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Summary

- All three main UK parties have promised to increase the Basic State Pension (BSP) at least in line with earnings. The Liberal Democrats have said they would do this from April 2011, Labour from April 2012 and the Conservatives at some point in the next Parliament.
- Labour and the Liberal Democrats plan to start increasing the State Pension Age (SPA) to 66 for men and women from 2024. The Conservatives have said they might bring this forward to 2016 for men and 2020 for women. If implemented, this would adversely affect men born between 1951 and 1959 and women born between 1955 and 1959.
- All would restrict the tax relief received by some on their pension contributions. Labour and the Conservatives would do this for 300,000 individuals with incomes above £130,000, while the Liberal Democrats propose doing this for all 3.1 million higher rate taxpayers. It is unfair to restrict tax relief on pension contributions without similarly restricting the tax paid on pension income. Such policies introduce considerable complexity and compliance costs.
- The Conservatives and the Liberal Democrats have both pledged to get rid of the requirement to annuitise all private pension pots before the age of 75. This reform risks worsening the operation of the annuities market and higher prices for some. The current system does not actually force individuals to annuitise retirement savings, as they are free to save for retirement in non-pension products.
- The Conservatives and the Liberal Democrats have both said they would review the current pension arrangements for public sector workers. Public sector pensions are more generous on average than private sector ones, but this is not itself a justification for cuts. Any future review should consider whether the remuneration packages being offered provide the appropriate incentives to recruit and retain staff at the lowest cost to taxpayers. The Conservative proposal to cap public sector pensions at £50,000 a year would not be a sensible reform.
- All three parties want to remove employers' right to make individuals retire at age 65. Employment legislation should contain provisions for employers to be able to assess their employees' abilities to carry out their roles and terminate their employment if they cannot perform their duties even with reasonable adjustments. But allowing age as a proxy for physical and mental capability does not seem desirable.

1. Introduction

This election briefing note reviews the policies that the three main UK political parties have announced in their manifestos that relate to state pensions, private pension saving, public sector

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pensions, and employment at older ages. A number of other policies that impact on the welfare of pensioners – such as winter fuel payments and free TV licences – are not discussed here, but some are assessed in another election briefing note.[2] In some areas there is overlap in the policies being proposed by the three main parties; in others the commitments are different. Despite a large review of pensions policy in 2006, which the then Secretary of State for Work and Pensions John Hutton heralded as "set[ting] out a new structure for the UK pensions system for the long term", all three main UK political parties' manifestos contain new pledges to reform the pension system.[3]

Section 2 discusses policies relating to state pensions: earnings indexation of the Basic State Pension (BSP) and reforms to the State Pension Age (SPA). Section 3 discusses policy proposals relating to private pension saving: extending access to employer-sponsored private pensions, reforms to tax relief on pension contributions and the compulsory annuitisation requirement. Section 4 discusses what the main parties have said about potential reform of public sector pensions. Section 5 examines proposed reforms to employment rights of older workers. Table 1.1 provides a brief overview of the manifesto commitments of the three main UK political parties that are discussed in this note.

[2] See M. Brewer and R. Joyce (2010), Welfare reform and the minimum wage, Election Briefing Note No. 8, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4830).

[3] Page vii of DWP (2006), *Security in retirement: towards a new pensions system* Cm.6841, The Stationery Office, London (http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/).

Table 1.1. Manifesto commitments on pension policy and older workers

Policy	**Labour**	**Liberal Democrats**	**Conservatives**
State Pensions			
Earnings indexation of the Basic State Pension	From April 2012	From April 2011. Increase in line with greater of earnings growth, RPI inflation and 2.5% thereafter.	In next parliament, date not specified
Increase State Pension Age to 66	2026 for men and women	2026 for men and women	Review to consider bringing forwards, not before 2018 for men and 2022 for women[a]
Private pension saving			
Move to auto-enrolment into private pensions	Yes	Yes	Yes
Restrict income tax relief on pension contributions	For those with income above £150,000[b]	For those with income above higher rate threshold	For those with income above £150,000[b]
Remove the compulsory annuitisation at age 75 requirement	No	Yes	Yes
Public sector pensions			
Impose cap on employer contributions, saving £1 billion a year	Yes	Yes	Yes
Further cuts?	No	Independent review	"address the growing disparity between public sector pensions and private sector pensions"; Pensions limited to £50,000 p.a.
Employment rights of older workers			
Scrap compulsory retirement ages	Will "proceed to end default retirement at 65"	Yes	Will "look at how to abolish the default retirement age"

[a] The Conservatives have stated that they would start increasing the SPA in 2016 at the earliest for men and 2020 at the earliest for women. However, if they took the same length of time (2 years) to implement the reform fully as the government is currently planning, the SPA would be 66 for men reaching this age from April 2018 onwards and for women from April 2022 onwards. This compares to April 2026 onwards (for both men and women) under the government's plans.

[b] The reform actually affects individuals whose gross income (i.e. taxable income plus individual pension contributions plus charitable donations) is above £130,000 and whose gross income plus employer pension contribution is above £150,000 with relief being tapered linearly from 50% at £150,000 to 20% for those with gross income (plus employer pension contribution) of £180,000 or over.

2. State pensions

Labour, the Conservatives and the Liberal Democrats have all pledged to index the BSP to earnings (rather than prices) at some time during the next Parliament. The key difference is in the proposed timing. All three parties are also committed to increasing the State Pension Age to 66 (and ultimately to 68). Again, the key difference in their proposals is when they hope to do this. The Pensions Act 2007 implemented a number of other changes to the state pension system, including increasing the ease with which individuals can qualify for a full BSP. However, none of the three main UK political parties has indicated that they would change any of these other reforms.

In addition to these pledges, which relate to the (non-means-tested) basic state pension and additional state pension, all three parties also appear to be committed to retaining the earnings indexation of the means-tested Pension Credit Guarantee. The continued earnings indexation of the Pension Credit Guarantee was legislated for in Pensions Act 2007 and none of the three main UK parties has suggested that they would amend this provision.

2.1 Earnings indexation of the Basic State Pension

From its introduction in 1948 until 1975, the weekly value of the BSP was increased on an *ad hoc* basis. Between 1975 and 1980, the level of the BSP was formally linked to the greater of price and average earnings growth. However, in 1980, this link with earnings growth was broken and since then the level of the BSP has generally been increased in line with increases in the Retail Price Index, which have been (on average) lower than growth in earnings.[4] Figure 2.1 shows that, as a result, while the BSP was worth 26.0% of average earnings in 1979, it was worth just 15.8% by 2008. A full BSP in 2008–09 was worth £90.70 per week. Had its level kept pace with average earnings growth from 1980 onwards, it would instead have amounted to £149.25 per week.

As part of a comprehensive review of pensions in the UK, the Government announced in 2006 that it would reinstate the link between the BSP and average earnings growth. Their stated objective was “subject to affordability and the fiscal position, to do this in 2012, but in any event by the end of the Parliament at the latest” and that the Government would “make a statement on the precise date at the beginning of the next Parliament”.[5] However, in their 2010 election manifesto, the Labour Party have now committed to re-linking the BSP to earnings growth from April 2012. The Liberal Democrats have said they would reinstate the earnings link a year earlier – in April 2011 – and the Conservative Party manifesto commits them to “restoring the link between the basic state pension and average earnings” but they have not said exactly when this would happen in the next Parliament.[6]

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[4] Since November 2001, the Labour government has increased the BSP by the greater of RPI inflation and 2.5% per year (see HM Treasury, *Pre-Budget Report 2001*).

