

# PENSIONS AND BENEFITS



## THE OBJECTIVES OF THIS CHAPTER ARE TO:

- 1 INTRODUCE THE DIFFERENT TYPES OF PENSION SCHEME PROVIDED BY THE STATE, BY EMPLOYERS AND BY FINANCIAL SERVICES ORGANISATIONS
- 2 EXPLAIN THE CAUSES AND SIGNIFICANCE OF CURRENT TRENDS IN THE PROVISION OF OCCUPATIONAL PENSIONS
- 3 OUTLINE THE ROLES PLAYED BY HR PROFESSIONALS IN THE FIELD OF OCCUPATIONAL PENSIONS
- 4 DISTINGUISH BETWEEN STATUTORY SICK PAY (SSP) AND OCCUPATIONAL SICK PAY (OSP)
- 5 ASSESS RECENT DEVELOPMENTS IN THE PROVISION OF COMPANY CARS BY UK EMPLOYERS
- 6 EXPLORE THE POTENTIAL OF FLEXIBLE BENEFITS SYSTEMS IN THE UK CONTEXT

Employee benefits commonly used to be known as ‘fringe benefits’, suggesting a peripheral role in the typical pay packet. The substantial growth in the value of most benefits packages over the past ten or twenty years means that the title ‘fringe’ is no longer appropriate. An increasing proportion of individual remuneration is made up of additional perks, allowances and entitlements which are mostly paid in kind rather than cash. The total value of benefits ‘paid’ by employers to employees commonly represents between 20 per cent and 50 per cent of an organisation’s salary budget, depending on what is included (IDS 1999). Pensions alone can easily account for 20 per cent, to which must be added the costs of providing some or all of the following: company cars, sick pay, meals, live-in accommodation, parking facilities, private health insurance, crèche facilities, mobile phones, Christmas parties, staff discounts, relocation expenses and any holiday or maternity allowances paid in excess of the required statutory minima. Smith (2000a, p. 153) shows that these extra elements of pay are distributed unevenly between members of staff. Those earning at the top of the scale (especially directors and senior managers) tend to gain rather more than average employees, 30 per cent or 40 per cent of their take-home pay being accounted for by benefits of various kinds.

Despite these developments, there remains a big question-mark over how far employees value the benefits provided to them by their employers or appreciate the extent of the costs involved in their provision. A survey of 13,000 employees carried out by Towers Perrin (IRS 2000a, pp. 5–9, Thompson and Milsome 2001, pp. 55–62) found that a majority were dissatisfied with the level of benefits provided and that only 21 per cent were interested in improving the package by reducing their take-home pay. They concluded that ‘traditional benefits are not a significant factor in the recruitment, retention and motivation of most employees’ because there was ‘a misalignment between their needs and the extent to which their employers are meeting those needs’. This does not mean, of course, that employers can easily stop offering benefits. While the full cost may not be appreciated by employees, they are generally in favour of the benefits and would resent their removal. Poor publicity would also inevitably follow the withdrawal of rewards such as pensions which are generally seen as being the hallmark of a good employer. The alternative courses of action involve communicating the true value of benefits to employees more effectively and providing them with a degree of choice as to which benefits they wish to receive. The latter approach, involving the provision of ‘flexible’ or ‘cafeteria’ benefits, has become very common in the USA and has received a great deal of attention in the UK too.

## PENSIONS

Occupational pensions are increasingly seen as a form of ‘deferred pay’ rather than a reward for a lifetime of employment, and as such are attracting more attention from employees, trade unions, government and the media. Once a peripheral concern of most HR departments, and many reward management specialists, they have now, as a result of recent developments, moved to the centre of the stage. The trade union AMICUS recently stated that pensions are the top priority issue for its members, while the CIPD’s annual survey on reward management practices now places the section on pensions at the beginning, ahead of all other pay topics (CIPD 2004).

