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Public Service Pensions:

good pensions that last

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Public Service Pensions: good pensions that last

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Foreword

People are living longer and that's good news. But it also means that we need to look afresh at what is affordable and sustainable for public service pensions. The cost of providing current pension benefits has been increasing, with the majority of this increase falling to the taxpayer. We need a long term solution that will last a generation: to do that it will need to be fair to public service workers and fair to other taxpayers.

That is why the Chancellor commissioned a review of public service pensions and asked Lord Hutton of Furness to chair the Independent Public Service Pensions Commission. Lord Hutton's report has been widely acknowledged as a landmark study. In March, the Government accepted his recommendations as the basis for consultation, with trades unions and other representative bodies. In taking forward this work, I have been keen that public service workers continue to receive good quality pensions. The Government recognises the valuable contributions of those who have committed their working lives to the delivery of vital public services.

In this paper the Government sets out its preferred scheme design. It is built on the foundations laid by Lord Hutton in his report. It offers guaranteed benefits on retirement, but on a fairer basis. High flyers would no longer be subsidised by their lower paid colleagues. It also recognises continued improvements in life expectancy, which has been and will continue to be a major driver in the cost of pensions. The Government expects scheme specific discussions to go forward based on this offer, but within this there is flexibility to consider workforce specific adjustments that might be necessary to deliver final designs by the end of this year.

I believe it is right that we protect those public service workers who, as of 1 April 2012, have ten years or less to their pension age. It is my objective that these people see no change in when they can retire, nor any decrease in the amount of pension they receive at their current Normal Pension Age. Scheme specific discussions will need to determine the fairest way of achieving this objective, taking full account of equalities impacts and legislation, while ensuring that costs to the taxpayer in each and every year do not exceed the Office for Budget Responsibility forecasts of public service pension costs.

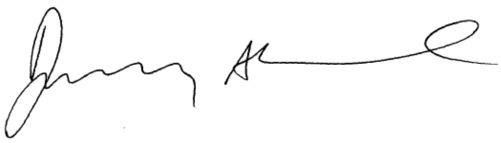
The Government is asking public service workers to retire later, at the same age as everyone else gets their State Pension. That is only fair in a society where we are all living longer and where fellow citizens in the private sector also expect to retire later. Nobody will be made to work longer, but pensions will be calculated on the assumption that people will work to their State Pension Age. Those retiring earlier or later will have a fair adjustment to the pension they receive. The Government is also asking public service workers to contribute more to their pensions than is currently the case. That is also fair if we are to reach a lasting solution.

But in return the Government will continue to offer public service workers a generous, fully index-linked defined benefit pension. The Government will continue to pay more towards public service pensions than the workforce. It is my intention to ensure that most low and middle earners working a full career will receive pension benefits at least as good, if not better than they get now.

The pension benefits that have already been earned are protected and for those currently in final salary schemes these benefits will be linked to their salary when they retire or leave the scheme.

Along with the Minister for the Cabinet Office, Francis Maude, I have engaged in central discussions with the trades unions. We have found common ground in our desire to ensure that public service workers continue to receive good pension provision that will ensure that a career in public service is rewarded with dignity in retirement. I have listened to the concerns expressed by the trades unions and the need for flexibility to meet workforce specific issues and have therefore increased the overall generosity of the preferred scheme design by revising the accrual rate.

I believe that the Government's offer is a generous deal, offering certainty and fairness to both the public service workers and other taxpayers. I consider this approach will stand the test of time, with no more reform for at least 25 years.



Danny Alexander, Chief Secretary to the Treasury

1 The case for reform

People are living longer, costs are increasing

1.1 People are living longer. This means the Government is paying public service pensions for much longer than expected when schemes were designed. As a result, those pensions have become much more expensive, with the bulk of this extra cost falling on the taxpayer. This increase in life expectancy is good news, but it is simply not affordable to spend more and more years in retirement. Some of the extra years must be spent working.

1.2 The Government has been clear from the start that there was a need to consider the long term affordability and sustainability of public service pensions. That is why the Chancellor invited Lord Hutton to chair the Independent Public Service Pensions Commission. Lord Hutton was asked to conduct a fundamental structural review and completed his work in March this year. His report provided invaluable analysis and evidence, making 27 recommendations.[1]

1.3 Lord Hutton set out the facts. The average 60 year old is living ten years longer now than they did in the 1970s. The cost of public service pensions paid out has risen by over a third over the last ten years to £32 billion a year. That is more than is spent on police, prisons and the courts combined. Most of this extra cost has been met by the taxpayer. [2]

1.4 Lord Hutton also found that 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. These costs have largely fallen on the taxpayer.[3]

Recent reforms are not enough

Cap and share

1.5 Between 2007 and 2008, the 'cap and share' reforms were introduced, capping the taxpayer contribution to the main public service pension schemes. These reforms proposed that any future increase in the cost of providing pension benefits, for example because people were living longer, would be met by the current members. This could be either through increased employee contributions or a reduction in benefits (for example an increase in normal pension ages). Cap and share was designed to prevent further increases in costs to taxpayers. But it did not address the already significant cost increases from past improvements in life expectancy. Nor did it specify how these savings would be made. It left public service workers without certainty about the contributions they would pay or the benefits they would receive in future.

1.6 However, no details of increases in contributions or increases in pension age were ever agreed. As Lord Hutton noted "cap and share cannot take account of the increases in cost of pensions over recent decades because people have been living longer. Also, untested, complex

[1] Independent Public Service Pensions Commission Final Report, 10 March 2010, pages 159-162, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[2] Independent Public Service Pensions Commission Interim Report, page 20, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm
[3] Independent Public Service Pensions Commission Interim Report, chart EX.3, page 11, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

cap and share arrangements cannot of themselves address the underlying issue of structural reforms, nor significantly reduce current costs to taxpayers".[4]

1.7 Under these cap and share arrangements, contribution increases in some schemes were anticipated to be required in 2012 and the Pre Budget Report 2009 showed £1billion of savings from April 2012[5] from employee contribution increases. The first year of the employee pension contribution increases[6] announced by the current Government at Spending Review 2010 will also take effect in April 2012. They will subsume the anticipated savings under cap and share and will deliver broadly the same level of savings. Further savings, reaching a total of £2.8 billion a year by 2014-15 will be introduced in subsequent years.