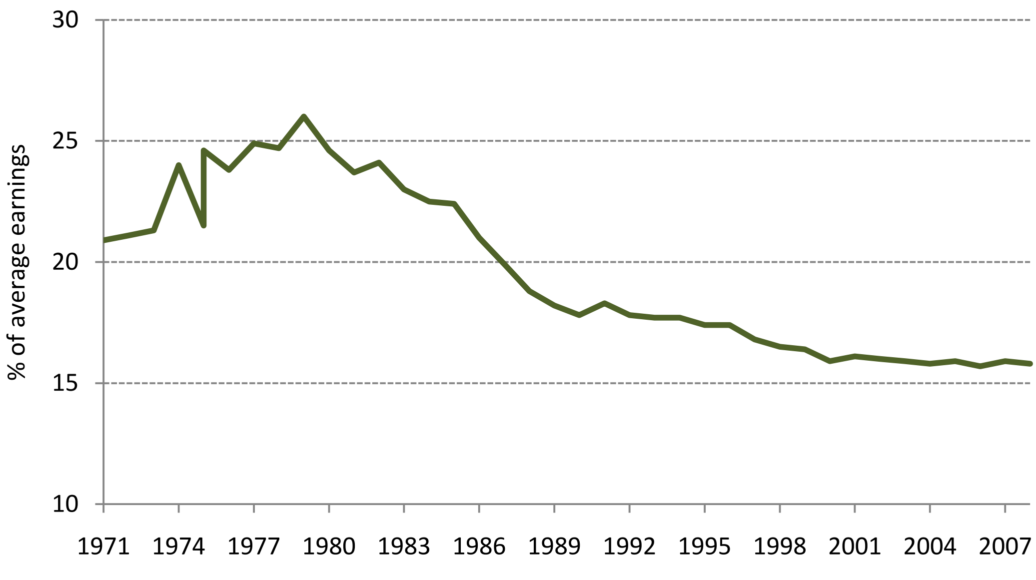
[5] DWP (2006), *Security in retirement: towards a new pensions system* Cm.6841, The Stationery Office, London (http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/).

[6] The Labour Party have committed to “A re-established link between the Basic State Pension and earnings from 2012” (page 6:2 of *The Labour Party Manifesto 2010*, http://www.labour.org.uk/uploads/TheLabourPartyManifesto-2010.pdf). The Liberal Democrats have pledged to “immediately restore the link between the basic state pension and earnings” and “uprate the state pension annually by whichever is the higher of growth in earnings, growth in prices or 2.5 per cent” (page 52 of *Liberal Democrat: Manifesto 2010*, http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf). Conservative Party pledge is on Page 12 of their manifesto, *Invitation to join the government of Britain*, http://media.conservatives.s3.amazonaws.com/manifesto/cpmanifesto2010_lowres.pdf.

The Liberal Democrats have explicitly stated that they would increase the BSP by the greater of earnings growth, price inflation and 2.5%. In most periods, earnings growth will tend to exceed growth in prices (and over the last few decades earnings growth has also exceeded 2.5% a year on average). However, in any one year, it is possible that earnings growth would in fact be lower than 2.5% or price inflation. Neither Labour nor the Conservatives have stated explicitly in their manifestos what would happen to the level of the BSP if earnings growth were to be lower than price inflation. However, in the Pensions Bill Debate (25 January 2007) then Secretary of State for Work and Pensions, James Purnell, rejected calls from David Laws, MP, to link growth in the BSP formally to the *greater* of earnings growth and price inflation. He stated that "the Government of the day should have some flexibility" in deciding whether or not to increase the BSP by more than earnings growth (including in those years where price inflation exceeded earnings growth). While this situation is not often likely to arise, it appears (given the costings of the Liberal Democrats' proposals provided by the Department for Work and Pensions (DWP), discussed below) that 2011 and 2012 are currently forecast by the Treasury to be two years in which average earnings growth will be no higher than (or perhaps even lower than) price inflation.

The agreement between the main UK parties that the BSP should be indexed to earnings is not longstanding. It was a Conservative government that, in 1980 formally linked increases in the BSP to growth in prices rather than to the greater of growth in prices or earnings, with the then opposition Labour Party remaining in favour of linking increases in the BSP to growth in earnings right through until the General Election of 1992. Since coming to power in 1997, Labour has pursued the strategy of price indexing the BSP, with the now opposition Conservative Party being in favour of restoring the earnings link since 2004.

Figure 2.1. The level of the Basic State Pension relative to average earnings, 1971 to 2008



Source: DWP, *Abstract of Statistics*, 2008.

Impact on individuals

The biggest winners (in proportion to their income) from increases in the BSP will be those who receive the BSP and are eligible for means-tested benefits but, for whatever reason, do not take them up. Those in receipt of Pension Credit, Housing Benefit and Council Tax Benefit will gain least as they will see their means-tested benefit entitlement reduced as a result of their higher income from the BSP. Since the BSP is taxable, those pensioners who are income tax payers will see some of their gains taxed away.

Across individuals of the same age, earnings-indexation will be more beneficial to those with greater life-expectancies than those with lower life-expectancies. Therefore, on average, women with a full BSP entitlement will gain more than men with a full BSP entitlement.

Impact on the public finances

Official public finance projections are already made on the basis that the BSP is to be indexed in line with earnings from April 2012.[7] Therefore, this policy commitment has no additional cost on top of current government policy. This means that, were the Conservatives not to restore the link until after 2012, they could use the money that Labour and the Liberal Democrats would use for this policy to spend on something else or to cut borrowing instead. Figures released by the DWP in 2005 suggest that earnings indexation of the BSP from April 2015 (rather than April 2012) would have saved £0.7 billion in 2012–13, £1.4 billion in 2013–14 and £2.1 billion in 2014–15 and every year thereafter.[8] However, the savings (and therefore the loss to pensioners) now would be smaller than this, as earnings growth is forecast to be more muted relative to price inflation than had been expected.

The Liberal Democrats' proposal to restore the earnings link a year earlier (in April 2011, rather than April 2012) and uprate by the greater of earnings growth, RPI inflation and 2.5% every year has been estimated to cost approximately £300 million a year from 2012–13 onwards, on top of the cost of the Government's commitments.[9] The DWP costing of the Liberal Democrat proposal – produced in January 2010 and based on the Treasury's economic forecasts underlying the 2009 Pre-Budget Report (PBR) – highlights two interesting points. First, DWP estimated that indexing to the greater of earnings growth and price inflation in April 2011 would have no cost implications compared to indexing to the greater of RPI inflation and 2.5%. This suggests that the Treasury's forecast for earnings growth in 2010 was no higher than its forecast for RPI inflation (which stood at 3% in PBR 2009). Second, DWP estimated that uprating by the *greater* of earnings growth and RPI inflation in April 2012 would cost £300 million more than simply uprating by earnings; this suggests the Treasury's forecast showed earnings growth actually lower than price inflation in 2011. It remains to be seen whether a Labour or Conservative government after the next election would actually increase the BSP by less than price inflation if earnings growth were to be lower. If they were not willing to do this, however, there would be further cost implications, just as there are for the Liberal Democrats' proposal.

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[7] See, for example, the Department for Work and Pensions long-term benefit expenditure projections (http://research.dwp.gov.uk/asd/asd4/long_term.asp).

[8] The original source is table 1 of the Work and Pensions Committee's Fourth Report, HC 1068(i), 2005–06 Session, http://www.publications.parliament.uk/pa/cm200506/cmselect/cmworpen/1068/106807.htm#a35, but the amounts have been uprated to today's prices. However, the saving will depend in practice upon the difference between growth in average earnings and RPI inflation between 2012 and 2015. See Brewer *et al* (2010), *Options for fiscal tightening: tax increases and spending cuts*, in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf.

[9] See Hansard, 13 January 2010, column WA162 (http://www.publications.parliament.uk/pa/ld200910/ldhansrd/text/100113w0002.htm).

2.2 Increasing the State Pension Age to 66

Since 1948 the SPA – the earliest age at which one can draw a state pension – has been 65 for men and 60 for women. Legislation passed in 1995 is increasing the SPA of women between April 2010 and March 2020 from 60 to 65 so that it will be equalised with that for men. Pensions Act 2007 legislated a further increase in the SPA – initially to 66 and ultimately to 68 – for both men and women. This is designed to increase the financial sustainability of the state pension system by reducing the proportion of life for which individuals are eligible for state pensions.

The increase to 66 is set to happen over a two-year period from April 2024 to March 2026. The Labour and Liberal Democrat election manifestos do not suggest any revisions to this timescale. In contrast, the Conservative manifesto (page 8) states that they would "hold a review to bring forward the date at which the state pension age starts to rise to 66, although it will not be sooner than 2016 for men and 2020 for women". (The later increase for women than men is in order to avoid conflicting with the current increase from 60 to 65 for women, which will not be completed until March 2020 in any case.)

Impact on individuals

The rationale for increasing the SPA is that individuals are living longer and thus the proportion of life spent in receipt of state pensions has been increasing over time and would continue to increase in the absence of changes to the SPA. One common misconception is that increasing the SPA is the same as increasing "retirement ages". Indeed, David Cameron has referred in speeches to their plans to "increase the retirement age to 66".[10] However, even at the moment, the majority of people leave paid work before reaching the current SPA. Therefore, increasing the age at which one becomes eligible for state pension income to 66 would not necessarily increase the age at which people leave work to 66 as well – the effects are more complex.