The role of employers in providing pensions has moved up the agenda for several reasons, but underlying all of them are the long-term demographic trends which have called into question the ability of the established UK pension system to provide an adequate income to older people after they retire. On the one hand people are living increasingly longer and thus require a bigger pension to provide them with an income across their years of retirement. On the other, fewer children are being born, leading to an increase in the **dependency ratio**, by which is meant the proportion of retired people *vis-à-vis* working people in the economy. At present in the UK there are around 3.3 people working for every pensioner, but this figure will reduce quite rapidly after 2010. By 2030 it is expected to fall to 2.7 and to continue declining for two further decades (Hopegood 1994). This has major implications for the government, which will have to raise taxation very considerably in order to fund decent state pensions for so many retired people, in addition to providing for their health, welfare and other care needs. The government is seeking to tackle this issue in different ways. Overseas immigration is being allowed to rise considerably for the first time in decades, while the state pension age is likely to rise to 70 in the near future. However, an important part of the strategy is to shift the burden of providing pension income from the state to the private and occupational sectors. For this strategy to succeed ways must be found to encourage today's working population to save a great deal more for their own retirement than is currently the case. Employers will also have to be persuaded both to make contributions themselves and to provide pension schemes which encourage workers themselves to contribute. Unfortunately, in recent years the opposite trend has occurred. Far from growing, the occupational sector is declining in terms of both the number of people covered and the size of pension that is being provided to retirees. In fact, since 2000 we have witnessed the dismantling of large parts of the established occupational pensions structure. A majority of larger employers have downgraded their pension commitments, reducing the amount of money they contribute to funds and shifting investment risks on to employees. This ongoing situation is regularly seen in the press and by pensions experts as constituting a 'pensions crisis' (IRS 2003a).

### ACTIVITY 29.1

Robert Noble-Warren (1986) talks about 'lifetime planning' as a series of 'rest and recuperation' periods throughout life as well as the planning of financial provision. Lifetime planning has to start with a statement of your life's objectives. What are your life's objectives and what work, rest and financial plans can you make to achieve these?



### State schemes

The state runs two schemes: a basic scheme and the State Second Pension (S2P) scheme. The latter replaced SERPS (the State Earnings Related Pension Scheme) in 2002, but people who contributed to SERPS have all their accrued entitlements under that scheme protected. Every employee is obliged to contribute a standard amount to the basic scheme, which currently provides an old age pension at the age of 65 for men and 60 for women. By 2020 the pensionable age for both men and women will

be 65 and in the 10 years prior to this date there will be a gradual phasing in of the new pensionable age for women. Anyone earning above a 'low earnings threshold' determined by the government (£10,800 in 2003) makes payments towards S2P through their national insurance contributions, it being intended that the scheme will pay out an additional flat-rate state pension to those who retire after April 2006 or 2007 (IDS 2002a, pp. 22–3). SERPS operated along similar lines, but produced a second state pension that varied in size depending on how much had been contributed by the individual retiree.

The state pension scheme is organised on a pay-as-you-go basis. This means that there is no state pension fund as such, and the money that is paid to today's pensioners comes from today's taxes and national insurance contributions. The money that will be paid to today's contributors, when they become pensioners, will come not from the investment of their and their employers' contributions, but from the contributions of the workforce and their employers in the future. This is why there is growing concern about the ability of future governments to be able to fund state pensions for many more retired people beyond a basic subsistence level.

### Occupational schemes

The UK has had, for many years, one of the most extensive and effective systems of occupational pension provision in the world. There are over 150,000 separate schemes in operation with combined assets worth approximately £600 billion. Just over 10 million people are members of occupational pension schemes, while around eight million pensioners draw an income from their funds (Government Actuary's Department 2003). Although there has been some reduction recently in the proportion of the workforce covered by occupational pensions, they remain by far the most significant employee benefit in terms of their cost to employers.

In general, occupational schemes provide an additional retirement pension on top of the state pension, providing better and wider-ranging benefits than the state schemes and a great deal more flexibility. They are most often found in large organisations and the public sector, but some smaller organisations also run such schemes. Men and women have equal access to occupational schemes and, since 1990, have had to be treated equally in respect of all scheme rules. Yet, in spite of this, men and women continue to fare differently in terms of pensions benefits due to the typical pattern of women's employment being different from male patterns and women's longer average life expectancy. A higher proportion of managerial and professional workers have occupational pensions than other groups, blue-collar workers being the least likely to be in schemes. It is no longer lawful for an employer to exclude part-time or temporary workers.

With the exception of one or two in the public sector, occupational schemes do not pay their pensioners in the pay-as-you-go manner operated by the state, but create a pension fund, which is managed separately from the business. The advantage of this is that should the organisation become bankrupt, the pension fund cannot be seized to pay debtors because it is not part of the company. The money in the pension fund is invested and held in trust for the employees of the company at the time of their retirement.

Larger organisations administer their own pension funds through an investment or fund manager. The manager will plan how to invest the money in the fund to get the best return and to ensure that the money that is needed to pay pensions and other

benefits will be available when required. An actuary can provide mortality tables and other statistical information in order to assist planning and must be hired regularly to carry out a formal actuarial assessment of the scheme's assets and liabilities. Smaller organisations tend to appoint an insurance company or a bank to administer their pension funds, and so use their expertise. Pension funds can be invested in a variety of different ways, and are often worth more than the market value of their sponsoring companies. As a result they have come to dominate investment on the stockmarket.