Change to indexation

1.8 This Government changed the policy on the indexation of a range of state benefits, tax credits and state pensions including public service pension schemes[7], from the Retail Prices Index to the Consumer Prices Index effective from April 2011. Public service pensions are primarily affected once they are paid out.

Public Service Schemes are not affordable

1.9 Reforms to date have been insufficient to reverse the increase in costs of public service schemes from rising longevity. Chart 1.A[8] shows the huge increases in the cost of public service pensions over the past 30 years, from less than 1 per cent of GDP in 1970 to nearly 2 per cent now. The chart shows that spending on public service pensions has *begun* to fall, as a result of all the reforms that have been implemented to date, including cap and share, higher pension ages for new entrants, and, more recently the change in indexation from RPI to CPI. This includes unspecified cuts to the value of pensions from cap and share, assumed in Pre-Budget Report 2009. However, even with all of these reforms, costs remain historically high. This is supported by the National Audit Office's analysis.[9]

[4] Independent Public Service Pensions Commission, Interim Report, 7 October 2010, box 2.A page 39 http://www.hm-treasury.gov.uk/d/hutton_pensions.htm.

[5] HM Treasury Pre Budget Report 2009, page 8 and 113, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm.

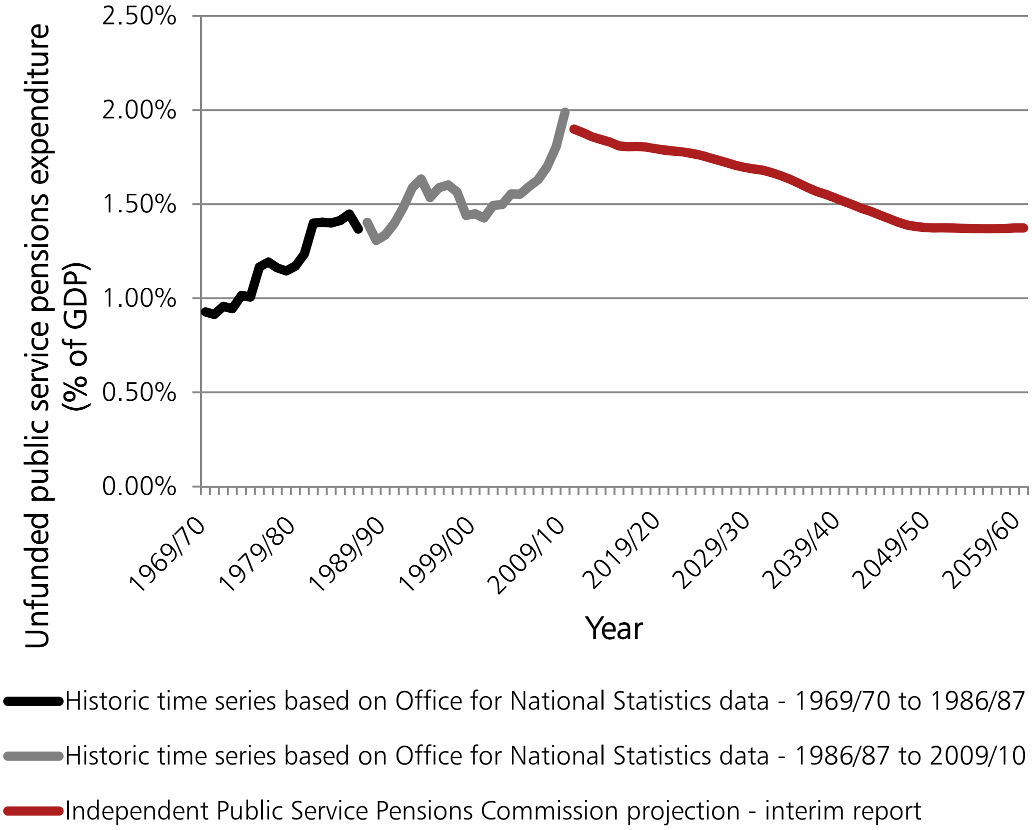
[6] Written Ministerial Statement by Chief Secretary to the Treasury 19 July 2011, Hansard, column 92 WS.

[7] The legislation on uprating links the increase from public service pensions to the increase in the additional state pension.

[8] Future cashflow projections were calculated by the Government Actuary's Department based on assumptions prescribed by the Office for Budget Responsibility. Pensions expenditure (1987/88- 2009/10) is published in the ONS Blue Book, table 6.1.4S. Pre-1987 pensions expenditure is based on ONS published data.

[9] The impact of the 2007-08 changes to public service pensions. December 2010, National Audit Office, http://www.nao.org.uk/publications/1011/public_service_pensions.aspx

Chart 1.A: Historic and projected unfunded public service pensions expenditure as a proportion of GDP



Source: HM Treasury

1.10 With rising costs in healthcare and other demands on taxpayers, this is not affordable.

1.11 The Government accepts Lord Hutton's view that the previous reforms set out above "have not fully addressed the underlying issues of sustainability and fairness. Although some existing members of some schemes have had increases in their pension ages, to reflect increasing longevity, most have not. Cap and share cannot take account of the increases in cost of pensions over recent decades because people have been living longer."[10]

The Government's objectives for reform

1.12 Lord Hutton's evidence and analysis shows there are three key drivers for significant reform:

- Longevity - People are living much longer. Current public service pension provision is no longer affordable because people are spending longer in retirement. This is the main risk to the sustainability of public service pensions.
- Flexibility - Pension provision no longer reflects the way the modern labour force lives and works.
- Fairness - The predominantly final salary scheme designs currently in place mean that lower-paid public service workers are subsidising the pensions of the highest paid.

[10] The Independent Public Service Pensions Commission Interim Report, 7 October 2010, Chapter 2, Box 2.A, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm.