Requiring people to wait an additional year before they can receive their state pension makes most individuals who have some entitlement to a state pension financially worse off in terms of their lifetime income, though those who would move onto other means-tested or health-related benefits will find that at least some of their income loss will be recouped. There are three margins on which people who are affected could adjust their behaviour. First, they could choose to work for longer so as to make up this shortfall in their lifetime income. Second, they could choose to consume less (and save more) during their working life, so as to allow them to have the same income in retirement as they had been planning. Third, they could choose not to change either the length of their working life or their consumption during working life and instead simply accept being poorer in retirement. Assuming that some individuals choose to adjust their work behaviour somewhat, overall retirement ages would increase. However, if some individuals also adjust their planned consumption during working life and retirement (or if individuals can recoup their income through less than a one year delay in retirement), then retirement ages would increase by less than the increase in SPA.

People may also tend to increase their retirement ages in response to an increase in the SPA if the SPA acts as a signal of the 'appropriate' age at which to retire. While many people leave paid work before the SPA, the SPA is still the single most common age at which people exit the labour market at the moment.

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[10] David Cameron, 18 April 2010, http://www.conservatives.com/News/Speeches/2010/04/David_Cameron_An_Invitation_to_Older_People.aspx.

The people made directly worse off by the Conservatives' proposed reform would be men born between 1951 and 1959, and women born between 1955 and 1959. These people would find they have to wait longer before they can claim their state pension. This would make them financially worse off, though this direct effect on income could be offset if they respond to the increase by working for longer and so increase their income through earnings. Of course, they may still feel worse off (even if their income does not fall) because they would have to work, whereas in the absence of this policy change they would have chosen to retire. Those who would want to work for longer but who, for whatever reason, were unable to do so would be among the biggest losers financially (assuming they did not instead receive other means-tested or health-related benefits of equal value to the state pension forgone). Those planning to work beyond the SPA anyway would also be less able immediately to boost their income to replace any lost state pension.

Those who die younger would lose a greater proportion of their state pension entitlement: the largest proportional losses of total state pension income will be for those who survive to age 65 but not to age 66. However, the state pension is not a particularly well targeted mechanism for increasing support to those in poor health.

Assuming that the age of eligibility for Pension Credit Guarantee remains linked to the female SPA as it currently is, another group who would potentially lose out from this policy are those who will reach 65 between April 2020 and March 2026 and who would (in the absence of this change) have been eligible for the Pension Credit Guarantee. These low income individuals would have to rely for a little longer on other sources of income – such as working-age means-tested benefits – before being able to claim this (relatively more generous) means-tested benefit for pensioners.

The Conservatives have proposed bringing forward the increase in the SPA so as to reduce the cost of providing state pensions relative to what is implied under current government policy (this is discussed further below). Without cuts to spending on social security benefits – of which the BSP is the most expensive – all three main UK parties would have to make extremely large cuts to spending on public services in order to achieve their objective of reducing government borrowing.[11] Therefore this reform may be one way in which cuts to public spending could be delivered while, to some extent, limiting the harm to public services.

Impact on the public finances

As the Conservatives are only proposing bringing forward any increase in the SPA to 2016 at the earliest, this policy will not have any significant impact on public spending until 2016. As the SPA is phased upwards for men and then for women the savings from this policy would increase. However, at the point at which the SPA would start to increase anyway under current government policy (April 2024), the savings from the Conservative proposal relative to current policy will start to diminish and will ultimately disappear altogether. Therefore, the Conservatives' proposal would potentially reduce borrowing between 2016 and 2026, relative to current government policy, but would have much less effect on spending and borrowing before or after. (There may be some increase in tax revenues before 2016, if people choose to work more in anticipation of this reform being implemented. To the extent that accumulated borrowing would be lower by 2026 under this policy, spending on debt interest payments thereafter might also be lower.)

[11] See R. Chote, R. Crawford, C. Emmerson and G. Tetlow, *Filling the hole: how do the three main UK parties plan to repair the public finances?*, Election Briefing Note No. 12, 2010, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4848).

Increasing the SPA would reduce public spending on state pensions and a number of other benefits whose eligibility age is linked to the female SPA (such as Pension Credit Guarantee and Winter Fuel Payments). There may be further gains to the Exchequer if this policy encourages individuals to work for longer and thus pay additional income tax and National Insurance Contributions (NICs) on their earnings. However, these savings will be partially offset by lower payments of income tax on state pension income and increased spending on working-age benefits (such as working-age incapacity benefits). Quantifying the magnitude of these effects is difficult, as it will depend on exactly how individuals change their behaviour.

In the February 2010 IFS Green Budget, Mike Brewer and James Browne estimate that – under the strong assumption of no change in behaviour – a one year increase in the SPA would lead to a total gain to the Exchequer of £2.2 billion. (This is from a £2.7 billion fall in spending on the BSP partially offset by a net increase in spending on other benefits and a net reduction in tax revenue.)[12]

The Conservatives have claimed that a one-year increase in the SPA would save £13 billion a year. However, the underlying research on which they base this figure actually estimates the savings from a one-year increase in *retirement ages*; the research estimates the effect of this would be a net gain to the Exchequer of $^{2}/_{3}$% of national income, which would amount to around £10 billion in today's terms.[13] This estimated saving is almost certainly too large for a one year increase in the state *pension age*, because it assumes that everyone would work for one more year whereas some will undoubtedly not change their behaviour; for example, those whose health prevents them from being able to work and those who are sufficiently wealthy that they do not wish to work.[14]

More recently PricewaterhouseCoopers has estimated the annual Exchequer savings from a one-year increase in the SPA, including an attempt to model how individual retirement behaviour might change, at £5 billion (0.35% of GDP).[15] The true savings are uncertain, but this figure is perhaps the best available. Future research into how women respond to the increase in SPA from 60 to 65 could help shed some light on how men and women might respond to subsequent increases in the SPA.

3. Private pension saving

The Government has recently passed legislation that will require employers to enrol most employees automatically into a private pension.[16] Both the Conservatives and the Liberal Democrats have said that they would also implement this radical reform. In other areas of private pension reforms there are some differences between the three main parties – in particular over which individuals should receive restricted income tax relief on their pension contributions and whether pension pots should have to be annuitised by age 75. We discuss each of these in turn.

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[12] The fall in tax revenues is because income from the BSP is subject to income tax and this fall in revenue is despite a one-year rise in the age at which employee National Insurance ceases to be payable on earnings. Source: Brewer *et al* (2010), *Options for fiscal tightening: tax increases and spending cuts*, in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf.

[13] We believe the £13 billion figure used by the Conservatives is higher than the figure we have referred to as it is calculated as 2/3% of nominal future GDP.

[14] The costing is reported in http://news.bbc.co.uk/1/hi/uk_politics/8291835.stm. See NIESR press release of 6 October 2009, http://www.niesr.ac.uk/pubs/searchdetail.php?PublicationID=2406.

[15] Source: J. Hawksworth, C. Dobson and N. Jones (2010), *Working longer, living better: A Fiscal and Social Imperative*, London: PwC Public Sector Research Centre (http://www.pwc.co.uk/eng/publications/working_longer_living_better.html).

[16] For a discussion see C. Emmerson and M. Wakefield (2009), *Amounts and Accounts: reforming private pension enrolment*, Commentary No. 110, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4541).

3.1 Restrict tax relief on pension contributions

From April 2011, the Government has announced that pension contributions will no longer be exempt from income tax for those whose gross incomes (i.e. taxable income plus individual pension contributions plus charitable donations) are above £130,000 and whose gross incomes plus employer pension contributions are above £150,000. This would create complexity, unfairness and inefficiencies, but despite this none of the three main parties has pledged to reverse it.[17]

Instead of this policy, the Liberal Democrats have said they would restrict tax relief on pension contributions to the basic rate (20 per cent) for all individuals. In other words, anyone with income above the higher rate threshold will be required to pay some income tax (the difference between the higher rate, 40 per cent, and the basic rate, 20 per cent) on the contributions made by them or their employer to their private pensions each year. The Liberal Democrats estimate that this would raise £5.5 billion a year (or around 0.4% of national income) in 2011–12. An individual with earnings of £50,000 per year contributing £7,500 (15% of salary) to their pension would face an extra tax bill of £1,500 per year from this reform.

