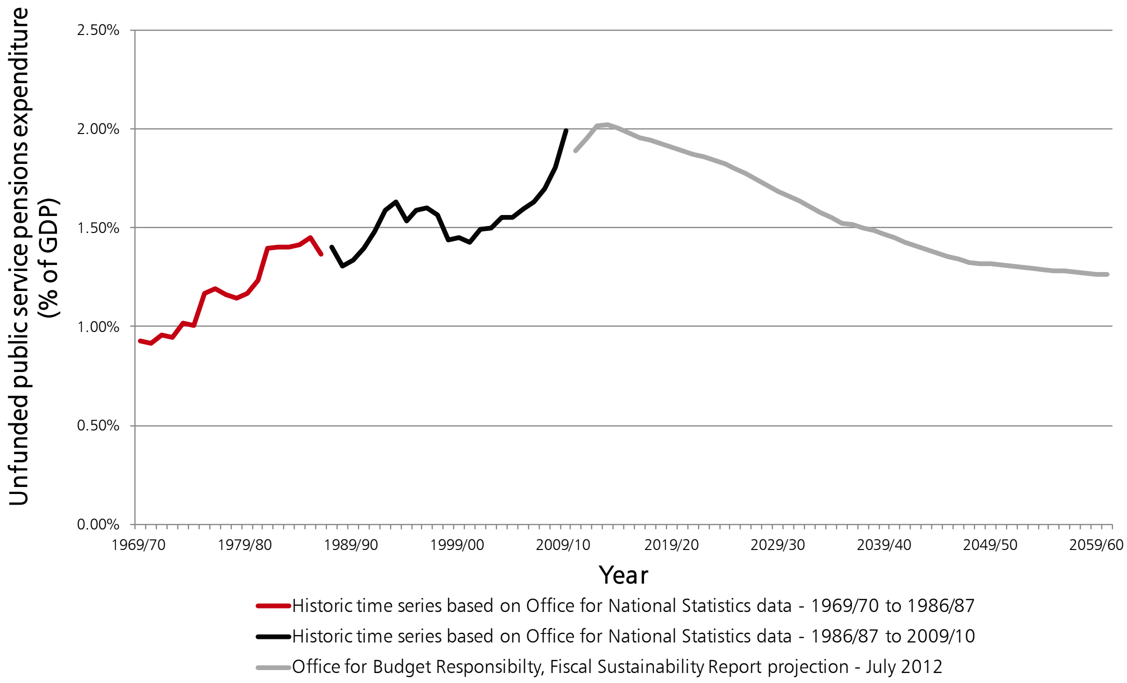
3.57 However, as we expect to see a present value saving to the exchequer of £65 billion under policy option 2 compared to policy option 1, but no effect on the services (benefits) provided, it is fair to surmise that policy option 2 would also provide a Net Present Value saving of £65 billion. The chart below shows the costs to the Exchequer falling as a percentage of GDP from 2 per cent of GDP in 2015-16 to 1.3 per cent in 2060-61. This is 0.1 per cent lower than without the reforms resulting from this Bill. These costs would continue to marginally fall thereafter, until steady state is reached around 2090.[15]

[13] There is a time delay between the arrival of costs and benefits to the Exchequer, since costs are incurred after pension members retire (and cease providing services). But given the longevity of public service pension provision, this time delay is deemed irrelevant to the cost-benefit analysis to the Exchequer.

[14] IPSPC Interim Report, page 107 http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

[15] HM Treasury calculations based on ONS data and projections from the Office of Budget Responsibility's Fiscal Sustainability Report 2012

Chart 3.D: Historic and projected unfunded public service pensions expenditure as a proportion of Gross Domestic Product



Other costs and benefits

3.58 Although they have not been included in the analysis above, the monetised costs and benefits to scheme members and employers are set out in the table below.

Table 3.C: Other costs and benefits

Cost category	Policy option 1	Policy option 2
Costs of pension contributions for public service pension scheme members[16]	£330 billion in present value terms. £15 billion as an annual average (2012 prices).	£330 billion in present value terms. £15 billion as an annual average (2012 prices).
Costs of pension contributions for public service pension scheme employers[17]	£650 billion in present value terms. £30 billion as an annual average (2012 prices).	£590 billion in present value terms. £25 billion as an annual average (2012 prices).
Pension benefit accruals for public service pension scheme members	£980 billion in present value terms. £45 billion as an annual average (2012 prices).	£920 billion in present value terms. £40 billion as an annual average (2012 prices).