1.13 The Government believes it is possible to chart a way ahead on public service pension reform that offers fairness and certainty for public service workers and other taxpayers alike. It is only by having a fundamental reform that delivers fairness that public service pensions will be sustainable for decades to come, giving public service workers the certainty they deserve. The Government has the following objectives:

- 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;
- aid the recruitment and retention of the right people in the right jobs;
- 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.

2 The Government's offer

What the Government is offering to public service workers

2.1 The Government accepts Lord Hutton's view 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."[1]

2.2 The Government believes that Lord Hutton's reports set out a clear and urgent case for change. Lord Hutton's work sets out the basis for a once in a generation opportunity to reform the system.

The Government's offer

2.3 The Government has engaged in open and constructive dialogue with the trades unions since February. These discussions are ongoing both centrally through the Trades Union Congress, and within each of the individual pension schemes covering different workforces.

2.4 The Government and the trades unions have already established the basis for agreement in July, including on:

- the importance of transparency, with proposals for the design of new schemes based on consistent assumptions and methodology and costed by the Government Actuary's Department (GAD);
- the importance of the Government ensuring that there is a full Equality Impact Assessment before changes are implemented;
- that any changes should be designed to minimise opt outs and maximise participation rates in schemes, including among low earners, young workers and part time workers; and,
- developing shared principles on best practice in scheme governance and administration.

2.5 Since July, the Government and the Trades Union Congress have continued to meet on a regular basis to discuss the reforms. Alongside this, there have been discussions at scheme level for each scheme. The Government has appreciated the constructive and considered way that both trades unions and employers have approached all of these discussions.

2.6 The Government is making a generous defined benefit pension offer to public service workers, that will ensure future generations of public service workers will continue to receive pensions among the very best available. The Government's offer is conditional on the trades unions and the Government reaching agreement on the reforms. If agreement has not been

[1] Independent Public Service Pensions Commission Final Report, page 3. http://www.hm-treasury.gov.uk/d/hutton_pensions.htm.

reached by the end of the year, the Government may need to revisit its current proposals. The Government's offer will deliver affordable, sustainable and fairer public service pensions. What is proposed compares favourably to the current pension provision that is offered by the private sector. Below is the offer in more detail:

- benefits already earned are protected;
- for those in final salary schemes, those past benefits will be linked to their final salary when they leave the scheme or retire;
- for those public service workers who, as of 1 April 2012, have ten years or less to their current pension age, the Government's objective is that they will see no change in when they can retire, nor any decrease in the amount of pension they receive at their current Normal Pension Age. Schemes and unions should now discuss the fairest way of achieving this objective, taking full account of equalities impacts and legislation, while ensuring that costs to the taxpayer in each and every year do not exceed the Office for Budget Responsibility forecasts for public service pensions;
- Government will continue to pay more overall toward pension benefits than the workforce;
- The Government's preferred scheme design will ensure:
    - guaranteed, index-linked pension benefits on retirement;
    - an accrual rate of 1/60ths and earnings indexation for benefits while still working in the public service;
    - fairer distribution of benefits across the workforce; and,
    - that most low and middle earners working a full career will receive pension benefits at least as good, if not better than they get now.
- People will not be forced to work longer. For those with 10 years or less to retirement on 1 April 2012 there is further protection set out above. For other public service workers there will also be a choice about when to retire with fair adjustments to the pension for those retiring earlier or later than the State Pension Age.

2.7 In return, the Government is asking public service workers to pay more towards their pensions[2] and work a bit longer, so that they can continue to receive pensions that are significantly more generous than their private sector equivalents.

2.8 The Government believes that its proposals are generous, fair and flexible:

- Generous. People working a full career in the new scheme would receive a pension on retirement worth around three-quarters of their average salary. This would be among the best pensions available from any employer. On top of that, they would get the Basic State Pension. Public service workers would have to contribute around a third of their salary to get the same pension benefits in an individual private pension plan. Table 2.A below shows the pension pots required to deliver equivalent benefits for a range of public service workers;
- Fair. The proposed Career Average scheme design means that no longer will high earners be subsidised by lower paid staff in final salary schemes. Lord Hutton found "Those who retire on a higher salary in a final salary pension scheme receive a

[2] At the Spending Review 2010, the Government announced an average 3.2 percentage point increase to employee contributions by 2014-15. The Government has since set out a preferred approach to protecting the lowest paid: no increase in employee contributions for those earning less than £15,000 and no more than a 1.5 percentage point increase in total by 2014-15 for those earning up to £21,000. High earners will pay more, but the Government has proposed capping the maximum increase at 6 percentage points (before tax relief) by 2014-15 (Hansard, Chief Secretary to the Treasury, 19 July 2011, column 92 WS.

significantly higher annual pension per £100 of employee contributions."[3] The offer is also fair to other taxpayers, recognising the need for everybody to spend longer in employment and controlling the costs and risks of public service pension provision; and,

- Flexible. The Government's offer recognises the changing pattern of working lives, removing barriers to labour market mobility created by final salary schemes. The offer also recognises the need for scheme specific discussions to have the flexibility to consider workforce specific issues.

Table 2.A: Pension pots needed to deliver equivalent benefits to proposed public service pension provision after a full career

		Preferred scheme design	**Pension pot required**
	Final Salary	Value of pension benefits from CARE with 1/60ths accrual	Equivalent Pension pot
Nurse	£34,200	£22,800	£600,000
Teacher	£37,800	£25,200	£675,000
Civil Servant	£29,800	£24,300	£650,000
Local Government Officer	£21,500	£17,500	£475,000
Health Assistant	£14,600	£11,900	£325,000

Comparing public and private sector reward packages

2.9 The Government's offer is among the very best available. In the private sector, at present only 34 per cent of workers are in an employer sponsored pension scheme at all[4]. This will change with the Government's introduction of workplace pension reform and NEST (National Employment Savings Trust) from October 2012. The Government expects that many employers introducing new schemes to meet their automatic enrolment duties will use defined contribution schemes. Under a defined benefit scheme the worker receives a pension calculated from their earnings, whereas within the defined contribution schemes the amount of pension depends on the level of contributions by the worker and employer and the performance of those funds. Defined contribution schemes can charge a fee, whereas public service workers pay no fees for their defined benefit pensions.