Is there a rationale for restricting tax relief on pension contributions?

Restricting tax relief on pension contributions has been justified on the grounds of fairness, and as an anti-avoidance measure, since individuals can currently avoid paying higher rates of tax on their income by putting it into pensions and then only paying basic rate tax on it in retirement. However, this argument supposes that all pensioners will have incomes below the higher rate threshold. The Liberal Democrats point out that many of those receiving relief at the higher-rate will only pay basic-rate tax in retirement, but this will not be true of all current higher-rate taxpayers.[18] The Liberal Democrat proposal is, however, more coherent than the Government's plan, as the very richest pension savers are much less likely to pay only basic-rate tax in retirement. If some individuals are higher-rate taxpayers in retirement, it is hard to see how it can be unfair for higher-rate taxpayers to receive 40 per cent relief when basic-rate taxpayers receive 20 per cent relief, yet at the same time *not* be unfair for higher-rate taxpayers to pay 40 per cent tax on their pension income when basic-rate taxpayers pay only 20 per cent. If somebody is a higher-rate taxpayer throughout their adult life, it seems unfair for the tax relief on their pension contributions to be restricted to 20 per cent and for them then to pay 40 per cent tax on their pension income.

Furthermore, it is actually arguable whether it is really unfair for people to receive higher-rate relief and then pay only basic-rate tax: in effect such individuals are simply smoothing their taxable income between high-income and low-income periods, undoing the 'unfairness' that an annually-assessed progressive tax schedule creates by taking more tax from people whose incomes are volatile than from people whose incomes are stable.

Even if receiving higher-rate relief and then paying basic-rate tax is seen as unfair, that does not diminish the case for accompanying the restriction of tax relief on contributions with a restriction of the tax paid on pension income (perhaps with transitional arrangements so that those who have received higher-rate relief in the past do not pay only basic-rate tax in retirement). If relatively few

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[17] See C. Emmerson (2010), *A response to the Treasury consultation on restricting pensions tax relief*, IFS Press Release, March 1, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4773).

[18] Though the snapshot statistics of the income tax rates facing current pension savers and current retirees they use to illustrate the point are somewhat misleading – those currently contributing may not necessarily face the same tax rates in retirement as current retirees, not least because of ongoing fiscal drag and in any case it is the proportion of individuals who used to be higher rate income tax payers who pay higher rate income tax in retirement that matters not the proportion of all individuals who now pay higher rate income tax in retirement.

individuals pay higher-rate tax on their pension income, that merely suggests that such a policy would be cheap. A policy that treats pension contributions and pension income asymmetrically is indefensible.

For those who expect to be higher-rate taxpayers in retirement, restricting the tax relief on pension contributions to 20 per cent (but still charging higher rate income tax when the income is drawn in retirement) will make private pensions a relatively unattractive investment option. We can be confident that pension saving would fall as a result of this reform (although this might be offset, at least to some extent, by increased saving in other forms).

Complexity and compliance costs

The Liberal Democrat proposal has some advantages relative to the government's proposal as it avoids severe "cliff-edges" that the government's policy creates. However, the disadvantage of the Liberal Democrat proposal is that roughly ten times as many individuals (all 3.1 million higher rate income taxpayers as opposed to the 300,000 estimated to be affected by the Government's preferred reform) would be affected by the policy and thus many more would face additional compliance costs. Restricting tax relief on pension contributions adds complexity to the tax system. It is fairly simple to tax each individual's contribution to a defined contribution (DC) pension scheme at the appropriate rate, but it is far more difficult to tax contributions to defined benefit (DB) schemes. In order to tax these correctly it would be necessary to value the contributions for each individual each year. To do this properly, one would typically need to know, among other things, what their final salary will be, when they will draw their pension, how long they will live, the appropriate discount rate for valuing future pension entitlements, future inflation rates, the likelihood that the employer goes bankrupt in a period when there was also a deficit on the pension fund, and whether the individual will be married when they die.

In practice a rule of thumb for calculating the value of contributions to DB schemes would need to be implemented in order to try to prevent the compliance costs from being prohibitively high. The Treasury has, for example, devised such a rule to value the contributions to DB schemes for those affected by the Government's proposed restriction of tax relief for individuals with income above £130,000.[19] But, however the Liberal Democrats chose to do it, such a policy would be likely to involve significant compliance costs for scheme organisers and/or members as well as being a somewhat rough-and-ready measure, creating a distortion in terms of the choice between DB and DC schemes.

3.2 Remove requirement to annuitise pension funds by age 75

Currently individuals who hold money in private pensions are required to use these funds to buy an annuity before they reach age 75. The rationale for such a requirement is that the government offers preferable tax treatment to money saved in pensions precisely because they want to encourage individuals to provide an income stream for themselves in retirement. Thus the compulsory annuitisation requirement ensures that any funds that have received favourable tax treatment are used to provide a retirement income stream, rather than being withdrawn for other purposes. This requirement goes some way to addressing two market failures:

[19] For further details see the documentation available at: http://www.hm-treasury.gov.uk/consult_pensionsrelief.htm

- **Moral hazard**: in the absence of this requirement, individuals may intentionally deprive themselves of an income stream (by withdrawing their pension funds and spending it on something) and then claim means-tested state benefits.
- **Adverse selection**: in the absence of compulsory annuitisation requirements, annuity markets suffer from adverse selection. In other words, individuals normally have more information about how long they are likely to live at the point they buy an annuity than the annuity providers do; thus annuity providers find it difficult to offer different prices to individuals with different life expectancies and so, at any given price, only those who expect to live for a relatively long time will find it attractive to buy an annuity. Compulsory annuitisation somewhat circumvents this problem because, at the point in working life when someone voluntarily contributes to a private pension (i.e. commits to one day having to purchase an annuity), their information about their own longevity may not be any better than the annuity provider's knowledge ultimately is (and will be less information than they have at the date they purchase their annuity).[20]

These two potential market failures are not just theoretical concerns: both have been seen in practice. In particular moral hazard has been observed in Australia (where it is known as "double dipping"): as their equivalent of the basic state pension is means-tested, some retirees spend their private pension pots quickly and subsequently qualify for this means-tested support. There is evidence of selection in the UK annuities market: among annuitants, those who choose to buy products whose payments are fixed in cash terms (nominal annuities) live for less long on average than those who choose to purchase products whose cash payments rise over time (such as index linked or escalating annuities).[21] Such differences in life expectancies that are known to the individual would, if unknown to the life insurance company selling the annuity, worsen the operation of the annuities market and lead to higher prices for some.

The requirement to annuitise funds held in a pension helps to alleviate both of these problems, but it has been unpopular for some time among many of those who leave annuitising their pension fund until close to age 75. Of course, in practice, individuals in the UK are not actually forced to annuitise at age 75: they could have chosen to save for retirement outside of private pensions (for example in Individual Savings Accounts) where there is no requirement to annuitise. Also it is sometimes stated that individuals are exposed to the risk that the annuity rate available when they reach age 75 will be poor. But this is also not correct: individuals are currently able to annuitise at any age between 55 and 75 and therefore could gradually move into annuities before reaching age 75.

Both the Conservatives and the Liberal Democrats have pledged to remove the compulsory annuitisation requirement altogether if elected. A straight abolition of compulsory annuitisation would not be sensible due to the severe moral hazard and adverse selection problems that it would create. Both parties have assured us that they are aware of the moral hazard problem and that, therefore, individuals would not be free to spend all of their accumulated funds and then fall back onto means-tested benefits. The Conservatives would require individuals to annuitise a minimum

[20] One advantage of defined benefit schemes is that individuals are pre-committing to their pension a long time before retirement when they will have less private information about their life expectancy. See J. Banks, R. Blundell and C. Emmerson (2005), 'The balance between defined benefit, defined contribution and state provision', *Journal of the European Economics Association*, Vol. 3, No. 2-3, pp. 466-476 (http://www.ifs.org.uk/publications/3389).

