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PUBLIC SECTOR PENSION REFORM

MODELLING A SHIFT TO A FUNDED DEFINED-CONTRIBUTION SCHEME

A Policy Exchange Research Note

Ben Sweetman and Iain Mansfield

Foreword by Baroness Noakes DBE

Policy Exchange

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By Baroness Noakes DBE, former President of the Institute of Chartered Accountants in England and Wales

Unfunded public sector pensions are one of the most significant components of the public sector's future spending commitments, constituting £1.4 trillion of liabilities. These commitments do not appear on the public sector balance sheet, meaning that they are largely hidden from sight – yet they place a heavy obligation on future generations.

Over recent decades, pension provision in the private sector has undergone a profound transformation away from defined benefit schemes and towards defined contribution schemes. This has been driven by a number of factors but the bottom line was a desire for reduced exposure to risk and for cost stability. Businesses realised that the generosity of defined benefit schemes could not be maintained indefinitely. Yet the public sector remains exposed and taxpayers find themselves footing the bill.

It cannot be fair that taxpayers should be asked to pay for public sector pensions on terms that are increasingly not available outside the public sector. At a time when the national debt represents 95% of our GDP, annual debt interest payments are forecast to reach £114 billion, and pressures on the public purse are ever-increasing, we simply cannot afford to ignore the financial impact of the current public sector pension system. Policy Exchange's research note makes a vital contribution to the case for reform by providing a credible and realistic estimate of the financial impact of reforming the system.

The approach set out in Policy Exchange's paper strikes an appropriate balance between fairness and affordability, protecting the accrued rights of current members and ensuring new public sector employees receive a pension that compares favourably with private sector comparators – and that would ensure an adequate income in retirement. The graduated transition to the new scheme would limit the short-term costs, while generating savings of over £30 billion a year in the longer term.

The scale of the liabilities involved means that public sector pension reform cannot be avoided by any government serious about long-term fiscal responsibility. As Policy Exchange rightly observes, gripping this nettle would send a powerful signal to the bond markets that the Government was serious about getting on top of future public sector spending.

But pension reform should not be framed simply as a cost-saving exercise – there is also an issue of intergenerational fairness. Younger taxpayers will bear the cost of maintaining the current system, yet most will not themselves benefit from the generosity of defined benefit pensions. Ignoring this reality is neither progressive nor responsible.

Political determination would be needed to deliver reforms of this scale, but the reality is that an honest conversation about the sustainability, fairness and future of our current public sector pension system is long overdue. The longer reform is delayed, the higher the costs will be.

About the Authors

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Summary

The UK's public sector pension schemes constitute a £1.4 trillion (c. 45% of GDP) unfunded liability to the public sector balance sheet.[1] This is in addition to the officially recorded national debt of around £2.9 trillion (95% of GDP) and debt interest payments forecast to be £114 billion for 2025-26.[2]

Policy Exchange's report *Beyond our Means*[3] set out proposals for transferring all public sector workers from their current unfunded defined benefit pension schemes to a new, funded, defined contribution scheme with standardised employer contributions of 10%.

This policy note considers an alternative model of public sector pension reform, in which only new joiners to the public sector are placed onto the revised scheme, while the current defined benefit schemes remain open for current members only.

Rationale for change

Public sector pensions are typically defined benefit schemes, unlike the defined contribution schemes that predominate in the private sector. Public sector schemes are also considerably more generous than those in the private sector, with employers making a contribution of 25-30%, compared to an average private sector contribution of 6%.

In addition, with the exception of the Local Government Pension Scheme (LGPS), most public sector pension schemes are unfunded: instead of being invested to fund future entitlements, both employee and employer contributions are simply paid to the Treasury, with current pension outgoings paid out of current tax revenue or borrowing. This creates significant future liabilities for the public purse.