Pay

2.10 Direct pay comparisons between the public and private sector are not easy due to differences in roles and skills. But recent studies have estimated the difference, on average, between public and private sector pay, after controlling for the type and characteristics of employees. They have found that at a minimum, public service workers are not underpaid in relation to the private sector.

2.11 A study by the Office for National Statistics[5] found that in 2007 there was an average pay premium attached to working in the public service of 5.3 per cent. There are differences

[3] Independent Public Service Pensions Commission Final Report, March 2010, page 23, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm.

[4] ASHE 2010, http://www.ons.gov.uk/ons/rel/ashe/patters-of-pay/1997-2010-ashe-results/index.html.

[5] ONS release: July 2011 www.statistics.gov.uk/articles/.../public_private_sector_pay_july2011.pdf

between workforces, levels of skill and regions. During the recession, the private sector adjusted more speedily to the shock and the ONS estimate that the premium had widened to around 7.8 per cent in April 2010. The Institute for Fiscal Studies also recently calculated the public service pay premium in 2009 and 2010 at 5.2 per cent for men, 9.6 per cent for women – 7.5 per cent on average.[6]

2.12 Lord Hutton considered a number of studies and observed that: "private sector pay does not seem to be systematically higher. If anything, public service pay seems usually to be higher for employees with low or medium education".[7]

2.13 The public service reward package also includes elements such as leave entitlements, learning and development opportunities, and flexible working.

2.14 The Government's offer means that public service workers will continue to receive good quality pensions that are significantly more generous than many of their private sector equivalents. The Government wants to see the high levels of pension take up by public service workers continue.

[6] Institute for Fiscal Studies Green Budget , February 2011. http:// www.ifs.org.uk/publications/5460

[7] Independent Public Service Pensions Commission, Interim Report 10 March 2010, page 107, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

3 Future scheme design

Scheme-specific designs and cost ceilings

3.1 The Government is discussing these reforms with trades unions both centrally and at scheme level. The Government recognises that different designs may suit different workforces. As part of these discussions, the Government has set out its preferred design for the schemes. Further details are set out below.

3.2 To allow alternatives to this design to be considered while controlling overall taxpayer costs, the Government has set out "cost ceilings" for the four major public service schemes. This allows the trade unions to put forward alternative proposals and recognise the trade-offs that would be involved. Cost ceilings have been set as scheme-specific contribution rates expressed as a proportion of pensionable pay. They have been set sufficient to deliver the Government's preferred design, based on advice from the Government Actuary.

3.3 The Government provided initial cost ceilings at the beginning of October to inform scheme specific discussions on future provision. The Government has now revised these cost ceilings following further discussions with the TUC, taking account of the issues that have been raised and therefore reflecting the higher accrual rate of 1/60ths.This represents an eight per cent improvement in the Government's offer.

3.4 Table 3.A sets out the cost ceilings for the main public service pension schemes in England and Wales:

Table 3.A: Cost ceilings for scheme specific discussions

Pension Scheme	Gross cost ceiling	Taxpayers	Employees[1]
NHS Pension Scheme (England and Wales)	21.9%	12.1%	9.8%
Principal Civil Service Pension Scheme [2]	22.5%	16.9%	5.6%
Teachers Pension Scheme (England and Wales)	21.7%	12.1%	9.6%
Local Government Pension Scheme (England and Wales)[3]	20.4%	10.9%	9.5%

Source: HM Treasury following advice from the Government Actuary's Department

[1] Employee contributions are based on weighted average member contribution rates as at 2010. Net cost ceilings will be revised based on projected membership data, should this have a material impact on the comparison of a scheme design with the Government's preferred design.

[2] The Principal Civil Service Pension Scheme is for England, Wales, Scotland and home civil servants in Northern Ireland.

[3] Gross and net cost ceilings for the Local Government Pension Scheme are based on the proposal to increase member contributions by 3.0 percentage points on average by 2014-15. However, the Government launched a consultation on 7 October into the level of member contribution increase, entitled "*Consultation on proposed increases to employee contribution rates and change to scheme accrual rates, effective from 1 April 2012 in England and Wales*". If the outcome of the consultation is that member contribution increases are less than 3.0 percentage points, the cost ceilings will be amended appropriately.

3.5 These cost ceilings ensure that most low and middle earners working a full career will receive pension benefits at least as good, if not better than they get now. The Government will be contributing more overall than the workforce towards these pensions.

3.6 Final designs will also need to satisfy the Government that the taxpayer will be protected in the event that the cost of providing pensions increases. The Government believes that the only way to achieve this for the taxpayer is if the Normal Pension Age in scheme designs is linked to the State Pension Age. This link is essential to fairness: the Government is asking public service workers to work as long as everyone else. This link is also essential to sustainability: the flexibility which a link to the State Pension Age gives is what makes a defined benefit pension a viable offer for future generations.

Cost cap

3.7 Lord Hutton recommended a fixed cap on taxpayers' contributions to schemes as a proportion of pensionable pay. This would ensure public service pensions remain affordable and sustainable, in the event of an unexpected, significant increase in costs within the new schemes that has not been managed by scheme design. The employer contribution cap will operate following the introduction of new schemes. The cost cap is distinct from the cost ceiling. The cap will be an ongoing feature of the final schemes, to provide 'backstop' protection against unforeseen risks. The cost ceiling exists to facilitate decisions on the design of the schemes, ensuring that the total cost of different scheme designs remains the same. Further discussion of the design of the cost cap will need to take place in due course.

