



Exploding Public Sector Pensions Myths: A Briefing for Trade Union Members

Headlines about public sector pensions seem to have been appearing on a daily basis ever since the credit crunch started to bite. Attacks on pensions have been made by the Conservative Party, the Liberal Democrats and the CBI, alongside various newspaper and internet commentators.

These attacks say that public sector workers are unfairly rewarded and benefiting from “gold plated” pay and pensions. They rightly identify a growing gap between public and private sector pensions caused by the employer retreat from decent pensions in the private sector, but wrongly conclude that the answer is to level down public sector pensions. They say that public sector workers should “share the pain” and that public sector pensions should be cut to the level of the private sector. Unions defend public sector pensions but not as a special case. We want to see everyone at work able to look forward to a decent pension when they retire.

The Attacks

“My vision over time is to move increasingly towards defined-contribution rather than final-salary schemes” for employees in the public sector. “We have got to end the apartheid in pensions.” *David Cameron*

“Taxpayers who are struggling to build their own personal pension will be lumbered for decades by the cost of covering public sector workers who retire years earlier on risk-free pensions.” *CBI*

“It is unfair for businesses and families struggling in the downturn to pay higher taxes to fund pensions that they cannot afford for themselves or their employees.” *Institute of Directors*

Spending on public sector pensions is “completely out of control”. *Vince Cable, Treasury spokesman for the Liberal Democrats*

“Gold-plated public sector pensions...are unjust, unsustainable and unfair to ordinary people, many of whom have had to postpone their own retirement or seen their private pensions reduced to nothing.” *Taxpayers’ Alliance*¹

¹ The Taxpayers’ Alliance is a pressure group that campaigns against tax and public spending. Many of its staff and founders appear to be current or former Conservative Party members.



MYTHS AND FACTS

MYTH #1 The cost of public sector pensions is spiralling out of control.

REALITY Costs are set to increase somewhat (as are all pensions costs), but not by an unsustainable amount.

What are the Facts?

Many attacks on public sector pensions give a huge number for the cost of future liabilities. But they rarely explain what this means.

Public sector pension liabilities go a long way into the future. Young people at work today building up a public sector pension could well live for another eighty years. If you estimate the costs of all public sector pensions for decades into the future and then present it as a bill that has to be paid immediately, then it is hardly surprising that you end up with a frighteningly big number.

For example an organisation called the British North America Committee got headlines recently for saying that the cost of public sector pensions was 85% of GDP (the total wealth produced by the country each year). Their press release said:

"Public sector pension liabilities are £1,177 billion, about £20,000 for every person in the UK, equivalent to 85% of GDP"

But these figures do not mean very much. This is just another attempt to work out the total cost of public sector pensions going for decades into the future and expressing it as if it all had to be paid in one go, rather than over the decades the pensions are in payment.

This is what David Lipsey, the chairman of Straight Statistics – a pressure group that campaigns against the misuse of statistics – said about this report:

"The innocent might think that this means 85 per cent of our GDP in future is going to go to support those getting public sector pensions, leaving just 15 per cent for the rest of us. This is plain rubbish."

"The liability to pay public sector pensions is stretched over many, many years – from now until the last existing public sector employee dies. It is a statistical howler that would make an "O" level student blush to compare this with the figure for GDP for a single year. To make matters worse, we can safely expect GDP to increase over the years to come (if it does not, neither will pensions, reducing the actual liability). So the proportion of present GDP represented by the liabilities is even less relevant. What matters, if anything, is the proportion of future GDP that they represent."



The Treasury does indeed produce estimates of the cost of paying public sector pensions as a proportion of GDP (not taking into account contributions). They show an increase from 1.5% of GDP to 2% by 2027-28. After this projections show a slight decline in the proportion of GDP taken up by public sector pensions. It is not surprising that there is some cost increase in the next few decades as we live in an ageing society. Either the cost of pensions will increase or many more pensioners will live in poverty. But public sector pensions take up a much smaller share of GDP than state pensions and long term care – also both set to increase in the face of longer lives.