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[1] OBR Fiscal Risks and Sustainability, 2025, Link
[2] OBR Economic and Fiscal Outlook, November 2025, Link
[3] Beyond our Means, Policy Exchange, 2025, Link

Repeated studies have shown that many public sector employees do not value their pension at the cost which it takes to provide it, and that a remuneration package with a salary/pension balance more in line with private sector norms would constitute better value for money for the taxpayer in recruiting and retaining talented individuals.[4]

Further details of public sector pensions, taken from *Beyond our Means*, are set out at Annex A.

Options for reform

There are multiple ways in which public sector pensions could be reformed:

- Retaining a defined benefit model but altering the terms. This could include altering the employee or employer contribution rate, changing the accrual rate or changing the retirement age, amongst other options. The reforms that took place under the Coalition Government were of this nature.
- Retaining a defined benefit model but shifting to a funded scheme. This would necessitate the creation of a fund or funds, into which employer and employee contributions would be invested, and from which future pensions would be paid. The LGPS is an example of such a scheme.
- Move to a funded defined contribution scheme, similar to those that are the norm in the private sector.
- Move to a 'hybrid' scheme, in which the defined benefit portion only applies up to a certain salary threshold, with contributions above this being used to build up a defined contribution pot. The University Superannuation Scheme is an example of such a scheme. The defined benefit portion could be funded or unfunded.
- Move to a funded collective defined contribution scheme,[5] in which members are paid an income for life on retirement, based on their

[4] What's the Value of a Pension? Actuaries in Government, 2024, Link
[5] See, for example, Pensions: Collective Defined Contribution Schemes, House of Commons Library, 2025, Link

contributions and average life expectancy, but where the actual amount that each member receives may vary. The Royal Mail Collective Pension Plan is an example of such a scheme.

In each of the above cases, the changes could be applied either to all current and future members (i.e. fully closing the current schemes), or only to new members (i.e. closing the existing schemes to new members only, while keeping them open for existing members).[6]

Despite the acknowledged issues with the UK's unfunded public sector pension liabilities, a major challenge to reform is frequently perceived to be the short-term cost associated with moving from the current, unfunded, model, to a funded model – whether defined benefit, defined contribution, or other hybrid model.

This is because currently, the pension contributions of existing public sector workers are not invested, but instead returned to the Treasury – while the pensions of current retirees are paid for out of current spending.

Moving to a funded model would instead see the contributions of current workers invested – as is required in the private sector, for both defined benefit and defined contribution schemes – and the proceeds used to pay for the pensions of these workers when they retire. This would eliminate the future liabilities. The pensions of existing retirees, however, would continue to need to be paid, creating a shorter-term pressure on public spending.

Policy proposal

This research note models a proposal to, over time, shift the public sector workforce to a new defined contribution funded pension scheme, with a standardised employer contribution of 10% and an employee contribution of 5%. This would ensure public sector employees continued to receive a good income in retirement, with the total proportion of salary being invested into an employee's pension (15%, considering both employer and employee

[6] The latter would mirror the approach to when the civil service 'Premium' scheme was closed to new entrants in 2007, while remaining open to existing members.

contributions) being above the 12% contribution rate recommended by Pensions UK.[7]

Such a scheme would still compare favourably with the majority of private sector schemes, maintaining the public sector's reputation for a good pension, and taking into account the fact that average pay in the public sector is just under 5% lower than average pay in the private sector.[8]

The change would be implemented in the following way:

- With the exception of the Armed Forces Pension Scheme, the current public sector schemes would be closed to new entrants. Existing members would continue to remain members and build up contributions and entitlement.

- Any person newly joining, or rejoining, the public sector would be placed upon a defined contribution scheme, with a minimum employee contribution of 5% and an employer contribution of 10%.[9]

- The new defined contribution scheme would be a funded one: employer and employee contributions would be invested, with these investments determining the member's future pension.

