National Audit Office

Public service pensions

HM Treasury

REPORT

by the Comptroller and Auditor General

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Key facts

£33.5bn

total benefits paid (ongoing payments and lump sums) to pensioners by the four largest pay-as-you-go schemes in 2019-20

2.0%

projected gross pension benefit expenditure across all public service pension schemes, as a percentage of GDP in 2019-20

£10,000

average annual pension paid by the four largest pay-as-you-go schemes in 2019-20

£25.4 billion	total taxpayer funding in 2019-20 of the four largest pay-as-you-go schemes, including employer contributions and a balancing payment from HM Treasury
£8.2 billion	total employee contributions in 2019-20 into the four largest pay-as-you-go schemes
105%	real-terms increase in total benefits paid annually over the past 20 years across the four largest pay-as-you-go schemes (the armed forces, civil service, NHS and teachers' pension schemes)
69%	increase in the number of pensioners across the four largest pay-as-you-go schemes over the past 20 years to 2.8 million
16%	real-terms increase over the past 20 years in the average annual pension paid (excluding lump sum payments) by the four largest pay-as-you-go schemes
1.5%	projected gross pension benefit expenditure across all public service pension schemes, as a percentage of GDP from 2064-65 (HM Treasury's measure of affordability)

Summary

Background

1 As an employer, the government provides public service employees with access to occupational pension schemes. As at 31 March 2020, there were more than 8 million members of four of the largest public service pension schemes (the armed forces, civil service, NHS and teachers' pension schemes), of which 2.8 million were retired and receiving pension benefits and 5.2 million were either current or former employees. Around 25% of pensioners and 16% of the working-age population are members of a public service pension scheme.

2 Most public service pension schemes operate on a pay-as-you-go (or 'unfunded') basis with payroll contributions from current employees and their employers, and additional funding from HM Treasury, used to pay pension benefits to those members already in retirement. Funded schemes (such as the Local Government Pension Scheme), by contrast, use employer and employee contributions to create investment assets in a pension fund, with those assets and associated returns used to pay for future pensions.

3 In general, public service pensions have become more expensive over time as the number of people receiving them has increased, owing to more members entering retirement and living longer. This trend applies across public and private pensions and is consistent with international experience. HM Treasury, the government department responsible for policy in relation to public service pensions, is concerned about increasing costs and affordability, in the context of other demands on public finances.

4 In 2010 the government established the Independent Public Service Pensions Commission, chaired by Lord Hutton (the Hutton Review) to undertake a fundamental structural review of public service pensions. We have previously reported on the rising costs of public service pensions. In 2010 we published two reports, covering (i) the current and future costs of public service pension schemes, and (ii) the impact of changes to the government's schemes in 2007-08.[1] In 2016, we published a report looking at public service pensions in the context of the government's balance sheet.[2]

1 Comptroller and Auditor General, *The cost of public service pensions*, Session 2009-10, HC 432, National Audit Office, March 2010. Comptroller and Auditor General, *The impact of the 2007-08 changes to public service pensions*, Session 2010-11, HC 662, National Audit Office, December 2009.
2 Comptroller and Auditor General, *Evaluating the government balance sheet: pensions*, Session 2016-17, HC 238, National Audit Office, June 2016.

5 Following the Hutton Review final report in March 2011, and a period of negotiations with trade unions representing public service employees, the government introduced reforms intended to manage the future costs of providing pensions. The government's objectives for pensions reform were 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 costs 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
- that reforms stand the test of time, with no more reform for at least 25 years.

Prior to 2012, the government had a further stated objective for public service pensions: "to aid the recruitment and retention of the right people in the right jobs". HM Treasury also intends that public service employers bear the costs of their recruitment decisions.

6 To deliver the objectives, since 2011 HM Treasury took several steps, including moving members from pensions based on their final salary to their career average salary; aligning the normal pension age with the State Pension age; changing the inflation measure used to increase pensions annually; and establishing a mechanism (the 'cost control mechanism') aimed at protecting taxpayers by sharing the risk of cost increases fairly between scheme members and other taxpayers. A Court of Appeal judgment in 2018 (the 'McCloud judgment') found that protections offered to those closest to retirement were discriminatory on the basis of age; the government is working to remedy the discrimination and complete the implementation of the reforms.