[21] See A. Finkelstein and J. Porterba (2002), 'Selection Effects in the United Kingdom Individual Annuities Market' *Economic Journal,* vol. 112 (January) pp. 28–50 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=308898) and A. Finkelstein and J. Porterba (2004), 'Adverse Selection in Insurance Markets: Policyholder Evidence from the U.K. Annuity Market' *Journal of Political Economy*, 2004, vol. 112, no. 1, pt. 1 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=489682).

amount of their pension pot to ensure they had sufficient annuity income to avoid future eligibility for means-tested benefits. The Liberal Democrats would place a limit on the amount that individuals could draw from their pension fund each year (as is the case with income drawdown arrangements up to age 75 at the moment) to help avoid this (although the maximum amounts would have to be carefully designed to prevent the fund from being depleted before death and then qualifying for means-tested support). However, both parties' policies would worsen the problem of adverse selection. This would be more true of the Liberal Democrats' proposal (as their policy would mean that individuals could completely avoid having to purchase an annuity) than the Conservatives' (as they would still require all pension funds to be annuitised up to a point).

Both the Liberal Democrat and the Conservative policies would benefit those individuals who currently do not wish to buy an annuity (despite having chosen to save in a private pension) and who become able to take advantage of the relaxation of the rules. This would also increase the relative attractiveness of saving in DC pensions in future compared to saving in DB pensions since the latter are annuitised automatically.

The other potential cost is, if individuals choose to save more in a private pension as a result of this reform since this would certainly lead to an upfront loss of tax revenues and may also lead to a loss of tax revenues overall if individuals ultimately end up paying a lower rate of tax than if they had not put this additional money in a pension. This is less of an issue for the Liberal Democrats since their proposal to limit tax relief to the basic rate of income tax for all individuals means that pension saving would be relatively less attractive for higher rate taxpayers than under the Conservatives (or, indeed, under Labour) and it is likely to be higher rate taxpayers who would take advantage of the relaxation in annuitisation rules. Under the Conservatives, pension saving would remain relatively tax favoured and therefore any increase in pension saving as a result of this reform would lead to a reduction in income tax revenues. A costing has not been provided in the Conservative Party manifesto (and it would be very difficult to cost). It would be possible to limit the cost of this reform: for example, the size of the tax-free lump sum that could be taken by individuals who were choosing not to annuitise at the age of 75 could be restricted (although neither the Liberal Democrats nor the Conservatives have proposed this).

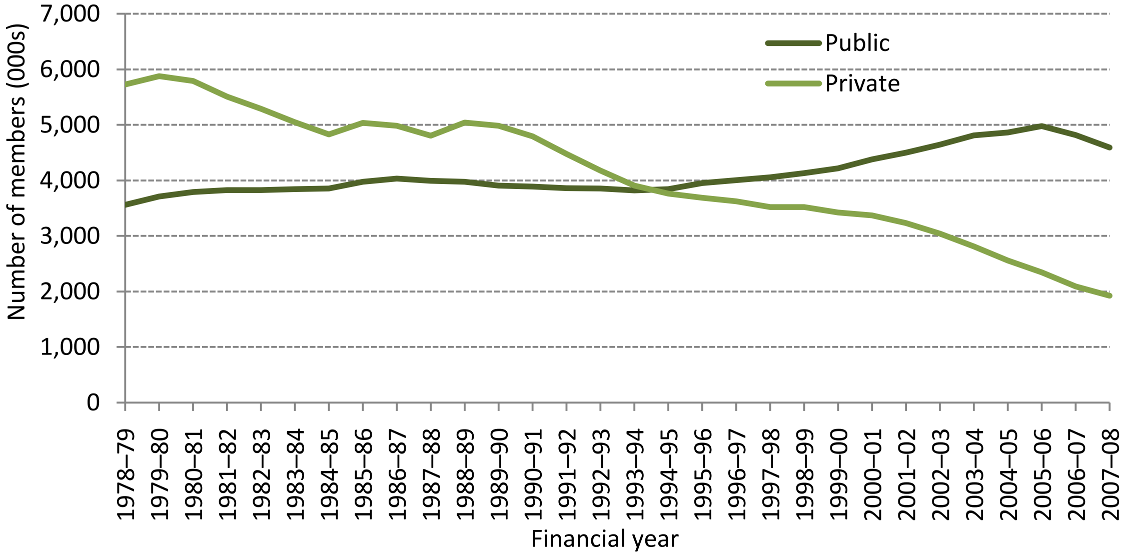
4. Public sector pension reform

Both the Liberal Democrats and the Conservatives (though not Labour) have proposed, in their manifestos, further reforms to public sector pension schemes. In particular, the Liberal Democrat manifesto (page 17) states that they will look into further "Reforming public sector pensions to ensure that they are sustainable and affordable for the long term, with an independent review to agree a settlement that is fair for all taxpayers as well as for public servants". The Conservative Party manifesto also states (page 12) that they would look at "working with the trade unions, businesses and others to address the growing disparity between public sector pensions and private sector pensions, while protecting accrued rights".

The cost of pensions for public sector workers is a politically sensitive issue. In part this is motivated by the fact that private sector employers have increasingly moved away from defined benefits (DB) schemes – pensions that typically depend on years of scheme membership and a measure of earnings, such as final salary – towards defined contribution (DC) schemes – pensions that depend on the amount contributed, the rate of return on investments made, and the annuity rate at retirement – whereas there has not been a shift on anything like the same scale in the public sector.

The trend away from defined benefit (DB) pensions in the private sector has been taking place since at least the early 1980s (as shown in Figure 4.1), although it does seem to have accelerated since 2000. In contrast, membership of public sector DB pension schemes was relatively flat between 1979 and 1996 but has grown since Labour came to power as public sector employment has been increased.

Figure 4.1 Principal membership of contracted-out DB plans, by sector



Note: Figure shows "principal" membership; for those with more than one pension membership, this is defined as the one with highest earnings in that tax year.
Source: Figure 1.1 of R. Crawford, C. Emmerson and G. Tetlow (2010), *Occupational pension value in the public and private sectors*, Working Paper No. 10/03, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4804) using data from Department for Work and Pensions, *Second Tier Pension Provision statistics*, (http://research.dwp.gov.uk/asd/asd1/tabtools/stpp_summary.xls).

Popular criticism of public sector pensions tends to focus on two grievances: first, that most public sector pension schemes are unfunded leaving a large future taxpayer liability and, second, that such schemes are more generous than pension schemes offered to most private sector workers. Before discussing these two points in turn, we will first discuss recent reforms to public sector pension schemes. We will then discuss what we think to be more important issues to consider when examining whether and how to reform public sector pensions further.

Recent reforms to public sector pension schemes

Public sector pensions have recently been reformed by the Labour Government. These reforms have, on average, reduced the generosity – and therefore the future cost to the taxpayer – of pensions provided to new entrants in these schemes. Typically these reforms have involved increasing the age at which a new entrant can receive an unreduced pension from 60 to 65 (for example this was true of the Teacher's Pension Scheme (TPS), the NHS pension plan and the Principal Civil Service Pension Scheme (PCSPS)) meaning that new members joining a public sector scheme at age 20 would have to contribute for five more years in order to receive the same annual pension for five fewer years.[22] For those affected, this is a very substantial reduction in generosity –

[22] An estimate of the impact of this reform is provided in Disney, R., Emmerson, C. and Tetlow, G. (2009), 'What is a public sector pension worth?', *Economic Journal*, Vol. 119, No. 541 (http://www.ifs.org.uk/publications/4666).

but as it only applies to new entrants it does not affect the majority of public sector workers, and will take a very long time before the lower cost to the taxpayer fully accrues. In 2005, the Treasury estimated the present discounted value of the net saving to the taxpayer from these reforms, which also included changes to ill-health retirement provisions and to employee contribution rates, would total £13 billion. To put this in context, the estimated saving represents 2.8 per cent of the contemporaneous official estimate of total projected public sector pension liabilities (£460 billion, as shown in Figure 4.2).[23] Of these savings 85% were estimated to come from new entrants to the schemes.

In addition the Government has introduced the possibility of a cap on employer (taxpayer) contributions to schemes (which does not reduce the generosity of the pension that is being accrued, but would mean that the employee will have to make a bigger contribution) and in the November 2009 Pre-Budget Report committed to imposing this cap which is estimated by the Treasury to cut public spending by £1 billion a year from 2012–13.