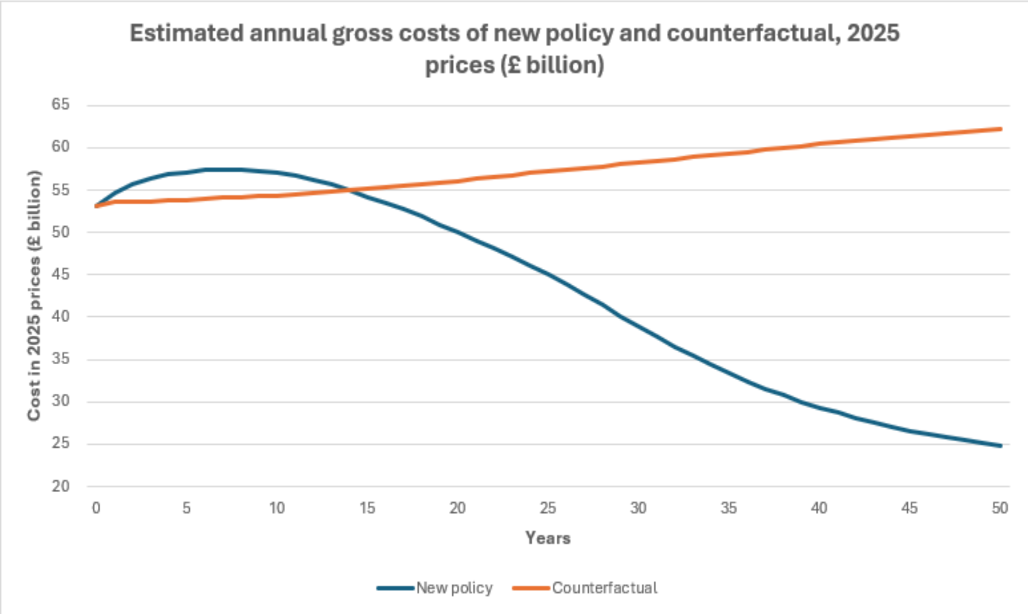
- As with all employer-provided schemes, employees who wished to would be permitted to opt-out.

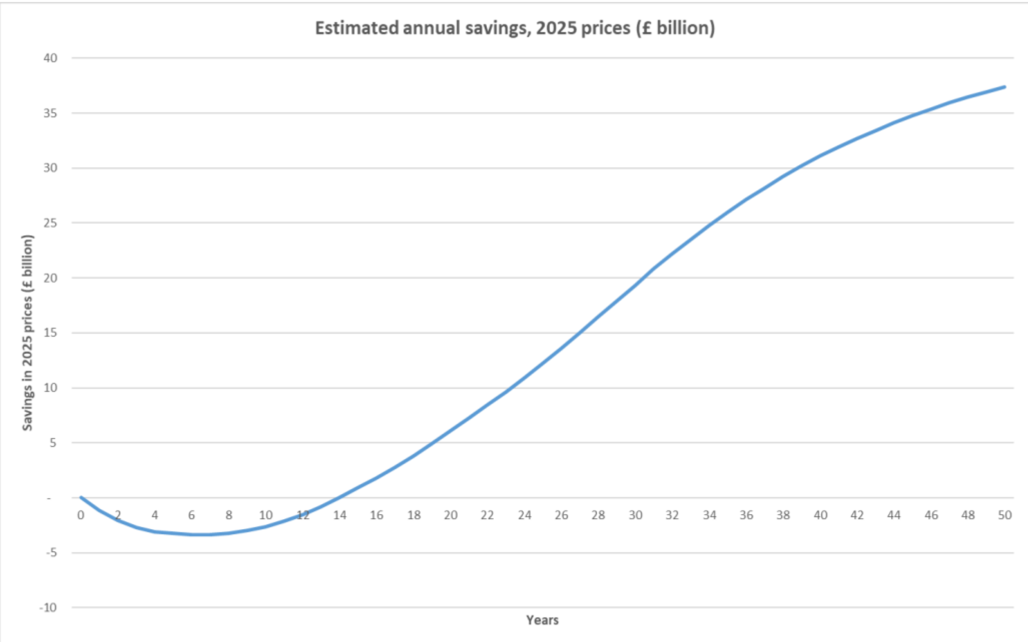
As discussed above, adopting such a policy would lead to an increase in public spending, as existing liabilities would continue to need to be met while contributions for members on the new scheme would be invested into a dedicated fund.[10] The increase is, however, significantly smaller than under the approach in which all public sector workers are transferred to a new scheme. This is because, initially, since the majority of public sector workers remain on