Current workforce – protection and choice

3.8 The Government has always been clear that it would protect the benefits that have already been earned by public service workers. 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";
- 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;
- for those with 10 years or less to their pension age on 1 April 2012, the Government's objective is that they will see no change in when they retire, nor any decrease in the amount of pension they receive at their current Normal Pension Age. Schemes specific discussions will determine the fairest way of achieving this objective, taking full account of the equalities impacts and legislation, while ensuring that costs to the taxpayer in each and every year do not exceed the Office for Budget Responsibility forecasts of public service pension costs, which do not take account of the further reforms set out in this document;
- other workers will also have a choice about the age at which they retire – they are not being forced to work to their State Pension Age. Current public service workers can draw the full pension benefits they have earned under their current pension scheme at their current Normal Pension Age. However, they may choose to work longer and earn more pension benefits under the new scheme;
- public service workers will continue to earn benefits in their current pension arrangements until the new schemes are introduced. The Government makes a significant contribution toward the cost of these pensions; and
- for those who have already retired, or have left the public service but not yet started drawing their pension ('pensioner' and 'deferred members' respectively), all rights to

future benefits, including those potentially payable on death, will be deemed to be accrued rights, including the age from which members are entitled to take pensions.

3.9 For the great majority of the workforce, opting out would make them worse off. Before taking such decisions people would be strongly advised to take independent financial advice.

Government's preferred design

3.10 Lord Hutton made 27 recommendations to the Government. Many of these referred to the design of the new schemes, including how costs should be controlled.

3.11 The Government has accepted all these recommendations as a basis for discussion. The Government has also gone further – and will ensure that most low and middle earners working a full career will receive pension benefits at least as good, if not better than they get now.

3.12 Based on Lord Hutton's recommendations and on discussions with trades unions so far, the Government has a strong preference for the design of the new schemes. The Government has set out in full its preferred design for new schemes (see Box 3.A below), which would provide public service workers with a high-quality pension in retirement.

Box 3.A: The Government's Preferred Design for New Pension Schemes

The Government's preferred design is built on the following for members of the NHS, civil service, teachers and local government pension schemes:

- a Career Average Revalued Earnings (CARE) pension scheme;
- Public service workers benefits to be earned at a rate of 1/60ths of pensionable earnings each year;
- Public service workers will have their benefits increased each year they are working in the public services in line with earnings revaluation;
- a Normal Pension Age linked to State Pension Age (or 65, whichever is higher);
- pensions in payment to increase in line with the Consumer Prices Index (CPI);
- benefits earned by leavers to increase by CPI from the date of leaving until retirement;
- average member contributions for the unfunded public service pension schemes set at the level of the existing schemes after the increase of 3.2 percentage points currently planned;
- in the funded Local Government Pension Scheme both member contributions and other adjustments to benefits will be reflected in cost ceilings following the outcome of the Department for Communities and Local Government's consultation on alternatives to contribution increases. This means that the cost ceilings presented here are indicative and not final;
- members given the option at retirement to convert £1 of annual pension into a £12 one-off lump sum payment in accordance with HMRC limits and regulations;
- ill-health, death and survivors benefits (ancillary benefits) to match those currently provided by schemes that are open to new members;
- members who leave the scheme and rejoin within 5 years to be able to link their new service with previous service, as if they had always been an active member;
- members transferring between public service schemes to be treated as having continuous active service (which would include those transferring between schemes who had rejoined public service after a gap of less than 5 years); and,
- an employer contribution cap to provide backstop protection to the taxpayer against unforeseen costs and risks.

What the cost ceiling delivers under the preferred scheme design for current public service workers

3.13 To illustrate the effects of introducing the Government's preferred scheme design, case studies are provided that demonstrate the effects on current public service workers and the choices they have open to them. Two are set out below. These fictional case studies are based on assumptions also set out in Annex A and follow career paths based on data from the Institute for Fiscal Studies[4] analysis of the Labour Force Survey. The final benefits available may vary, as these are subject to the ongoing scheme specific discussions. Those working a full career will also receive a full Basic State Pension – currently around £5,300 per annum.

[4] The salary progressions are based on an IFS paper by Disney, Emerson and Tetlow that used data from the Labour Force Survey (LFS) (1994 to 2006) to generate earnings profiles. For each example, final salary spine data (for the nurse and teacher) or best estimates of final salaries were calibrated against the end points of the LFS profiles to produce salary profiles

Box 3.B: Case studies on the effects on public service workers of a move to the Government's preferred scheme design

Case study 1 is a male civil servant working as an immigration officer and will have worked in the civil service for 18 years when the new scheme is introduced and will be 40 years old. He earns £22,000 a year.

Table 3.B: Options for current workforce: case study 1

Pension at 60, old scheme	Options to consider		
£9,100 p.a.	Retire at 67 – his State Pension Age	Retire at 61 years and 6 months	Leave pension scheme, buy private pension worth same
	£12,800 p.a.	£9,100 p.a.	Invest 35 per cent of pay p.a.

Case study 2 is a female primary school teacher and will have worked as a teacher for 23 years when the new scheme is introduced and will be 45 years old. She earns £32,000 a year.

Table 3.C: Options for current workforce: case study 2

Pension at 60, old scheme	Options to consider		
£15,200 p.a.	Retire at 67 – her State Pension Age	Retire at 62 years	Leave pension scheme, buy private pension worth the same
	£20,000 p.a.	£15,200 p.a.	Invest 38 per cent of pay p.a.

The figures shown above demonstrate the different value of the choices that employees will consider, and there will be other options between retiring at 60 or 67 not illustrated here. More details of these case studies and three others (nurse, high earning local government executive and low paid local government worker) are set out in Annex A.

Key Features of the Preferred Scheme Design

3.14 The key elements of the scheme design are described below. The Government's proposals deliver a generous level of benefits, as can be seen in the examples above and in Annex A.