The second claim made is that the cost of public service pensions is “out of control”. This is not the case. Not only is the share of public sector pensions in the country’s wealth less than 2% of GDP every year in the Treasury’s projections, the changes negotiated in many unfunded schemes caps employer costs with employees picking up the bill if people live longer than expected and pension costs rise more than expected.

Another way of looking at the cost of pensions is known as the “net public service pensions” net public service pension cost. It is the difference between benefits paid out to today’s pensioners from unfunded schemes and current contributions paid by current staff. In the current financial year this is estimated to be £4.1 billion or about 0.3% of GDP.

This is eminently affordable, but the figure can change a lot from year to year. This is not because of bad planning or anything being “out of control” – simply because it is the difference between two much bigger numbers that are not linked to each in the short term. These big numbers are:

- the costs of pensions paid out each year – and pension levels are linked to the cost of living; and
- the total contributions paid by staff and employers in the public sector, which is linked to the numbers of staff and the year’s pay settlement.

Over time earnings tend to go up more than prices so this will tend to reduce the net cost of pensions. But there can be sharp variations from year to year – particularly as pay in the public sector is often held back by politicians and then catches up once the damage done to recruitment and retention needs to be mended.

In 2009/10, for example, the increase in the cost of benefits will be determined largely by the 5% increase in the cost of living (RPI) in September 2008. But the increase in contribution income will be determined largely by the size of pay increases in the public sector during 2009/10. So when politicians freeze or hold public sector pay below inflation it has the odd effect of appearing to make pensions more expensive, even though those extra costs are more than met by reduced expenditure on the wider wage bill.

Of course other factors will also affect the cost of pensions. For example, how many people retire each year and how long pensioners live will affect the cost of pensions and the number of current staff and what grades they are on will determine the income figures. But these change relatively slowly over time and don’t produce the big changes between years that critics seize on.



Pension Reforms

The Government and trade unions have negotiated various reforms to public sector schemes in recent years. The reforms were made mostly in response to higher demands from increased life expectancy, with schemes now sharing the risk of members living longer.

Most public sector pension schemes have increased the normal pension age from 60 to 65 for new entrants, in line with most private sector schemes. Only the armed forces, police and fire schemes have kept theirs below 65, reflecting the physical demands of these jobs.

Nurses, teachers and local government employees are now paying more on average towards their pensions than before the reforms. This agreement resulted in an initial increase in member contributions of 0.5% on average with possible further rises when valuations take place every 3 or 4 years.

New cost-sharing arrangements were put in place that mean that if higher pension benefits are paid or if life expectancy continues to rise more quickly than expected, the resulting cost will fall mainly on public sector scheme members rather than on the taxpayer.

The Pension Policy Institute² has estimated the reforms have reduced the immediate cost of benefits by 12.5% and the Government expects the reforms to result in savings of around £13bn on the NHS, teachers' and civil service schemes, spread over a 50-year period.

MYTH #2. Savings could be made by replacing final salary (defined benefits) schemes by a defined contribution scheme

REALITY. Scrapping defined benefit pensions would mean increased public spending on public sector pensions in the short and medium term

What are the Facts?

David Cameron has proposed replacing defined benefit schemes with defined contribution schemes in order to save costs. In defined contribution (DC) schemes (also known as money purchase schemes) the pension payment depends on the value of the investment in the individual's pension pot upon retirement. Most public sector pensions are final salary schemes (also known as defined benefits schemes) which guarantee a pension based on the number of years worked for the organisation and the final salary upon leaving.

If new or existing staff were switched to DC schemes, then spending on pensions would increase. This is because most of the cost of paying pensions at any time is covered by using the contributions paid by or on behalf of current employees. If those contributions are instead paid into members' own DC pots then they could not be used to pay for the pensions of already retired public employees.

In other words tax payers would be paying at the same time for the pensions of those who have already retired and to build up funds to pay pensions in the future for staff currently working – a double whammy.

If the quality of public sector pensions is substantially reduced this could also lead to many retired public employees becoming reliant on means tested benefits. This is because many public sector employees are low paid workers, already on quite low pensions. Increased spending on means test benefits would offset some of any saving on pension contributions in the longer term.