[7] First 100 days of government: Support adequate pension saving, Pensions UK (2024), Link
[8] Pressures on Public Sector Pay, Institute for Fiscal Studies, 2024, Link
[9] A public sector worker who left the public sector and later rejoined would be placed upon the new defined contribution scheme – however, one who simply moved jobs within their current sector, such as a teacher moving schools, or a civil servant moving departments, would not.
[10] The exception is the Local Government Pension Scheme – as it is already a funded scheme, switching to a 10% employer contribution results in an immediate saving.

unfunded schemes, their pension contributions will still be going to the Treasury, rather than to a separate fund.

In 2025 prices, we calculate that the additional funding required would be £1.1 billion one year after adoption, rising to a peak of £3.4 billion six years after adoption. Over the medium term, these costs would decrease, with the break-even point coming 14 years after adoption. From this point on, savings begin to accrue rapidly: rising to £6.1 billion per year 20 years after adoption, £19.4 billion per year 30 years after adoption and £37.4 billion per year 50 years after adoption (all figures in 2025 prices).





Adopting such a policy would significantly reduce the government's long-term liabilities and therefore would send an important signal to the bond markets about the government's commitment to controlling public spending. As part of a broader package of tax and spending decisions, it would be an important element impacting the interest rate at which the Government can borrow money, and therefore help to keep the amount spent on debt interest payments under control.

The OBR has estimated that a 1 percentage point change in short- and long-term interest rates would alter debt interest payments by £20.8 billion a year.[11] Therefore, if this policy resulted in a fall in interest rates of just 16 basis points, this would entirely negate the peak additional short-term costs, and create additional savings in every other year. This is a plausible level of impact, when one places it in the perspective of interest rate changes following previous major Government decisions on tax and spending[12].

Modelling and Assumptions

Future pension costs were modelled by projecting the future stock of active, deferred and retired pensioners for five of the largest government pension schemes. Future flows of pension members between each category and average payouts were modelled based on historical data and extrapolated under reasonable assumptions. These costs are compared to a counterfactual which assumes that the current public sector pension scheme policy regime continues.

The Civil Service, NHS, Teachers, Police and Local Government Pension Schemes were each modelled separately – these schemes, together with the Armed Forces Pension Scheme (which is unaffected by this proposal) constitute 95% of public sector pension members. For each scheme, Superannuation reports from 2020/21 to 2023/24 provided historical data on the current number of people of active, deferred or pensioner status, flows of people leaving each pension scheme, flows of people deferring from their active status, flows of

[11] Debt maturity, quantitative easing and interest rate sensitivity, OBR (2021), Link
[12] For example, it is comparable to the amount that 10-year gilt prices rose when the Government abandoned plans for welfare reform – intended to save c. £5 billion a year by the end of the decade – in July 2025,

people retiring or becoming a dependant as well as average annual payouts per pensioner.