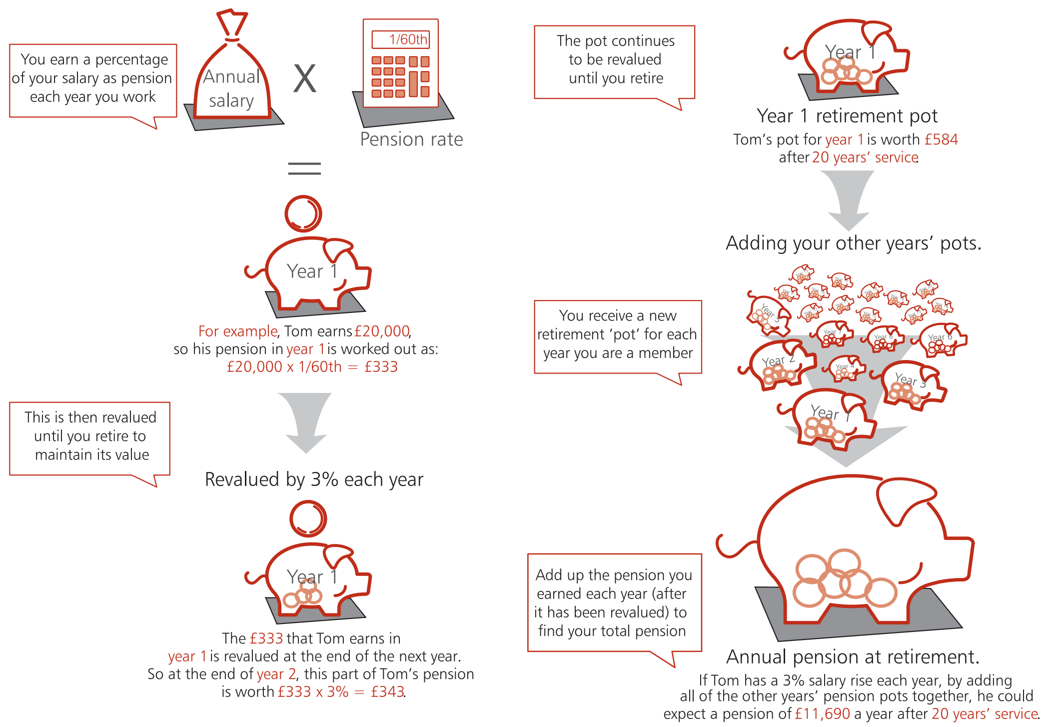
3.15 The features described below relate to the Government's preferred design. The changes will apply only to future pension earnings; benefits already earned are protected.

Pensions based on Career Average Revalued Earnings

3.16 The amount of pension that an employee earns for each year of service will be 1/60^{ths} of pensionable pay. This is reflected in the cost ceilings set for schemes.

3.17 Each year's pension amount will increase in line with earnings indexation during active membership of the pension scheme. The final pension will be worked out by adding each year's revalued pension amounts together. This is known as a Career Average Revalued Earnings (CARE) pension.

Box 3.C: How CARE works



The parameters used here are purely illustrative and are not recommendations. This diagram has been prepared by Hymans Robertson LLP.

3.18 Most current public service pension schemes are final salary schemes. Some, for example the Nuvos civil service scheme, are already 'career average'. Both final salary and CARE schemes offer a guaranteed defined pension at retirement.

3.19 In final salary schemes, public service workers who experience faster wage growth benefit disproportionately at the expense of the majority. Lord Hutton found that the median annual pension payout for an employee who retired on a salary in the highest fifth was almost 30 per cent higher than the pension payout for someone who retired on a salary in the lowest fifth. Larger benefits for high flyers, relative to their contributions, are an inherent feature of final salary pension schemes[5].

3.20 CARE schemes address this unfairness. They also remove the risk to the taxpayer of high salary increases at the end of a career, which can significantly increase the cost of pensions. A CARE scheme will offer fairer outcomes for women, who make up around two-thirds of public service workers and who typically experience lower salary growth than men[6].

Pension age linked to the individual's State Pension Age

3.21 Lord Hutton recommended that the Normal Pension Age be linked to the State Pension Age in order to manage the increasing cost of pensions as people live longer. The Government strongly believes that linking public service pension ages to the State Pension Age is fair for all.

[5] Independent Public Service Pensions Commission Final Report, 10 March 2011, page 10 and 23, http://treasury.gov.uk/d/hutton_pensions.htm

[6] Independent Public Service Pensions Commission Final Report, 10 March 2011, Chart 4.A page 88, Independent Public Service Pensions Commission Final Report, 10 March 2011, page 178, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

3.22 Scheme members will be able to retire earlier if they choose, but their pension will be lower if they do.

3.23 In addition to the transitional arrangements set out above, public service workers who are close to retirement will see little or no change, because the pension they have already earned will continue to be linked to their final salary on retirement. The impact of the later retirement age is relatively less for women as they have greater life expectancy than men. [7]

3.24 There are exceptions to this. Lord Hutton recommended that Normal Pension Age for police officers, firefighters and armed forces "should be set to reflect the unique characteristic of the work involved. The Government should therefore consider setting a new Normal Pension Age of 60"[8]. The Normal Pension Age for police officers will decided after Tom Winsor has published the part two report of his independent review of police officer and staff remuneration and conditions early in the New Year.

Variations from the Preferred Scheme Design

3.25 The Government has set out its preferred design for reformed pension schemes. However, discussions are ongoing. This preferred design does not therefore represent the final position. Individual workforces have different requirements from their pension scheme. Working within the cost ceiling, scheme level discussions are considering the preferred design for the new public service pension schemes. They will be able to make trade-offs between specific features of the scheme if they consider a different design to be more appropriate for their workforce. This could include:

- the choice of career average or final salary;
- the revaluation for active and deferred members;
- the rate at which members can commute pension benefits into a lump sum;
- the design of ancillary benefits, such as ill-health, death and survivor benefits;
- flexible retirement, caps and abatement; and,
- how schemes will manage cost risks.

3.26 In order to ensure costs and risks are managed the Treasury has set some parameters on variations from scheme design. Proposals must manage taxpayer risks. Cost ceilings alone cannot manage the risks that taxpayers are exposed to in defined benefit schemes. This is why Lord Hutton recommended that the Normal Pension Age should be linked to the State Pension Age. The Government continues strongly to believe that this is the right approach to managing the rising and uncertain costs of longevity. Since risk ultimately lies with the taxpayer, the Government requires that any approach that varies from this must be agreed with HM Treasury.