² Pension Policy Institute (2008) An assessment of the Government's reforms to public sector pensions



Public Sector Pensions – Definitions

Defined Benefit and Defined Contribution Schemes

A **Defined Benefit (DB)** scheme (also known as a Final Salary scheme) offers a defined or predetermined level of pension benefit. The benefits are expressed as a fraction of the final salary for every complete year worked for the organisation or as a scheme member of the final salary pension.

In a **Defined Contribution (DC)** scheme (also known as a Money Purchase Scheme), a pension fund is built up using employee and employer contributions. The pension available at retirement depends on the level of contribution paid, investment returns earned over time and the cost of purchasing the pension at retirement. These things are not known in advance. Therefore the pension it produces cannot be known. The contribution is defined, but not the pension.

Public Sector Pensions – Definitions

Funded and Unfunded Schemes

The terms funded and unfunded do not relate in any way to the contributions made by employees. Public sector scheme members contribute between 3.5% and 11% of their salary annually to their own pensions.

The Local Government Pension Scheme and the Universities Superannuation Scheme are 'funded' schemes, in which the funds required to pay future pensions are built up over time. This separate fund allows resources to be planned and managed over time to meet pension liabilities, as occurs with private sector DB schemes. There are around 4.25 million active, deferred and pensioner members of public sector funded schemes

Other public sector schemes such as those for civil servants, health workers, teachers, firefighters and uniformed police officers are 'unfunded.' Current pensions for staff are paid directly from central government's current revenue (made up of contributions paid by civil servants, teachers, fire fighters and uniformed police officers in employment, and their employers). There are over 5.5 million active, deferred and pensioner members of unfunded schemes.

The significance of the difference between funded and unfunded schemes is often misunderstood or misinterpreted. Contributions are calculated and paid in unfunded schemes in much the same way as in funded schemes. The main difference between the two is that while unfunded schemes, in effect, lend contributions directly to the Government and receive a designated rate of interest in return, funded schemes keep control of their contributions and invest them in a range of assets.

When benefits are paid by the unfunded schemes, it is portrayed as public expenditure. In reality it is largely repayment by the Government to schemes of the invested contributions with the money being passed on as benefits to scheme members. Deficits (and surpluses) are identified at scheme valuations in both funded and unfunded schemes and addressed in the same way by adjustment of contributions and/or benefits.



MYTH # 3. The discrepancy between private and public sector pensions needs to be tackled by punishing the public sector

REALITY. We should level up pensions – not level them down

What are the Facts?

Many justify attacks on public sector pensions by the decline in the number and quality of private sector defined benefit pension schemes.

Around 85% of public sector employees are members of an employer-sponsored pension scheme, most of whom have a Defined Benefit scheme. However, in the private sector 40% of employees are members of an employer-sponsored pension scheme but only 15% of employees are active members of a Defined Benefit scheme.

Private sector employees have been hit hard by the employer retreat from good pensions. But this does not justify punishing public sector workers. Two wrongs do not make a right.

Public sector pensions support lower-paid members of the workforce. Well-paid private sector employees are likely to get a decent pension on top of their pay. The real difference between public and private sectors is among the low and average paid. The attack on public sector pensions may be wrapped up in rhetoric about fat-cat public servants, but it is really an attack on the low paid in the public sector. Only 20% of private sector employees who earn between £100 and £200 a week are members of an employer-sponsored pension scheme whereas 70% of public sector employees in the same pay range are pension scheme members.

The recent economic turmoil has had a huge impact on private sector DB and DC schemes. Savers in DC schemes have seen the value of pension pots plummet, while the private employer sponsors of DB schemes now have to make up the deficits. Unfunded public sector schemes have not been hit by market turbulence. Tax payers have not suddenly had to find funds to make up scheme deficits, and government can plan for the future funding of public sector pensions.

Private sector schemes need to be funded because there can be no guarantee that the sponsoring employer will still be around when staff retire. Public sector employers, ie the state, will exist in perpetuity and, as in other countries such as the USA, we tend to have unfunded pensions for central government functions such as health and the armed forces but funded schemes in local government.