Unfunded liabilities

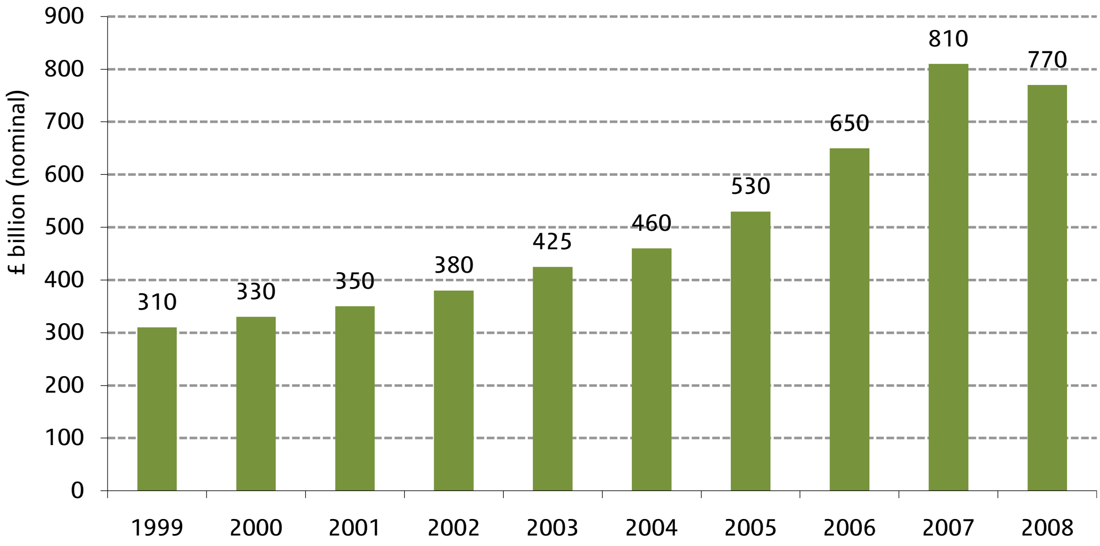
Some public sector pension schemes are – like private sector pension schemes – designed to be funded, which means that the contributions made by public sector employees and their employers are paid into a pot to be invested and subsequently used to pay the pensions of these public sector workers. The Local Government Pension Scheme is an example of such a scheme. Other public sector pension schemes operate on an unfunded basis. This is where the contributions made by members and their employers are simply paid to the Treasury each year and then pension payments to current retirees are paid by the Government, from the contributions received from current workers and – where necessary – with a top-up from general tax revenues. The three largest unfunded public sector schemes are the TPS in England and Wales[24], NHS pension plan and the PCSPS.

There has been much focus on the scale of unfunded liabilities that have been accrued in public sector pension schemes. Until recently these were larger than the official measure of public sector net debt (which stood at £497.8 billion in March 2007 before the financial crisis and associated recession began). The estimated value of these liabilities has also grown rapidly since 2000 (as shown in Figure 4.2). However, much of this increase – and much of the fall that occurred between 2007 and 2008 – was due to changes in the assumed discount rate. In other words, these figures have changed principally not because the amount that we expect to pay out in particular future years has changed but rather because how much we 'value' each pound of future outlay at in today's terms has changed. As the discount rate fell (meaning that £1 of pension to be paid in, say, 2020 now costs more in today's terms than previously thought) the estimated liabilities rose sharply.

[23] Sources: House of Commons Hansard Written Answers, 25th October 2005 Column 314W (http://www.publications.parliament.uk/pa/cm200506/cmhansrd/vo051025/text/51025w30.htm); 11th November 2005 (http://www.publications.parliament.uk/pa/cm200506/cmhansrd/vo051111/text/51111w04.htm); and 25th June 2007 (http://www.publications.parliament.uk/pa/cm200607/cmhansrd/cm070625/text/70625w0089.htm); Evidence to the Treasury Select Committee by the then Chancellor of the Exchequer Gordon Brown on the 8th December 2005 (http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/739/5120807.htm).

[24] For a detailed analysis of the generosity of the TPS see Disney, R. Emmerson, C. and Tetlow, G. (2010), 'The value of teachers' pensions in England and Wales', *Fiscal Studies*, Vol. 31, No. 1, pp. 121-150 (http://www.ifs.org.uk/publications/4791).

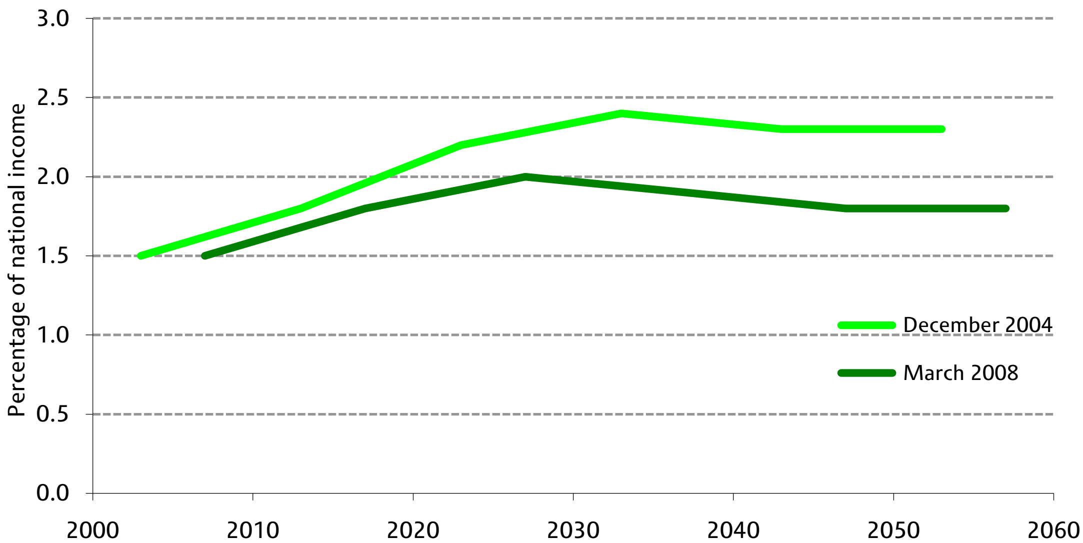
Figure 4.2 Estimated future public-service pension payments



Note: Years refer to the financial year in which three quarters of the calendar year lie.
Sources: Table 8, page 60 of N. Record, *Sir Humphrey's Legacy: Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (http://www.iea.org.uk/files/upld-book390pdf?.pdf) using various parliamentary answers quoting official estimates from the Government Actuary's Department; HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2008 (http://www.hm-treasury.gov.uk/bud_bud08_longterm.htm).

A better measure of the costs of unfunded pension schemes is the percentage of future national income that is expected to be devoted to them in future years. This has the attraction of not being sensitive to the choice of discount rate. The most recent data were published by the Treasury in its March 2008 Long-Term Fiscal Report and are shown in Figure 4.3, alongside the earliest vintage of comparable data that we have been able to locate from the December 2004 Long-Term Fiscal Report. This shows that outgoings are forecast to increase sharply over the next twenty years from 1.5% of national income in 2007–08 to 2.0% of national income (i.e. a one-third increase in spending as a share of national income) in 2027–28 before falling back to 1.8% of national income in 2057–58. It is also clear from Figure 4.3 that the projected outgoings as of March 2008 were lower, and expected to increase by less, than the expected outgoings as of December 2004.

Figure 4.3. Estimated future public-service pension payments



Note: Years refer to the financial year in which three quarters of the calendar year lie.

Sources: HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2004 and 2008 (both available from http://www.hm-treasury.gov.uk/bud_bud08_longterm.htm).

The generosity of public sector pensions

Previously David Cameron has said that "my vision over time is to move increasingly towards defined contribution rather than final salary schemes [for the public sector]" and that "we have got to end the apartheid in pensions".[25] This raises the issue of whether the pensions of public sector workers are relatively generous.

Recent work by IFS researchers has compared the distribution of pension accrual of public sector workers to that of private sector workers in both 2001 and 2005, and examined how, on average, pension accrual changed over this period.[26] This work found – or at least confirmed – the following:

- Pension coverage is higher among public sector workers than private sector workers.
- Among members of pension schemes, pension accrual – measured as a share of earnings – is typically higher among public sector workers than private sector workers.
- Between 2001 and 2005 overall pension accrual of private sector workers fell as increased accrual within DC pension arrangements was not sufficient to make up for the long-running decline in membership in DB arrangements. In contrast, there was no significant change in pension accrual among public sector workers.
- Falling pension accrual among private sector workers between 2001 and 2005 and unchanged pension accrual among public sector workers over the same period meant that the remuneration of public sector workers in the form of pensions grew faster relative to that of private sector workers.