During the 1990s as the worth of stocks and shares increased, the typical pension fund found itself in surplus. It thus had more assets than it needed to pay its liabilities. As a result benefit levels were increased and many employers were able to enjoy lengthy 'contribution holidays', meaning that they did not have to put any money into their funds. In recent years this position has changed radically as stockmarkets have fallen, life expectancy has risen, the amount of taxation levied on the funds has been increased and costly new regulations have been imposed. By the end of 2002 all but nine of the FTSE 100 companies (i.e. the largest in the country) had pension funds in deficit, the combined shortfall amounting to £77 billion. This was equivalent to 93 per cent of their annual operating profits. The figures for smaller companies were even worse, their fund deficits representing over 130 per cent of operating profits (IRS 2003). New accounting regulations, known as FRS17 standards, threaten to make the situation worse after 2005 as they will require companies to include details of pension fund assets (and hence the substantial deficits) in their annual accounts. The current picture, from an employer's point of view, is thus one of very substantial escalating costs and far less predictability about how much by way of a contribution the organisation will have to make each year. This has resulted in profound changes being made by many private sector funds, which have substantially reduced the likely level of pension that many employees will receive when they retire. At the time of writing (early 2004) an improved stockmarket position has led some commentators to contend that the worst is over and that we will begin to see a reversal of recent trends, but there is little sign of this happening in practice (IRS 2004, p. 31). Occupational pensions take one of three basic forms.

**Defined benefit schemes** dominated for the past thirty or forty years, but the number of people with access to them has declined hugely in the last two or three years. Virtually all the public sector schemes take this form, but they now account for just 42 per cent of the schemes offered by private sector employers. Even among larger employers, only 66 per cent now operate defined benefit schemes (National Association of Pension Funds, 2003). Here contributions are made into a single organisation-wide fund which is invested on behalf of members by a fund manager. Retired employees then draw a pension from the fund calculated according to a defined formula. Most defined benefit schemes take the final salary form, in which the value of the pension is determined by the level of salary being received by each individual at the time of retirement. In the private sector it is common for this to be calculated on a 'sixtieths' basis, whereby the retiree is paid an annual pension equivalent to 1/60th (1.67 per cent) of their final salary multiplied by the number of years' pensionable service they have completed. In the public sector it is usual for the figure to be based on 'eightieths', with a tax-free lump sum being paid in addition at the time of retirement. In either case the size of pension is heavily related to the length of scheme membership, the maximum pension payable equalling two-thirds of final salary. Examples of final salary calculations are given in Figure 29.1.

**Figure 29.1**  
Final salary schemes – examples of various contribution periods with a 1/60th and a 1/80th scheme

<b>Sixtieths scheme</b>	
Final salary	= £24,000
Contributions for 5 years	= $1/60 \times 24,000 \times 5$
Pension	= £2,000 per year
Final salary	= £24,000
Contributions for 25 years	= $1/60 \times 24,000 \times 25$
Pension	= £10,000 per year
Final salary	= £24,000
Contributions for 40 years	= $1/60 \times 24,000 \times 40$
Pension	= £16,000 per year
<b>Eightieths scheme</b>	
Final salary	= £24,000
Contributions for 25 years	= $1/80 \times 24,000 \times 25$
Pension	= £7,500 per year
Lump sum	= $3/80 \times 24,000 \times 25 = £22,500$

Another form of defined benefit scheme bases the pension calculation on the average salary earned over a period of 5, 10 or 20 years prior to retirement rather than on pay in the final year. Unless most of someone's pensionable service has been spent earning close to the final salary level, such schemes are less generous than the final salary variety in terms of the amount of pension paid. High levels of inflation also reduce the value of pensions calculated on an average salary basis.

Most defined benefit schemes are contributory. This means that monies are paid into the fund on a regular basis by both the employer and the employee. In the case of employees the contribution is fixed as a percentage of salary (typically 5 per cent), a sum which is subject to tax relief. Employers, by contrast, are obliged only to pay in sufficient funds to ensure that the scheme remains solvent. When the pension fund is in surplus, as many were in the 1980s and 1990s, employers can take 'contribution holidays'. By contrast, when the fund is in deficit, the employer has to contribute whatever is necessary to ensure that assets are sufficient to meet possible liabilities. This means that the amount of employer contribution can vary considerably, year on year, in an unpredictable fashion. In 2003 contribution rates for employers were averaging 15–16 per cent of salary (NAPF 2003). Employers, like employees, gain from tax relief on contributions paid.