Reform across public service pension provision in the United Kingdom

3.27 The cost ceilings for four major public service pension schemes have been announced and work is ongoing to deliver final scheme designs by the end of this year[9]. The cost ceiling for the Firefighters' Pension Scheme in England will be set by the end of November, to allow further consideration of workforce assumptions with the relevant trades unions. This will not delay the

[7] Independent Public Service Pensions Commission Final Report, 10 March 2011, Chart 4.A page 88, Independent Public Service Pensions Commission Final Report, 10 March 2011, page 178, http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

[8] Independent Public Service Pensions Commission Final Report , 10 March 2011, page 14., http://www.hm-treasury.gov.uk/d/hutton_pensions.htm

[9] See footnote 2 above.

overall timetable for delivering the final scheme design. Cost ceilings for other schemes (police officers, armed forces and the judiciary) will be set within the first few months of 2012.

3.28 The Devolved Administrations are currently considering how best to approach the future reform agenda. The Government believes there are benefits to continuing with common provision across the United Kingdom.

3.29 Smaller public service schemes will be expected to adopt reforms that are consistent with those adopted by the larger schemes, as now and to the same timetable for implementation.

Conclusion

3.30 The Government's offer is generous and reasonable both to public service workers and other taxpayers. Public service pensions remain generous compared to the pensions that similar employees receive in the private sector. The Government's offer is conditional on the trades unions and the Government reaching agreement on the reforms. If agreement has not been reached by the end of the year, the Government may need to revisit its current proposals.

A Case Studies: what it means for public service workers

Case Study 1:

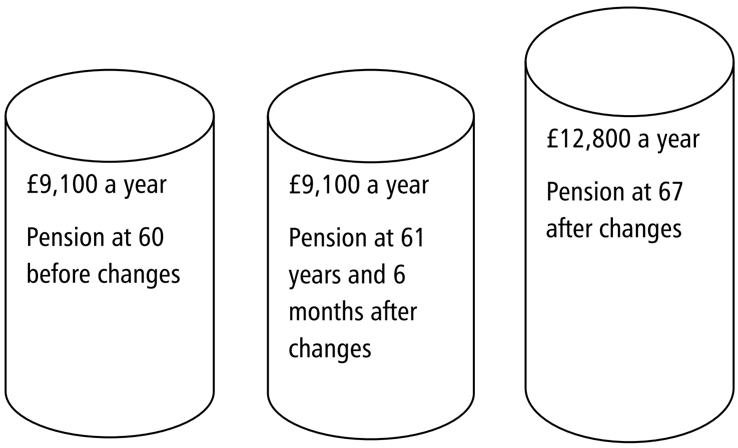
- 37 years old male (40 years old when the scheme changes)
- 18 years working in Civil Service when the scheme changes
- Member of the Civil Service Classic Scheme
- Earning £22,000 a year and pays 1.5 per cent towards pension

What do the pension reforms mean for this person?

- Protection: He has earned £3,900 annual pension so far. This includes the annual pension equivalent of his lump sum. All this is protected.
- No change: If the scheme didn't change he would get £9,100 a year when he retires at age 60

What options are available to this person?

- Work to 67: If he decided to work to 67 he could increase his pension to £12,800 a year. But working to this age is his choice.
- Keep expected pension amount: If he wanted to keep the pension amount expected before the scheme changed he would need to work to 61 years and 6 months.
- Leave: If he decided to leave the scheme now and buy himself a personal pension to match the amount he would have earned in the scheme between now and age 60 he would need to pay 35 per cent of his salary each year.



Case Study 2:

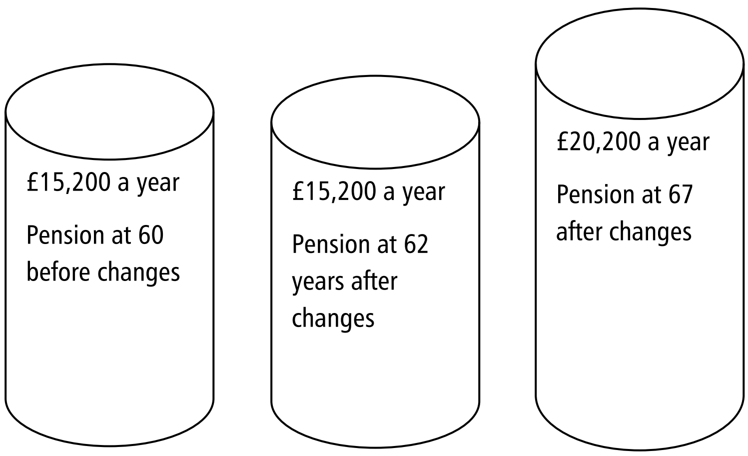
- 42 years old female (45 years old when the scheme changes)
- 23 years working as a primary school teacher when the scheme changes
- Member of the Teachers Pension Scheme
- Earning £32,000 a year and pays 6.4 per cent towards pension

What do the pension reforms mean for this person?

- Protection: She has earned £8,700 annual pension so far. This includes the annual pension equivalent of her lump sum. All this is protected.
- No change: If the scheme didn't change she would get £15,200 a year when she retires at age 60

What options are available to this person?

- Work to 67: If Jean decided to work to 67 she could increase her pension to £20,200 a year. But working to this age is her choice.
- Keep expected pension amount: If she wanted to keep the pension amount she was expecting before the scheme changed she would need to work to 62 years.
- Leave: If she decided to leave the scheme now and buy herself a personal pension to match the amount she would have earned in the scheme between now and age 60 she would need to pay 38 per cent of her salary each year.



Case Study 3:

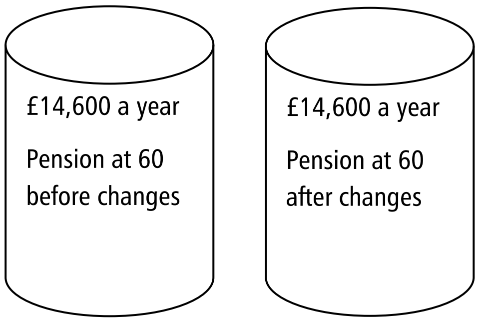
- 55 years old female (58 when the scheme changes)
- 36 years working full time in NHS as a nurse when the scheme changes
- Member of the NHS Pension Scheme 1995 Section
- Earning £30,000 a year and pays a 6.5 per cent of pay towards her pension

What do the pension reforms mean for this person?