In other words, pensions provided to workers in the public sector were indeed more generous on average than pensions offered to private sector workers in 2001, and this disparity grew between 2001 and 2005. However, looking simply at pensions is not the whole story. Pensions make up only one part of workers' total remuneration packages – the others being current pay, bonuses and other benefits. To make a sensible comparison between remuneration in the public and private sectors, we need to consider all elements of remuneration together, rather than pensions in isolation.

Comparing total remuneration

The research by Crawford, Emmerson and Tetlow (2010) also presents the average shares of total remuneration taken by earnings, bonuses and accrual within DC and DB pension arrangements in the public and private sectors. As shown in Figure 4.4, pension accrual forms a much greater proportion of the remuneration of public sector workers on average than private sector workers, with private sector workers receiving a larger share of their remuneration in usual earnings or bonuses than public sector workers.

Establishing whether the total remuneration of 'comparable' workers is higher or lower in the public sector than the private sector is extremely difficult – see Bozio and Johnson (2010) for a discussion.[27] However, examining the average *changes* in current pay and pension accrual between

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[25] See 'Cameron hints at phasing out public sector pensions' *Financial Times*, 26 November 2008 (http://www.ft.com/cms/s/0/cb9bc356-bc10-11dd-80e9-0000779fd18c.html).

[26] R. Crawford, C. Emmerson and G. Tetlow (2010), *Occupational pension value in the public and private sectors*, Working Paper No. 10/03, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4804).

[27] A. Bozio and P. Johnson (2010), 'Public sector pay and pensions', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, http://www.ifs.org.uk/budgets/gb2010/10chap9.pdf

2001 and 2005, Crawford *et al* (2010) concluded that, while growth in average current pay was higher in the public sector than the private sector, this was further augmented by faster average growth in pension accrual over this period. It is impossible to know, however, on the basis of this evidence alone whether this reflected public sector remuneration 'catching-up' with private sector remuneration, or the public sector pulling ahead.

Figure 4.4. Composition of remuneration, by sector (2005)

Source: Figure 5.2 of R. Crawford, C. Emmerson and G. Tetlow (2010), *Occupational pension value in the public and private sectors*, Working Paper No. 10/03, London: Institute for Fiscal Studies (http://www.ifs.org.uk/publications/4804).

There may well be good reasons for different types of employers to offer different remuneration packages. Therefore, simply because the private sector tends to offer a greater proportion of remuneration in the form of current pay and less in the form of (in particular, DB) pensions does not mean that the public sector should do the same. Any review of public sector pensions should carefully examine three issues. First, is the current mix of remuneration of public sector workers appropriately split between pensions and pay? Second, could public sector pension schemes be made more transparent so that their value is better understood by their members? Third, do the current schemes provide appropriate incentives to members? Each is now discussed briefly in turn.

Do public sector employers offer the right balance between pay and pensions?

It is clear that public sector pensions are typically more generous and comprise a higher share of total remuneration than the pensions of private sector workers. This does not necessarily mean that they should be made less generous. For example, to draw this conclusion from Figure 4.4 would also lead to the conclusion that bonuses should be made more generous in the public sector, whereas it might be that higher pensions in the public sector and higher bonuses in the private sector are more appropriate. It is also clear that the current schemes are affordable in the sense that we can devote the share of national income to the pensions of public sector workers that is shown in Figure 4.3, if that is deemed sensible. What matters is whether the current remuneration package offers the optimal mix of current pay and pensions to recruit and retain appropriately qualified and motivated public sector workers. If pensions were inappropriately generous, then a reform that cut pensions and increased pay could lead to the same quality of public service provision at lower overall cost to the taxpayer. But unfortunately evidence on the relative efficacy of public sector pensions as opposed to public sector pay in attracting and retaining workers is lacking.

Whoever forms the next government will need to reduce government borrowing, with the plans set out in the three main parties' manifestos implying the need for deep cuts to spending on public services. Cutting the level of public sector pay is one option for immediately reducing spending and all three parties have said they would implement tight control of pay in order to help reduce the deficit. But it might be that further cuts to public sector pensions would be able to deliver greater long-term savings to the taxpayer at lower harm to the quantity and quality of public services. Unfortunately such reforms to unfunded public sector pensions would not contribute towards the immediate goal of reducing the headline deficit (and indeed, if higher pay awards were made in partial compensation, would work directly work against it). However, reducing the headline deficit should not come at the expense of alternative reforms that equivalently strengthen the long-term public finances at less harm to public service provision.

Could transparency be improved?

If public sector pension scheme members are not fully aware of the true value of their pension or public sector employers are not fully aware of the costs of the pension promises they make, it may be that pensions are currently being used inefficiently as a recruitment and retention tool. Even if the generosity of public sector pensions is not changed, it could be making their value more explicit to public sector workers, and their cost more explicit to their employers, would ensure that they are used more effectively. There are two relatively simple reforms that could help achieve this objective.

Employer contributions to public sector pensions could be increased with a commensurate cut in the subsidy from general tax revenues. In the current financial year, the Treasury forecasts that the outstanding liabilities of these schemes will increase by £22.7 billion (as a result of new pension promises being made to public sector workers) but that contributions from employers and employees will total £20.7 billion, thereby implying a £2.0 billion subsidy from general tax revenues.[28] This subsidy could be removed and the £2 billion instead passed straight to public sector employers to spend how they wanted (such a reform might best be implemented gradually over time in order to smooth out any transitional issues). At the same time the employer contribution to these schemes could be raised to make up the shortfall. This would be sensible as it would help to ensure that employers took account of the true cost of additional staff when making budget decisions.

Even if employers made the same staffing decisions and continued to offer the same remuneration package, this reform could still help as it might encourage public sector employers to inform their employees of the true value (cost) of their pensions. A further reform that might help to communicate to public sector workers the value of their pensions would be to increase public sector wages and, at the same time, to increase employee contributions to these schemes by the same amount.[29] This would leave take-home pay, pensions accrued, and the cost to the Exchequer unchanged but might help public sector workers value their pensions correctly, and thereby help the taxpayer achieve the maximum value for money from these commitments.

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[28] Source: Table D.1 (page 180), of HM Treasury (2009), *Public Expenditure Statistical Analyses*, London: HM Treasury (http://www.hm-treasury.gov.uk/d/pesa_180609.pdf).

[29] The cost neutral increase in salary would be slightly lower than the increase in contributions since higher public sector pay feeds into higher defined benefit pension entitlements.

Appropriate incentives?

Finally any review of public sector pensions should consider whether they are providing appropriate incentives to attract and retain workers. If not, it could be that cost neutral reforms could be made that improved their efficacy. One obvious example of where the current incentives might not be appropriate is that many members of many public sector pension schemes still have a Normal Pension Age (NPA) of 60. This means that they can draw a full pension at age 60 and thus have a reduced financial incentive to remain in work beyond this point and a strong signal to retire at this point. However, we might actually like to continue to employ many public sector workers beyond age 60 – for example, there may be many nurses and teachers with valuable experience that it would be better to try to retain. If this is the case, a sensible reform might involve increasing the NPA even if the savings from this reform were fully recycled back to public sector workers either through higher wages or alternatively through higher accrual for each year of pension membership. For example, the NPA could be increased to the male SPA for all existing public sector workers; this would increase it to at least 65 for those who still have a NPA of age 60 (because they joined the schemes before the most recent reforms) and would increase it further in future as the SPA is increased (to age 68 for those born after 5th April 1978 under current legislation).

£50,000 cap on pensions

The preceding discussion sets out how public sector pension reform should look at the generosity of the overall package on offer and also consider whether the incentives provided are appropriate. The Conservatives have a specific proposal for reform of public sector pensions which falls short on both criteria. Their manifesto (page 8) commits to "cap public sector pensions above £50,000". This is not a sensible way to cut the generosity of public sector pensions. It would mean that highly paid public sector workers would suddenly see their remuneration drop once their pension entitlement reaches £50,000 a year. For example if a public sector worker earning £100,000 a year receiving a pension contribution of £20,000 (i.e. 20% of salary) reaches the point where their pension is worth £50,000 per year they would lose their employer pension contribution which is equivalent to a one-sixth reduction in their remuneration package (£20,000 loss on a package previously worth £120,000). Assuming that this is not then compensated for by an increase in pay (and thereby negating any point of the reform) it would create a sharp cliff edge in remuneration at this point.