In some industries, as well as parts of the public sector, it has been traditional for occupational pensions to be non-contributory. In such schemes the employee makes no contribution at all, but nonetheless draws a pension calculated according to the final salary. Civil servants benefit from this kind of arrangement, as do many employees in the banking and finance sectors. Defined benefit schemes typically offer extra benefits such as ill-health pensions for those forced to retire early and death-in-service benefits for widows and widowers.

**Defined contribution schemes** (also known as money purchase schemes) are organised in a totally different way from defined benefit arrangements, and there are no promises about what the final level of pension will be. Employees and employers both contribute a fixed percentage of current salary to these schemes, usually 5 per cent or 6 per cent on a monthly basis. The pension benefits received are then entirely dependent on the money that has been contributed and the way that it has been invested. Where investments perform well, a good level of pension can be gained.

Where investments are disappointing, the result is a low level of pension. Further uncertainty derives from the way that money purchase schemes result in the payment of a single lump sum to the employee when he/she retires. This is then used to buy an annuity from an insurance company from which a weekly or monthly income is paid for life. Annuity rates vary considerably from year to year, and there is also considerable variation between the deals offered by different providers. In essence this means that the risk associated with pension investments is carried by the employee in a defined contribution arrangement, rather than by the employer as in a final salary scheme. For this reason defined contribution schemes are generally less satisfactory than defined benefit schemes when seen from an employee's perspective. Investments have to perform unusually well while inflation remains low for a money purchase scheme to give an equivalent level of benefit. However, despite these drawbacks, money purchase schemes are more flexible and more easily transferable than defined benefit arrangements. For people changing jobs frequently or working on a self-employed basis for periods of time, particularly during the early years of a career, they can thus be a more attractive option.

In recent years there has been a strong trend away from defined benefit schemes and towards defined contribution provision. At the time of writing 62 per cent of all UK schemes are of the money purchase variety, compared with only 5 per cent in 1990 (National Association of Pension Funds 1992 and 2003). The majority of newly established schemes take the defined contribution form, while many organisations now offer only a money purchase scheme to new employees. By 2003 all but 19 per cent of final salary schemes in the private sector had been closed to new members.

The trend has coincided with a period in which long contribution holidays have come to an end and in which the amount of regulation to which defined benefit schemes are subject has increased substantially. Employers have thus taken the opportunity to reduce their own liabilities and to move to a form of provision which is more predictable financially from their point of view. Many employees are less well served as a result, but the lack of appreciation and understanding of pensions issues referred to above has allowed employers to make the change without becoming any less attractive in the labour market.

**Hybrid schemes** too are becoming more common, although as yet they represent a small minority of UK pension funds. These, in various different ways, combine elements of the defined benefit and defined contribution forms of provision. The most common form is the 'money purchase underpin' which is basically a final salary arrangement, but one which calculates pensions and transfer values on a money purchase basis where these are higher. Such schemes seek to combine the best aspects of both main types of scheme. They offer a generous, secure and predictable pension, but also incorporate the flexibility associated with defined contribution schemes.

### ACTIVITY 29.2

Which of these three types of occupational pension scheme would you find most attractive at the current stage in your career? Under what circumstances might you change your preference?



## Group personal pensions

Since the 1980s there has been substantial growth in the market for personal pensions. Self-employed people have always needed to be concerned with making their own provisions for retirement, as they have been excluded from joining S2P, and before that SERPS. More general attention has been focused on this area due to increasing job mobility and the perceived greater portability of personal pensions. A personal pension is arranged, usually through an insurance company, and the individual pays regular amounts into their own 'pension fund' in the same way that they would with a company fund. The employer may also make a contribution to the fund, but at present there are very few employers who have chosen to do so.

An alternative arrangement is a Group Personal Pension plan (GPP) set up by an employer instead of an occupational pension scheme. From a legal and taxation perspective a GPP is no different from any individual personal pension arrangement, but charges are lower because the employer is able to arrange a bulk discount. The scheme is administered by an insurance company, the employer making contributions as well as the employee. Pensions are calculated on the same basis as an occupational money purchase scheme, but tend to be less extensive because employees are responsible for paying some of the administrative charges. From an employee perspective a GPP is inferior to an occupational pension scheme, but is better than a situation in which no employer provision is made at all. Such arrangements are mainly entered into by small firms, but one or two big companies have also set them up in place of conventional occupational pensions.