- Protection: She has earned £13,700 annual pension so far. This includes the annual pension equivalent of her lump sum. All this is protected. In addition, as she is within 10 years of retirement on 1 April 2012, she benefits from the further transitional protection and she will see no change in when she can retire nor any decrease in the amount of pension she receives.
- No change: If the scheme didn't change she would get £14,600 a year when she retires at age 60

What options are available to this person?

- Keep expected pension amount: If she wanted to keep the pension amount she was expecting at age 60 before the scheme changed she would not need to work any longer to receive the same benefits under the transition arrangements that have been proposed. Scheme specific discussions will determine the final approach.
- Longer working life: If she wanted to work longer, this would be a matter for her and her employer. She would continue to earn pension benefits, up to the maximum allowed.
- Leave: If she decided to leave the scheme now and buy herself a personal pension to match the amount she would have earned in the scheme between now and age 60 she would need to pay 41 per cent of her salary each year.



Case Study 4:

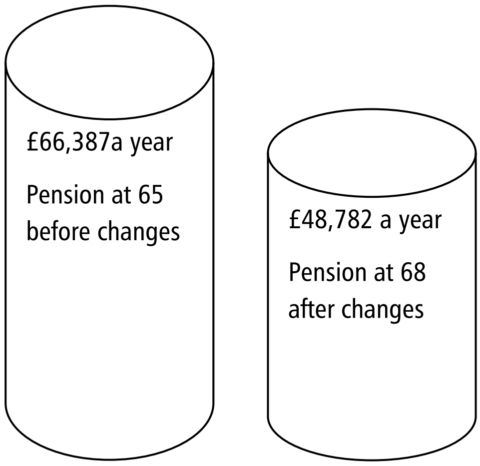
- 35 years old male, (38) years old when the scheme changes)
- 8 years working in Local Government when the scheme changes
- Member of the Local Government Pension Scheme
- Earning £30,000 but will earn £130,00 a year in today's money by the time he retires and pays 6.5 per cent contribution towards pension

What do the pension reforms mean for this person?

- Protection: John has earned **£10,373** annual pension so far. All this is protected.
- No change?: If the scheme didn't change John would get **£ 66,387** a year when he retires at age 60

What options are available to John?

- Work to 68: If John decided to work to 68 his pension would be **£48,782** a year. But working to this age is John's choice.
-
- Leave: If John decided to leave the scheme now and buy himself a personal pension to match the amount he would have earned in the scheme between now and age 60 he would need to pay 70 per cent of his salary each year.



Case Study 5:

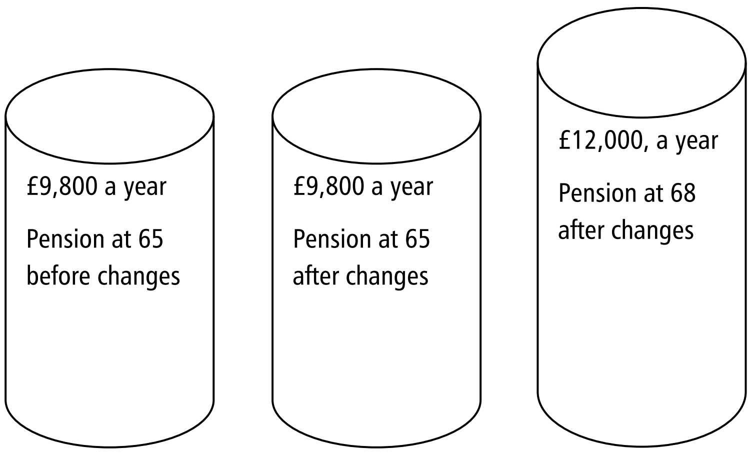
- 32 years old female (35 years old when the scheme changes)
- 13 years working in Local Government as an administrator when the scheme changes
- Member of the Local Government Pension Scheme
- Earning £20,000 a year and pays 6.5 per cent towards pension

What do the pension reforms mean for this person?

- Protection: She has earned **£2,300** annual pension so far. This includes the annual pension equivalent of her lump sum. All this is protected.
- No change?: If the scheme didn't change she would get **£9,800** a year when she retires at age 65
- Change: But with the proposed changes she will have 30 years service in the new scheme (2015 – 2045) so her pension would be **£9,900** a year instead if she retires at age 65.

What options are available to this person?

- Work to 68: If she decided to work to 68 she could increase her pension to **£12,000** a year. But working to this age is her choice.
- Keep expected pension amount: If she wanted to keep the pension amount she was expecting before the scheme changed she would not need to work any longer.
- Leave: If she decided to leave the scheme now and buy herself a personal pension to match the amount she would have earned in the scheme between now and age 65 she would need to pay 33 per cent of her salary each year.



Assumptions[1]

Pension amounts are discounted by salary inflation

Future pay increases - 4.25 per cent

All cases are assumed to be in the original relevant public service scheme and so have a pension based on an accrual rate of 1/80th and a cash sum of 3/80ths which has been converted to pension for comparative purposes or a pension of 1/60ths with no lump sum.

Accrual Salary used in each case study is at the commencement of the new scheme and not current salary.

Each case study has had a 3 year career break during their working life.

Employee contribution rates represent those currently being paid, but for those earning over £15,000 a year there will be an increase from 2012.

Career paths are based on IFS data[2]

CPI 2 per cent

Investment returns 5 per cent with no allowance for expenses

Public service schemes adopt the preferred scheme design (NPA = SPA, CARE, accrual rate of 1/60^{ths}).

DC pension contributions have been made over a full career from the current age

[1] These case studies have been prepared for HM Treasury by Hymans Robertson LLP using IFS data and Treasury assumptions.

[2] The salary progressions are based on an IFS paper by Disney, Emerson and Tetlow that used data from the Labour Force Survey (LFS) (1994 to 2006) to generate earnings profiles. For each example, final salary spine data (for the nurse and teacher) or best estimates of final salaries were calibrated against the end points of the LFS profiles to produce salary profiles.

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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
Fax: 020 7270 4861

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

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