To protect future pensions, private sector schemes (and funded public sector schemes) are regulated to ensure they have sufficient funds to meet their future commitments. But this tends to be on a cautious basis and deal with stock market volatility thus pushing up private sector pension costs. Funded public sector schemes can plot a more stable long term course. All schemes have to deal with issues such as increased life expectancy. The public sector has done this with the cost-sharing agreements backed up with a ceiling on employer costs described above.

As public sector schemes operate on a sustainable basis and employer contributions are capped, there is no financial justification to reduce benefit levels simply because employers have savaged private sector schemes.



Just how generous are public sector pensions?

Five million employees working in the public sector qualify for pensions, including 1.3m in NHS, 1.6m in local government, 600,000 teachers, 600,000 civil servants, 200,000 in the armed forces, 150,000 police officers and 50,000 firefighters.

The mean average public sector pension is £7,000 but the majority of public sector pensioners have pensions of less than £5,000.

The value of the main schemes in the public sector for new entrants are similar to a medium private sector final salary, at around 21% to 24% of salary on average.

MYTH # 4. Most public sector workers retire at 60 on two thirds of their final salary

REALITY: The majority of workers joining public sector pension schemes will retire and claim their pension at the age of 65.

What are the Facts?

Many reports about pensions would lead you to believe that most public sector workers retire at the age of 60 on two-thirds salary, but in fact this only applies to the very few people who work in public service for forty years or more. The pension age for many public sector workers has always been 65 and this now applies to most new joiners.

The average pension in Local Government is around just £4,000 per year, and just £2,000 for women while in the Civil Service the average is £6,500. The average pension for a female NHS worker is £5,000 but the median pension for women is much less. In fact half of all women pensioners who have worked in the NHS get a pension of less than £3,500 per year.

MYTH #5. It is unfair that public sector workers benefit from “gold plated” pensions

REALITY. The private sector is the real culprit for unfairness

What are the Facts?

The real inequality exists in the private sector, where highly paid executives receive the real gold-plated pensions. The TUC's 2008 Pensions Watch study of 346 directors from 102 of the UK's top companies found that they are set to earn a yearly pension of £201,700³. This is 25 times the average workplace pension that ordinary workers receive (£8,100). The study also revealed that the most senior directors of these firms had average pension funds of £5.2m, with an annual pension forecast of £333,400. In reality, most directors of the UK's largest private sector companies can look forward to retiring on a full pension at age 60, accrued on generous terms in a final salary scheme.

³ www.tuc.org.uk/extras/pensionswatch2008.pdf



Myth # 6. The Private Sector props up the Public Sector

REALITY. The UK economy depends on a thriving public sector as well as private sector

What are the Facts?

It is not a one-way street, but a complex relationship. Public sector workers and employers pay for the vast majority of pensions in payment through contributions. But without an effective public sector, the private sector would be far less productive. It directly benefits from the public sector through transport and information infrastructure and an educated workforce, whose social, health and welfare needs are attended to by the public sector. Third, it is also true that all workers pay for everyone's retirement income in one way or another. Private sector pensions are paid for through the price of goods and services, much like tax levels include the cost of public sector pension provision.

In short, the private sector could not function without the public sector and vice versa. The public sector contributes significantly to GDP and it is entirely unfair to suggest that the public sector is any way a drain on the private sector.

Public sector pension schemes also play an important economic role in other ways. For example, funded public pension funds provide billions of pounds worth of investment in the UK economy. Pensions are also an important element of the remuneration package and an essential recruitment and retention tool to attract people to deliver our vital public services. In addition, they play an important role in ensuring individuals have a reasonable income in retirement. They are an effective way of encouraging saving for retirement among a large part of the workforce, at a time of great turbulence and uncertainty.

Conclusion

The recent attacks on public sector pensions have used the economic crisis as excuse to attack pensions. The key issue about pensions should be ensuring every worker has access to a decent pension scheme; about levelling up not down. Public sector pension schemes are good quality and this should be applauded. The UK need good pensions for all, not lower pensions and poverty in old age for all. Society depends on public services, delivered by public servants who deserve decent pay and pensions.