### WINDOW ON PRACTICE

#### Pension scandals

Following the introduction of personal pensions in 1988 many thousands of employees who were members of occupational schemes were persuaded by salespeople working for insurance companies to leave their employers' schemes and take out inferior personal pension products instead. This became known as the 'pensions mis-selling scandal' because so many people lost out as a result. The government has required the companies concerned to compensate the individuals who were mis-sold pensions, but by 2001 there were still thousands of cases outstanding and waiting to be settled. This scandal, combined with the discovery in 1992 of the defrauding of the Mirror Group pension funds by Robert Maxwell, served to harm the reputation of the UK pensions industry. Mr Maxwell had used the funds to prop up ailing businesses owned by his group. Their combined worth was greater than the value of the companies themselves. When the group collapsed, the funds intended to pay past and present pensioners were found to have disappeared. Robert Maxwell committed suicide.

The government responded to public concern by setting up a committee under the chairmanship of Professor Roy Goode to examine the whole field of pension fund regulation. The result was the Pensions Act 1995, which substantially altered UK law on pension funds. In more recent years many have argued that the measures introduced in 1995 went too far in imposing new regulation. Government now talks about reducing the regulatory burden, but in terms of action the trend continues in the opposite direction.

## Stakeholder pensions

A new form of government-sponsored pension arrangement, the stakeholder pension, was established in 2001. These are aimed primarily at the five million or so middle income earners (that is, those earning in the £10,000 to £20,000 a year range) who do not have access to an occupational scheme. The aim is to reduce the number of people in future decades who are reliant on state pensions for their retirement income.

A stakeholder pension scheme can be operated by an employer, a financial services company or a trade union. They operate along money purchase lines and are regulated by established authorities. Charges are kept low because providers are obliged to follow minimum standards set by the government. Employers are not obliged to make contributions to a stakeholder pension, but must provide access to one through their payroll. If employees join a scheme, for example one provided by their trade union, the employer is therefore obliged to make deductions via the payroll out of pre-tax income.

Views vary on whether or not the stakeholder scheme can be hailed as a success. Supporters point to the fact that over 600,000 plans have now been set up, while critics stress that 80 per cent of these are 'designation only' which means that no money has actually been invested in them. Moreover, because many of the schemes which are being used are set up by employers to replace existing money purchase plans, it would seem that relatively few of the 5 million target group are actually benefiting in practice.

## OCCUPATIONAL PENSIONS AND HRM

While occupational pension schemes are governed by a board of trustees which includes member representatives, in most organisations the pensions manager and pensions department are part of the HR function. It is thus important that HR professionals are familiar with the types of scheme offered and the main operating rules so that they can give accurate and timely advice to staff and to potential recruits. They also need to be familiar with the regulatory environment for occupational pensions, which has changed considerably in recent years. Aside from new legislation outlawing discrimination on grounds of sex or against part-time and temporary staff, several other important regulatory changes have been made and new regulatory bodies established. The Pensions Act 1995 now sets out in detail what information must be disclosed to scheme members on request and what must be sent to them automatically each year. The Act also requires all occupational funds to meet a defined minimum funding level so that they are always able to meet their liabilities in the event of the employing company being wound up. Moreover, strict restrictions are now placed on 'self-investment', making sure that fund assets cannot be invested in property or other business ventures controlled by the sponsoring organisation. However, the most important single piece of legislation was the Social Security Act 1985 which put in place a series of measures to protect 'early leavers', ensuring that people who switch employers during their careers do not suffer substantial loss in the value of their pensions.

Early leavers now have one of three options in making their pension arrangements when they begin work for a new employer. One option is to claim back the

contributions that the individual has made into the former employer's pension scheme. Deductions are made in accordance with tax laws, and of course, the employer's contribution is lost, but a substantial sum can be reinvested in the new employer's scheme or in a personal pension. Another alternative involves opting for a preserved pension. With a final salary scheme, if there were no inflation, and if the individual progressed very little up the career ladder, a preserved pension from an old employer plus a pension from the recent employer would equate well with the pension they would have received had they been with the new employer for the whole period. However, if these conditions are not met, which in recent times they have not been, individuals who have had more than one employer lose out in the pension stakes. Past employers are required to revalue preserved pensions in line with inflation (to a maximum of 5 per cent), but the value of such a pension remains linked to the level of salary at the date of leaving.