Scope of our work

7 This report outlines how the public service pensions landscape has changed since the Hutton Review and highlights key challenges for the future. We examine data from the four largest pay-as-you-go pension schemes (NHS, teachers, civil service and armed forces) across the past 20 years to draw out long-term trends in pension costs and benefits. Throughout this report, when we refer to 'departments' we are also referring to other public service employers. State pensions and private sector pensions are outside the scope of this study, as are the schemes of privatised industries, such as the Royal Mail, or bodies that receive substantial public money but operate independently, such as the BBC. We do not make a judgement on whether public service pensions are affordable, as we consider this a policy decision.

8 The report is structured as follows:

- Part One provides background on public service pensions, covering the roles and responsibilities of key stakeholders, recent reforms and how performance is measured.
- Part Two outlines recent long-term trends in pension costs and benefits as well as future projections.
- Part Three highlights future challenges, including the age discrimination case resulting from the 2011–2015 pension reforms, the government's mechanism for assessing affordability and the role of pensions in recruitment and retention.
- The Appendices set out our audit approach and evidence base.

Key findings

Payments from the schemes

9 Total payments from public service pension schemes have grown significantly over the past 20 years. Total annual payments from the four schemes have risen by 105% (£17.1 billion) in real terms over the past 20 years, with £33.5 billion paid to pensioners. This included £28.5 billion of annual ongoing pension payments and £5 billion of one-off lump sum payments, with the NHS Pension Scheme the largest by payment value. The £17.1 billion increase in total payments also comprised ongoing pension payments (£13.9 billion) and lump sum payments (£3.2 billion). While future pension benefits have been affected by government's 2011–2015 reforms, such as the move to career average pensions, these changes will take many years to have an effect on total payments (paragraphs 2.3 to 2.4 and Figure 4).

10 The main factor driving the growth in total payments is the increasing number of pensioners. Total membership of the four schemes has increased from 5.1 million in 1999-2000 to 8.1 million in 2019-20. Most of the increase in pension payments is because of a 69% increase in the number of pensioners (to 2.8 million) between 1999-2000 and 2019-20. Of the £17.1 billion increase in payments over that period, £10.1 billion (in real terms) relates to the increase in pensioner numbers (paragraph 2.4 and Figure 5).

11 **Average annual pensions have grown by 16% in real terms since 1999-2000, but there is wide variation across schemes and groups of members.** The real-terms rise in average annual pensions since 1999-2000 has increased total payments by around £3.8 billion (in real terms). On average, pensioners across the four pay-as-you-go schemes received an annual pension of around £10,000 in 2019-20, up from £8,650 in 1999-2000. However, differences in pension payments between individuals and between groups of members arise because of a range of factors including the characteristics of different schemes, length of service and salary. For example, our analysis of the latest available data from 2016 shows that on average male scheme members receive £14,100 annually, whereas female scheme members receive £7,750 – a 45% difference. This gap is greatest in the NHS pension scheme at 63%. On average, male scheme members earn more over their careers and therefore build up a higher pension than female members. Scheme members who receive higher pay make higher contributions. There is also considerable variation across the schemes in average pensions with, for example, teachers' scheme members receiving £12,300 on average annually compared with £8,100 received by civil service scheme members (paragraphs 2.5 to 2.9 and Figures 6 and 7).

How the schemes are funded

12 **Pay-as-you-go public service pensions are funded through employee and employer contributions and a balancing payment from HM Treasury.** Employees and employers make monthly payroll contributions to public service pension schemes based on a set contribution rate and the employee's pay. As total contributions and the amounts paid to current pensioners may differ, HM Treasury makes an annual balancing payment to schemes to cover any shortfall (and retains any surplus). The total taxpayer funding for public service pensions therefore includes both employer contributions and the HM Treasury balancing payment (paragraphs 1.4 and 1.5, and Figure 1).[3]

13 **Employees are contributing substantially more to their pensions both individually and in total, because of the 2011–2015 reforms.** The 2011–2015 reforms increased contribution rates for pension scheme members. In 2019-20 total employee contributions from the four largest pay-as-you-go schemes amounted to £8.2 billion, 44% higher than 2009-10 (in real terms). On average, employees contributed around £2,700 in 2019-20 to their pensions, 33% higher in real terms than in 2009-10, and around 8.5% of average salaries in 2019-20. These increases in employee contributions are in the context of average pay decreasing 12% in real terms over the same period (to £31,600 in 2019-20), as prices increased faster than total pay (paragraphs 2.10 to 2.13 and Figures 8 and 9).