While such highly paid individuals might not attract much sympathy from the public a more sensible – although still probably not sensible – reform would be to cut the pay of highly paid public sector workers across the board (rather than focus cuts to those who happen to have accrued significant pension entitlements: for example because they have spent longer working in the public sector). The risk with such a reform is that many valuable public sector employees who are affected by the reform might jump ship to the private sector.

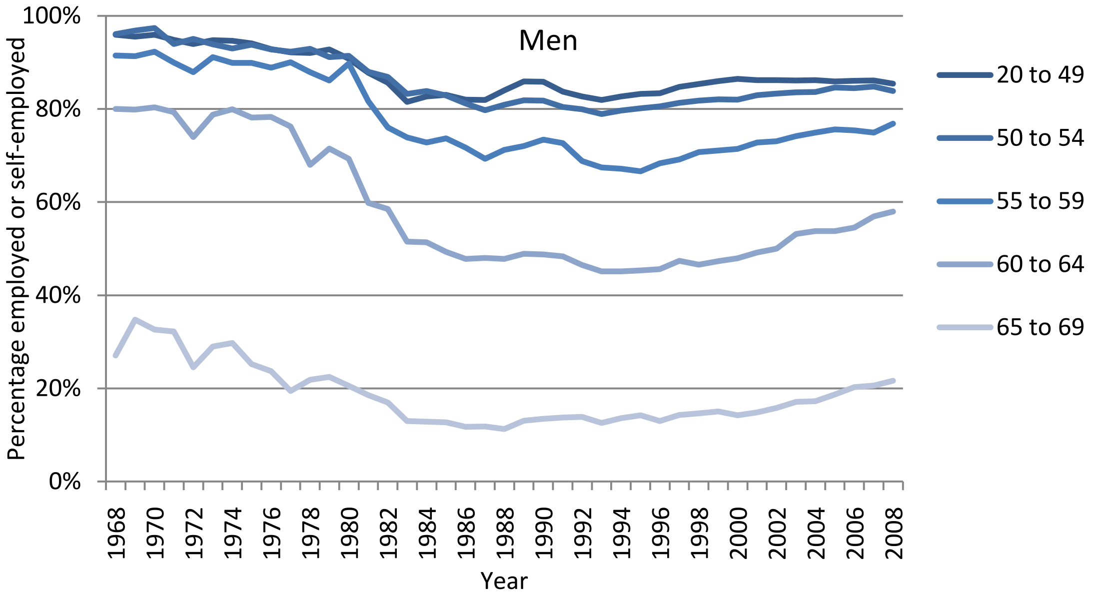
5. Employment rights of older workers

Increasing employment rates among older people has been a focus of government policy for some time. Employment rates of older women have been increasing over time, as later cohorts of women with greater attachment to the labour market start to move into their fifties and sixties. However, employment rates of older men fell through the 1980s and 1990s and – though they have now started to increase – still remain below the levels recorded in the 1960s and 1970s (as shown in Figure 5.1). With rapidly rising longevity and an increasingly aged population, increasing older-age employment rates is one of the key margins through which the net cost of supporting older people can be reduced. By working for longer, older people are likely to pay more income tax and NICs and receive less income from the state through out-of-work benefits.

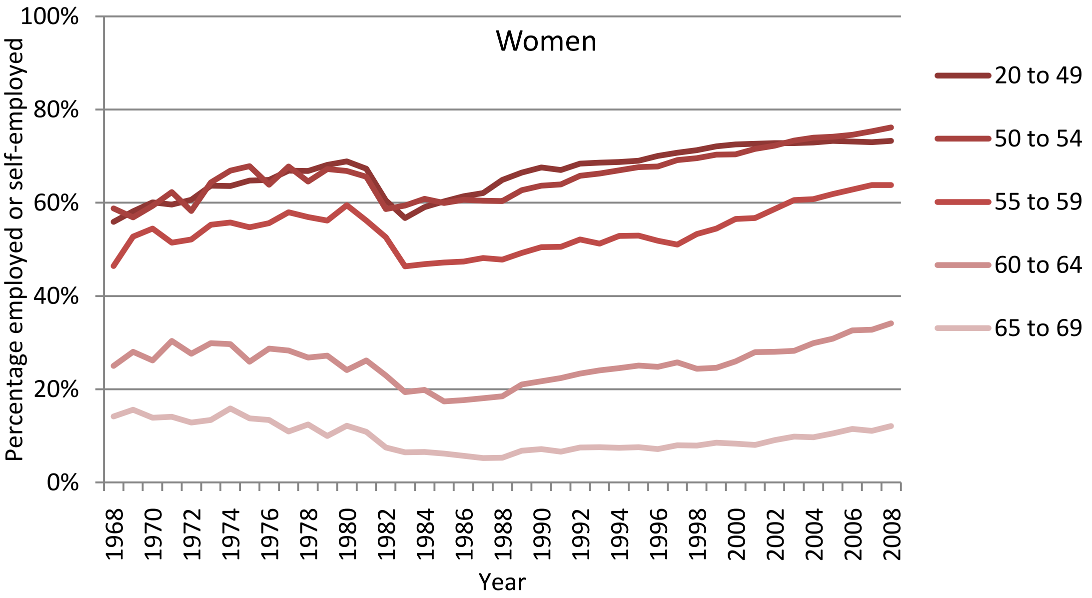
All three main UK political parties have suggested that they would seek to remove the current provision for a default retirement age of 65, which allows employers to require employees to leave work at the age of 65 on the grounds of age alone. Since 2006, employers have not been able to compel individuals to retire (on the grounds of age alone) before age 65, but they still have the right to impose a default retirement age of 65 or above. Though this provision has been challenged in the courts, in 2009 both the European Court of Justice and the High Court ruled that it did comply with an EU directive against age discrimination.[30] The Liberal Democrats have pledged in their manifesto to scrap the compulsory retirement age for all employees, while the Conservatives have said they will "look at how to abolish the default retirement age" and Labour have said they would "proceed to end default retirement at 65".

It seems clear that employers should not be forced to retain workers who are unable to carry out the duties required by their job and where appropriate adjustments to their working conditions or job requirement cannot be made. This could be due to diminished physical or mental capabilities. However, age seems to be a weak proxy for such deteriorations in health. Individuals of the same age may have very different physical and mental capabilities than one another and there is certainly no cliff-edge decline in health that is observed at age 65. Many 65 year olds will be both physically and mentally healthier than many 64 year olds – for example, 65 year-old women have, on average, longer life expectancies than 64 year-old men. Employment legislation should contain provisions for employers to be able to assess their employees' abilities to carry out their roles and terminate their employment if they cannot perform their duties even with reasonable adjustments. But allowing age as a proxy for physical and mental capability does not seem desirable.

Figure 5.1 Employment rates, 1968 to 2008, by sex



[30] See, for example, http://news.bbc.co.uk/1/hi/8274328.stm and http://news.bbc.co.uk/1/hi/business/7925203.stm.



Note: 1968 to 1983 taken from the Family Expenditure Survey, 1984 onwards taken from the Labour Force Survey.
Source: A. Bozio and C. Emmerson, *Extending working life: Segmentation analysis from the Labour Force Survey*, Presentation to the Department for Work and Pensions, February 2009.

Impact on individuals' retirement ages

While certain employees have been very vocal in their opposition to default retirement ages, it is difficult to know exactly how many people are really constrained by them and thus how many more people would be enabled to work for longer if they were removed. Employees do at the moment have the right to appeal against compulsory retirement at 65 and many employers do continue to employ people beyond this age.

Evidence from a household survey suggests that only a small minority of older workers felt constrained by compulsory retirement ages of 65. Emmerson and Tetlow (2006) found that just under half of employed men and just over one third of employed women aged 52 to 59 reported that their employer had a compulsory retirement age. Of those who reported that their employers' compulsory retirement age was 65 (32.5% of all employees aged 52–59), just 14.9% said they would actually want to continue working beyond that age if their employer allowed it.[31] Therefore, while removal of compulsory retirement ages would undoubtedly increase the welfare of those older workers who feel forced to retire earlier than they would like, it may not have much impact on overall employment rates at older ages. What evidence there is suggests that compulsory retirement ages are not the most important factor determining whether individuals do or do not work in their late sixties.

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[31] Source: C. Emmerson and G. Tetlow (2006), "Labour market transitions" in J. Banks *et al* (eds), *Retirement health and relationship of the older population in England: The 2004 English Longitudinal Study of Ageing*.