The third option is usually preferable, but is only open (in 2004) to people who have completed two years' membership of a scheme. This involves the transfer of the pension from the old employer's fund into that of the new employer. The process is straightforward in the case of a money purchase scheme, because the worth of each person's pension is readily calculated. It is simply the value of the employee's contributions, plus those of the employer, together with funds accrued as a result of their investment. The process is more complicated in the case of a final salary scheme, the transfer value being calculated according to standard actuarial conventions which take account of the employee's age, their length of pensionable service, the level of salary at the time of leaving and the current interest rate. All things being equal, 'early leavers' still fare worse than 'stayers' in terms of final pensions, but the difference is a great deal less than used to be the case.

Aside from giving advice and taking overall responsibility for pensions issues, HR managers are concerned with determining their organisations' pension policy. Is an occupational pension to be offered? If so, what form should it take? What level of contribution is the employer going to make? It is quite possible to make a judgement in favour of generous occupational provision simply on paternalistic grounds. Many organisations have thus decided that they will offer pensions because it is in the interests of their staff that they should. Occupational schemes represent a convenient and tax-advantageous method of providing an income in old age; it therefore makes sense to include a pension in the total pay and benefits package. The problems with such a commitment, particularly in the case of defined benefit schemes, are the cost and the fact that the long-term financial consequences are unpredictable. This, combined with the fact that many employees do not seem to appreciate the value of an occupational pension, means that many employers are now questioning their commitment to final salary schemes and to pension provision in general.

Research suggests that interest in and understanding of occupational pensions varies considerably from person to person (Goode 1993; Taylor 2000). Older people, professional workers and those working in the financial services sector usually have a clearer perception of their value than other groups of staff. For these groups pensions are important, and their labour market behaviour will be affected as a result. A firm which does not offer a good pension will thus find it harder to recruit and retain them than one which does. By contrast, a firm which largely employs younger people, and/or workers in lower-skilled occupations, may find that it makes more sense to offer additional pay in place of an occupational scheme.

### ACTIVITY 29.3

It has been argued that by making occupational pensions readily transferable, by increasing the complexity of the regulatory regime and by increasing taxation levied on pension funds, successive governments have provided a major disincentive to employers considering the establishment of a scheme. To what extent do you agree with this point of view?



### SICK PAY

As with pension schemes, the provision of sick pay is seen as the mark of a good employer. Sick pay is an important issue due to the need for control and administration of absence. Research suggests that sickness absence represents around 4 per cent of working time (CBI 2000), although there are large differences between sector and job type. The HR manager and the HR department have a variety of roles to play in relation to sick pay, particularly since the introduction of statutory sick pay in 1983 when state sick pay in addition to occupational sick pay became managed by the employer.

#### Statutory sick pay (SSP)

Statutory sick pay is a state benefit that has been in existence for several decades. It provides a basic income (£64.35 per week in 2004) to employees who are incapable of going to their normal place of work as a result of illness. SSP, however, is not claimed from a benefit office; it is administered by employers and paid through the payroll according to regulations set out in statute.

Since 1994 employers have been required to take full financial responsibility for SSP for the first four weeks of absence, after which they can claim back a portion of the costs from the state through reduced employer national insurance contributions. However, the method of calculation used now ensures that smaller employers are able to claim back a very considerably higher proportion of the costs than larger employers who usually have to fund it all themselves. Most employees are entitled to state sickness benefit; however, there are some exceptions: employees who fall sick outside the EU, employees who are sick during an industrial dispute, employees over pensionable age and part-timers whose earnings are below the lower earnings limit (£77 per week in 2004). These groups, as well as self-employed people, are obliged to claim state incapacity benefit instead from the Benefits Agency. SSP is built around the concepts of qualifying days, waiting days, certification, linked periods, transfer to the Department for Work and Pensions (DWP) and record periods.

**Qualifying days** are those days on which the employee would normally have worked, except for the fact that he or she was sick. For many Monday-to-Friday employees this is very straightforward. However, it is more complex to administer for those on some form of rotating week or shift system. Sick pay is only payable for qualifying days.

**Waiting days** have to pass before the employee is entitled to receive sick pay – at present the number of days is three. These three days must be qualifying days, and on the fourth qualifying day the employee is entitled to sickness benefit, should he or she still be away from work due to sickness.

**Certification** from a doctor is required after seven days of sickness absence. Prior to this the employee provides self-certification. This involves notifying the employer of absence due to sickness by the first day on which benefit is due – that is, immediately following the three waiting days.

**Linked periods** of illness mean that the three waiting days do not apply. If the employee has had a period of incapacity from work (PIW) within the previous eight weeks, then the two periods are linked and treated as just one period for SSP purposes, and so the three waiting days do not have to pass again.