3 In this report we use this definition of costs to the taxpayer as distinct from employee contributions, although employees are also taxpayers in their own right.

14 **While the taxpayer's proportion of total pension funding remains similar to 10 years ago, employer contributions have risen significantly in 2019-20**. The taxpayer funds about 75% of the costs of the four largest pay-as-you-go schemes, a similar figure to 10 years ago. In cash terms this was £25.4 billion in 2019-20. Of this, £23.3 billion came from employer contributions – up £6.4 billion on the previous year – and the rest came from HM Treasury. The increase in employer contribution rates in April 2019 (based on the results of the 2016 valuations) is largely the result of a change to the discount rate government used to estimate the current cost of future benefits to be paid out by the schemes. This increase is consistent with HM Treasury's intention for departments and other public service employers, who control staffing decisions, to bear the full cost of those decisions. Employers also bear some costs outside of their control, such as those related to deferred members and current pensioners. In 2019-20, departments partly funded the increases in employer contributions through existing budgets. For example, the Department for Education told us it had to fund around £270 million of cost increases from existing budgets (paragraphs 2.14 to 2.20 and Figures 8 and 10).

HM Treasury's measure of affordability

15 **Despite rising costs, the government expects that public service pensions will become more financially sustainable over time, but this forecast is subject to some uncertainty.** HM Treasury's measure of affordability compares projected pension expenditure to the UK's economic output (spend as a proportion of GDP) over the next 50 years. The government's most recent projections – published in 2018, before the COVID-19 pandemic and before the UK exited the EU – indicate that expenditure is expected to increase from 2.0% of GDP in 2019-20 to a peak of 2.1% in 2022-23 before reducing over time, to around 1.5% of GDP from 2064-65. This forecast change can be partly explained by past reforms, as an increasing proportion of retiring scheme members draws on the (cheaper to the taxpayer) reformed schemes, rather than the more expensive legacy schemes. This measure is sensitive to changes in projections of GDP, which are now less certain because of the economic impacts of the COVID-19 pandemic, EU Exit and climate change (paragraphs 1.13, 2.21 to 2.26 and Figure 11).

Current and unresolved issues

16 **A legal challenge overturned a key part of the government's 2011–2015 reforms, and the government's proposed remedies will present substantial challenges for schemes and their members.** In 2011, the Hutton Review said that special protections for members aged 50 and over should not be necessary if, as happened, the reforms retained the link between pensions and final salary for past service. It pointed to age discrimination legislation as a potential barrier to such protections. Despite this warning, and following negotiations with employee representatives, government decided to offer 'transitional protection' measures to those within 10 years of their normal pension age. In 2018, the Court of Appeal ruled that these measures were unlawful on the grounds of discrimination based on age. In February 2021, following consultation on options to remedy the discrimination, the government announced that it would offer eligible members a choice to receive benefits from the legacy or reformed pension schemes for their service between April 2015 and March 2022. The government currently estimates the cost of these proposals to be £17 billion. It has decided that scheme members will meet these costs. More than three million scheme members will need to make a complex decision about their plans for retirement, and they will need useful, reliable and timely information from scheme administrators to support them in making that decision. This presents a significant administration challenge for schemes. Work between the schemes and HM Treasury to deliver the remedy is under way, but HM Treasury has not yet set out in detail how it plans to support schemes (paragraphs 3.2 to 3.8).

17 **Government is concerned that the cost control mechanism introduced in the 2011–2015 reforms is not working as intended.** As a part of its 2011–2015 reforms, government established a 'cost control mechanism' intended to protect the taxpayer and ensure that the risks associated with pension provision are shared with scheme members; the mechanism was only intended to be triggered should 'extraordinary, unpredictable events' occur. Provisional results from the 2016 actuarial valuations indicated that costs had fallen and that the mechanism could be triggered, leading to an increase in pension benefits. HM Treasury took these results as an indication that the mechanism was not working as intended and asked the Government Actuary to review the mechanism. In 2019, following the McCloud judgment, the government paused the cost control mechanism and the review of the mechanism, as it considered the value and costs of schemes were too uncertain until HM Treasury had fully developed its response to the judgment. Employee representatives told us that the review of the mechanism has undermined trust between employees and the government, and trade unions have brought legal challenges against the government's decision to pause the mechanism. In July 2020 HM Treasury announced that the pause of the mechanism would be lifted, and employee and employer representatives have since had an opportunity to feed their views into the Government Actuary's review, which is due to report around April 2021 (paragraphs 3.9 to 3.14).