Core assumptions include

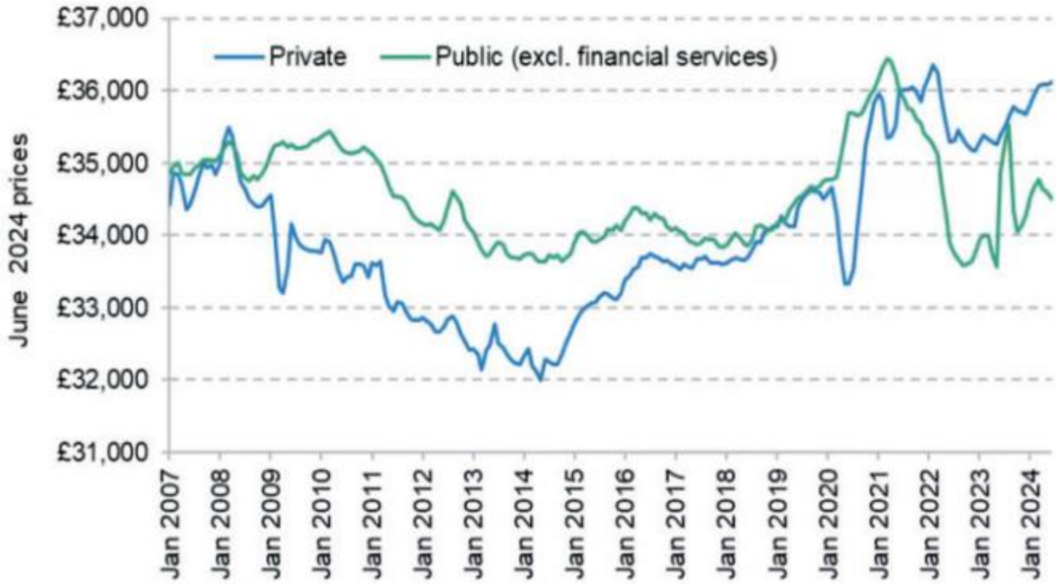
- The size of the workforce of each of these public sector employers remains constant over this time period.
- Average salaries (and therefore pensionable pay) increase at a real annual growth rate of 0.5%.
- Costs are calculated by multiplying the projected number of pensioners each year by the average payout per pensioner; in addition, the total lump sum payout on retirement is calculated as the projected number of retirees each year multiplied by the average retirement lump sum per retiree.
- When considering the defined benefit cohort, we assume that those who have recently joined are more likely to leave than employees with many years' service. Leaving rates therefore initially decrease before increasing gradually as the age of the active cohort increases and people become more likely to retire. The percentage of deferred members who are retiring is also assumed to gradually increase.
- The rate at which defined benefit pensioners die is taken as the average death rate from the Superannuation reports over the last four years. It increases linearly over time before eventually plateauing (in year 27) at 10% of the pensioner cohort each year.
- The counterfactual scenario is based on the gross costs of the current policy regime for public sector pensions. It also assumes that the size of the workforce for each public sector employer stays constant, and that, as in the modelled scenario, average salaries increase at a real annual growth rate of 0.5%.
- Some of these assumptions, particularly for the overall future size of the public sector, may be over-generous, but we have erred on the side of caution.

Annex A: A Summary of the principal Public Sector Pension Schemes and a Comparison with Private Sector Schemes

An excerpt from Policy Exchange's report, Beyond Our Means (2025).[13]

Compared to the private sector, an unusually high proportion of public sector remuneration is received as pension contributions, with employers making a contribution of 25% - 30%, compared to typically 5% - 10% in the private sector.[14]

While it is true that at very senior levels – particularly when shares and bonuses are factored in – public sector pay significantly lags private sector pay, on average, public sector pay is less than 5% lower than private sector pay.[15]



In addition to higher employer contributions, public sector employees also benefit from increased certainty, being in receipt of Defined Benefit pensions as opposed to the Defined Contribution pensions that are overwhelmingly more common in the private sector.