3.59 For both policy options, benefit accruals for public service pension scheme members are assumed equal to the sum of scheme members' and employers' contributions.

[16] Based on projections in the Office for Budget Responsibility's July 2012 Fiscal Sustainability Report and extending to 2060. These projections assume member contribution increases of 3.2pp on average being implemented in full by 2014-15.
[17] Estimates by the Treasury, based on the average ratio of member: employer contributions across the schemes. These do not account for the periodic nature of valuations to set employers contribution rates.

3.60 Costs to scheme members are the same under each policy option because average employee contributions in each scheme are expected to be unaffected by the scheme reforms. So employees pay the same for their pension provision under both policy options.

3.61 Costs to employers are less under policy option 2. They give a present value saving of £60 billion, due to the overall scheme designs providing benefits which are approximately 10 per cent less expensive (thereby reducing the level of contributions employers need to make to provide for future pension promises)[18]. Unlike with the Exchequer costs of the payment of public service pensions, the savings here do flow through within the forecast period.

3.62 As a consequence of the relationship between contribution receipts and pension benefit accruals, pension benefit accruals for public service pension scheme members are reduced by £60 billion in present value terms under policy option 2 compared to policy option 1. Over time, this flows into the Exchequer cost savings on gross expenditure on providing pension benefits.

3.63 In summary, compared to policy option 1, policy option 2 would: lead to cost savings for the Exchequer due to the reduction in costs of scheme benefits; have no impact on the services provided by public servants in return for total remuneration package; have no impact on scheme members' contribution outgoings; lead to reduced benefit accruals for scheme members; and lead to cost savings for employers due to smaller contribution outgoings (which offset the smaller benefit accruals for employees).

Conclusion

3.64 On consideration of the reasoning set out above the Government has decided to take forward policy option 2.

One In One Out, the moratorium on new regulation for micro-businesses and sun-setting policy

3.65 These proposals are spending measures rather than regulation since they primarily affect public spending and the public service workforce. They are out of scope of One In One Out, the moratorium new regulation for micro-businesses and sun-setting policy. This has been discussed with the Better Regulation Executive.

3.66 A minority of members in some of the schemes work for private sector employers, mainly where delivery of specific public services has been contracted out to an independent provider. The Teachers' pension scheme also includes a large number of members employed by Independent Schools.

3.67 Provisions in the Bill will allow for access to the new public service pension schemes to be extended to include those members who have been transferred out of the public sector to independent providers, but continue to provide public services. Qualified teachers in qualifying independent schools will also retain access to the Teachers' Pension Scheme.

3.68 The costs and benefits to the employer and employees of the key changes legislated for in the Bill will apply to private sector providers participating in the schemes. Private or voluntary employers who choose to undertake public service delivery contracts will also be affected by the changes in the sense that those staff providing public services will have access to the public service scheme they were in when the contract was awarded. Those employers will no longer be required to provide a 'broadly comparable' pension scheme as part of the terms of the contract.

[18] These figures form a part of the projected 40 per cent reduction in net expenditure, and savings of £430 billion over the next 50 years, referenced in section 1.

3.69 We are currently unable to isolate the specific impact on private sector and voluntary organisations. However, we estimate that the proportion of the costs borne by (broadly defined) private sector employers could be around 15 per cent of the total, within a range of 10-20 per cent. Policy option 2 is expected to reduce the costs to employers generally. Therefore, implementing the Commission's recommendations should directly benefit these organisations and reduce the cost of future government contracts.

3.70 The actual number of private employers participating in the public service schemes varies; for example, the Civil Service, Police and Armed Forces schemes have no members working for private employers. The largest number of members working for private employers can be found in the Teachers', NHS and Local Government schemes. The largest group of members with access to a public service pension scheme who do not deliver public services are those working in independent schools.

Equalities

3.71 The major unfunded pension schemes have undertaken an equalities impact analysis of their respective new scheme designs. The Treasury has also considered the impacts of the common provisions that will apply across all public service pension schemes. The analysis will be made available alongside the Public Service Pensions Bill. Consideration of equalities impacts will continue to take place as the reforms move from policy development through to implementation, via secondary legislation.

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-909096-03-5