The employer does not have to administer SSP for every employee indefinitely. Where the employee has been absent due to sickness for a continuous or linked period of 28 weeks the responsibility for payment passes from the employer to the state. A continuous period of 28 weeks' sickness is clearly identifiable. It is not so clear when linked periods are involved. An employee who was sick for five days, back at work for four weeks, sick for one day, at work for seven weeks and then sick for two days would have a linked period of incapacity of eight days. Alternatively, an employee who was sick for four days, back at work for ten weeks and then sick for five days would have a period of incapacity this time of five days. The DWP requires employers to keep SSP records for three years so that these can be inspected.

### **Occupational sick pay**

There is no obligation on employers to pay employees for days of absence due to sickness beyond what is required under the state's SSP scheme. However, most employers choose to do so via a benefit known as occupational sick pay (OSP). The most common approach is to continue paying the full salary for a set period of time, but other schemes involve reducing the pay rate for days taken off as a result of illness. In either case a sum in excess of the statutory minimum is paid, the portion accounted for by SSP being reclaimed from the state where possible. Paying the full salary is straightforward for those staff who receive a basic salary with no additions. It is more difficult to define for those whose pay is supplemented by shift allowances or productivity bonuses.

Occupational sick pay arrangements tend to be most generous in unionised environments and in the public sector, although professional and managerial employees are usually well covered in most organisations. The common public sector approach involves paying full pay for the first six months of an illness, once three years' service have been completed, before moving the employee on to half-pay for a further six months. Thereafter OSP ceases. At the other end of the scale are employers who pay no OSP at all. They take the view that occupational sick pay will be abused and so pay only what is due under the state scheme. Another approach involves paying a predetermined flat rate in addition to money provided via SSP.

Occupational sick pay schemes also vary according to the period of service required. Some employers provide sick pay for sickness absence from the first day of employment. Others require a qualifying period to be served. For some this is a nominal period of four weeks, but the period may be three or six months, or a year

or more. There is a major difference here between OSP and SSP. With SSP pay is available immediately after employment has begun.

We covered the methods used in order to support the section on managing absence effectively in Chapter 15.

## COMPANY CARS

A form of employee benefit which is a great deal more common in the UK than in other countries is the company car, nearly 2 million employees enjoying this benefit in 2000 (IRS 2000b, p. 2). Managers from overseas often take some persuading that cars are necessary to attract and retain high-calibre managers, but the received wisdom is that they are. Their importance to employees is demonstrated by the comparative lack of take-up of cash alternatives where these are offered (Smith 2000a, p. 161). After pensions, they are the second most significant employee benefit in cost terms, and are provided for some employees by over 90 per cent of large and medium-sized companies.

There are a number of sound reasons underlying the provision of company cars. First, for some there is a need as part of their jobs to travel very widely and regularly. Not everyone can be assumed to own a reliable car, so it is sometimes necessary to provide one simply to enable an employee to carry out his/her day-to-day job duties. In the case of sales representatives and senior managers the impression created when travelling on company business can be important. It is therefore often considered necessary to provide them with upmarket and up-to-date models to ensure that clients and potential clients are suitably impressed. A case can also be made on cost efficiency grounds for people who clock up a great number of business miles each year. The cost of paying them a reasonable mileage allowance to drive their own cars is often greater than the cost of providing them with a company vehicle; it costs £9,000 a year to reimburse someone who has travelled 30,000 miles at 30p per mile.

However, most possessors of company cars do not fit either of the above categories. Their car entitlements simply come as an expected part of the pay package for middle and senior managers. As such, they signify the achievement of a certain level of status. Indeed, in many companies the cars offered become steadily more imposing as people climb up the corporate hierarchy. Being upgraded to a more impressive car thus signifies in a very manifest way the company's approval. Downgrading, of course, has the opposite effect.

One of the reasons that company cars are so significant in the UK is historical, because before April 1994 they were a highly tax-efficient benefit. It was a good deal cheaper to drive a company car than to purchase one's own out of taxed income, so it made sense for people to be 'paid' in part with a car. This is now far from being the case.