18 HM Treasury's strategy for public service pensions has focused on affordability and does not explicitly consider the needs of employers or the role of pensions in the recruitment and retention of staff. HM Treasury officials told us that the government recognises the importance of pensions in the overall remuneration package, which includes pay and other benefits, and that it considers the role of pensions in recruitment and retention from this perspective. But HM Treasury's objectives (since 2012) do not consider the role of pensions in supporting the recruitment and retention of staff across public services, and its single formal measure for public service pensions considers affordability. The Cabinet Office is responsible for cross-government workforce planning and senior civil servant remuneration, and individual employers are responsible for ensuring the remuneration package they offer attracts the staff they need in other grades, within the wider pay policy HM Treasury sets. There is little progress since our 2010 report when we noted that HM Treasury and employers had not agreed a long-term strategy for how pensions support recruitment and retention. There had been no assessment at that time of the long-term impact on staff motivation and retention (paragraphs 3.15 to 3.17).

19 Some public bodies find the pension arrangements inflexible for supporting their workforce plans, which may present a risk to value for money. Employers told us that pensions can play an important role in retaining people with the right skills, but it is less clear whether current arrangements help them recruit new employees. For comparable private sector workers, pensions often form part of a flexible range of benefits alongside pay. As such, private sector employers have more flexibility to set the balance between different elements of remuneration, such as pay, pension and annual leave. Most public service employers can only offer potential employees the choice between staying in the scheme or opting out. There is some evidence to suggest that those in lower age and income groups are more likely to opt out of pension arrangements as they view contributions as unaffordable. Employers told us that they have looked at options for more flexible pension arrangements, such as allowing for higher pay in exchange for reduced pension benefits. HM Treasury has rejected proposals for more general flexibility, although it has allowed some employers to implement more flexible arrangements in specific cases. HM Treasury told us that, because pensions are relatively inflexible, it has used other approaches to recruit and retain staff – for example, introducing pension tax measures to help avoid senior clinicians reducing their overtime hours and retiring early. HM Treasury also told us that the government's commitment to making no major changes to public service pensions for 25 years limits the flexibility that it can provide, and it must consider the short-term impact on the public finances of any proposals (paragraphs 3.18 and 3.19).

Concluding remarks

20 Public service pensions are a notable benefit to public servants. HM Treasury focuses on the affordability of these pensions and who pays for them. The total costs of providing pensions have been increasing over time, reflecting increasing numbers of pensioners. The government's pension reforms over recent years have contained the rise in future taxpayer costs by making pensions less generous and by increasing contributions from employees. However, taxpayer funding has increased and it will take decades for the full effects of the 2011–2015 reforms to be seen in the government's affordability measure. The balance of taxpayer funding has shifted from central payments by HM Treasury to employer contributions by departments and organisations to ensure that employers bear the consequences of their employment decisions.

21 However, HM Treasury needs to monitor more than just affordability. Government's approach to protecting those nearest retirement has been ruled unlawful and will cost time and money to resolve. The government's reforms also take no account of pensions as a recruitment and retention tool, with pensions continuing to be relatively inflexible; the only real choice for most employees is to stay in the scheme or opt out altogether.

Recommendations

22 Through our work, we have noted several key issues that the government needs to address soon. HM Treasury should:

a develop plans to address the impact of the administrative challenge that its proposals in response to the McCloud judgment will have for employers and scheme administrators, so any changes can be implemented whilst maintaining a good level of service for members;

b resolve its concerns about the cost control mechanism and be open and transparent about the impact of any changes it makes for employers and scheme members;

c in conjunction with the Cabinet Office, work closely with employers to understand how public service pensions can best support their workforce planning, to ensure pensions are an effective tool in recruiting and retaining the staff they need;

d consider government's overall approach to ensuring that employees understand their pensions, particularly for the three million scheme members affected by the McCloud judgment who will need reliable and timely information, including from scheme administrators, to make decisions about their retirement plans; and

e consider whether broader performance measures, covering affordability and its other objectives, would give it greater assurance that it is delivering its objectives for public service pensions. For example, it could collect and analyse information regularly on the rate at which some groups are opting out of schemes.