[13] Beyond our Means, Policy Exchange, (2025), Link
[14] Average private sector employer contributions are 6%. Institute for Fiscal Studies, Adequacy of future retirement incomes: new evidence for private sector employees (2024), Link
[15] Graph taken from Pressures on Public Sector Pay, Institute for Fiscal Studies (2024), Link

Furthermore, most public sector pension schemes, with the exception of the Local Government Pension Scheme, where contributions are paid into a fund and invested, are 'unfunded', meaning that the employer contributions are not invested, but simply return to the Treasury, with pensions paid out of current expenditure. This means that the generous public sector pension schemes are building up major future liabilities for the taxpayer. These were recently estimated at £1.4 trillion.[16]

Details of Public Sector Pension Schemes

Over 95% of public sector pension scheme members are enrolled into one of the six largest schemes:[17]

	Employee contribution	Employer contribution	Type[18]	Accrual Rate[19]	Number of active members[20]	Number of contributing members[21]
Civil Service Pension Scheme[22]	4.60% - 8.05%	28.97%	Career Average	2.32%	1.7 million[23]	0.6 million
Teacher Pension Scheme[24]	7.4% - 12%	28.68%	Career Average	1.75%	2.2 million[25]	0.72 million

[16] UK public sector pension liabilities, ICAEW (2024), Link
[17] Civil Service Pensions, Martin Stanley, Link
[18] Each of the schemes also contains a degree of inflation protection, whereby the sum accumulated is uplifted by either CPI, or CPI plus a fixed percentage, each year.
[19] The proportion of one's salary that is added to a member's annual pension each year.
[20] All numbers include people paying into the scheme, people being paid a pension, and people who have a pension they have deferred. The schemes are England and Wales only, other than the Civil Service Pension Scheme and the Armed Forces Pension Scheme which are UK wide. Figures are for March 2024 other than for the Police Pension Scheme which is March 2020: this was the most recent available figure.
[21] References as for Number of Active Members.
[22] Civil Service Pension Scheme, Link
[23] National Audit Office, Link
[24] Teacher Pension Scheme, Link
[25] Department for Education, 'Teachers' Pension Scheme (England and Wales) Annual Report and Accounts 2023-24' Link

NHS Pension Scheme[26]	5.2% - 12.5%	23.7%	Career Average	1.85%	3.8 million[27]	1.9 million
Police Pension Scheme[28]	12.44% – 13.78%	35.3%	Career Average	1.80%	325,000[29]	120,000
Armed Forces Pension Scheme[30]	0%	65.5%	Career Average	2.13%	1 million[31]	194,000
Local Government Pension Scheme[32]	5.5% – 12.5%	21.1% (average contribution)	Career Average	2.04%	6.7 million[33]	2.1 million

The table above demonstrates two further elements of public sector pensions. First, despite the reforms of the Coalition Government, which were intended to make public sector pensions more affordable, overly-optimistic assumptions at the time of the reform have meant that the level of employer contributions has increased over the last 15 years, from around 16% in 2009 to closer to an average of around 27% today.[34] Moreover, the levels of member contributions are high compared to private sector schemes.[35] This has resulted in some public sector employees opting out of their pension schemes – despite their generosity – for reasons of affordability.

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[26] NHS Pensions, Link
[27] Department of Health and Social Care, 'NHS Pension Board Annual Report 2023 to 2024', Link
[28] Police Pension Schemes, Link
[29] Government Actuary's Department, 'Police Pension Schemes (England and Wales) Membership data' March 2023, Link.
[30] Armed Forces Pensions, Link
[31] Ministry of Defence, 'Armed Forces Pension Scheme Annual Report 2023-24', Link.
[32] Local Government Pension Scheme, Link
[33] Local Government Pension Scheme, Link.
[34] Briefing: Public Sector Pay and Pensions, Taxpayers' Alliance, (2024), Link
[35] The default employer contribution under the statutory auto-enrolment scheme is, for example, 5%.

For example, 15% of nurses in the starting band and 20% of doctors in core training have opted out of the pension scheme, which means they also receive no employer contribution to their pension either. Again, this reinforces the thesis that many public sector employees would be better off with a balance of remuneration which was less tilted towards pensions at the expense of take-home pay.[36]

[36] Pressures on Public Sector Pay, Institute for Fiscal Studies (2024), Link