The current tax regime introduced in April 2002 encourages employers to lease or purchase cars which are environmentally friendly. Until then company cars were simply taxed according to the number of miles driven on company business, the annual tax paid by the driver being equivalent to a percentage of the car's list price. The more business miles clocked up, the less tax was paid. In addition there were substantial discounts for people who drove older cars. Now the tax paid depends on carbon emissions or engine size and there are no reductions for people who drive a great number of miles or use an older vehicle. So there is a substantial incentive for

people who drive a great deal as part of their jobs to use smaller cars or larger ones with low carbon emissions. Most employers offer cash alternatives equal to the tax payable on the car (IDS 2002b, p. 1), but many of those eligible choose not to take these up despite the fact that there are no longer any obvious tax advantages associated with driving a company car. This is partly because company cars tend to be more expensive than individuals could justify spending from their own income, but mainly because of the substantial savings that still accrue in terms of insurance, maintenance and repair costs. The tax changes have, however, led to a preference for ‘trading down’. This means where a choice is given, employees are increasingly opting for a smaller car and more cash in their pay packets.

A major policy choice faced by employers in the provision of cars is whether to buy or lease their fleet. There are advantages and disadvantages associated with both approaches, much depending on the nature of the deal that is struck with a leasing company. Where the company is reputable and where the agreement provides for insurance, maintenance and repair of vehicles, the financial case for leasing is strong.

#### ACTIVITY 29.4

Assume that you have been offered a new job which comes with either the use of a new company car or a cash allowance. The salary is £35,000 per year. The car is worth £15,000, giving you an annual tax bill of £5,250. This is also the amount being offered by way of an annual cash allowance. Which option would you choose and why?



### LONDON ALLOWANCES

Most larger employers pay a standard, organisation-wide allowance or salary weighting to employees working in central London. In some cases such allowances are also paid to employees working in the region around London. The purpose is to attract and retain staff who are obliged to live and commute in the capital where the cost of property, transport and parking is so much higher than it is elsewhere in the country. The typical level of allowance is between £3,000 and £4,000 a year, the highest sums being paid by the finance houses of the City and the lowest by the retailers and public sector employers. According to IDS (2002c), the level of allowances has tended to rise more slowly than wage inflation generally and have often been frozen for a number of years. This has occurred because employers are increasingly moving towards the development of wholly separate London-based salary scales. The flat-rate allowance has thus become a less significant part of the total pay packet, allowing employers to target resources on the groups who are hardest to recruit. In tight labour markets, therefore, there is now a greater differential between pay rates in and out of London than was the case ten years ago.

### FLEXIBLE BENEFITS

Flexible benefits or ‘cafeteria plans’ have proliferated in the United States over recent years where they are specifically recognised in the tax regime. By contrast, take-up of

the idea in the UK has been slow (Smith 2000b, p. 379). However, several high-profile organisations have moved towards greater flexibility, and the case for others doing so is strong. Such flexibility involves giving individual employees a choice as to how exactly their pay packet is made up. The overall value of the package is set by the employer, but it is for employees to choose for themselves what balance they wish to strike between cash and the different kinds of benefit. Those who have children, for example, can opt for benefits that are of value to them such as childcare vouchers, access to a company crèche or additional holidays. A young person in their first job might well prefer to forgo most benefits in return for higher take-home pay, while an older person may wish to purchase additional years of pensionable service in exchange for cash or perhaps a car.

There are a number of good reasons for considering such an approach. First, it helps ensure that employees are only provided with benefits which they are aware of and appreciate. Resources that would otherwise be wasted by providing unwanted benefits are thus saved. The employer gets maximum value per pound spent, while at the same time allowing employees to tailor their own 'perfect' benefits mix. The result should be improved staff retention and a better motivated workforce.

#### WINDOW ON PRACTICE

In 1998 a large-scale merger took place between two of the world's largest professional services firms – Price Waterhouse and Coopers & Lybrand. The merged firm, called PricewaterhouseCoopers, employs 150,000 people in 150 different countries. While the two organisations were culturally similar, they had rather different traditions in the provision of benefits. Rather than continue with different people employed on different sets of terms and conditions, partners decided to harmonise everyone as soon as was possible. This process was made a great deal easier and less contentious by the decision to develop a new flexible benefits scheme called 'Choices'. It allows employees to trade cash for additional holiday, a choice of car, childcare vouchers, retail vouchers, insurance of various kinds and a pension. No one was required to alter their existing benefits package as a result of the merger unless they wished to.

Source: O. Franks and D. Thompson (2000) 'Rights and rites of passage', *People Management*, 17 February.

Flexible benefits plans take many different forms, the main distinction being between those that are 'fully flexible' and those that allow a degree of flexibility within prescribed limits. The former allow employees a free hand to make up their own package and to change it at regular intervals. Under such a regime an employee could theoretically swap all benefits for cash, or could double their holiday entitlement in exchange for a pay cut. A degree of restriction is more common, a compulsory core of benefits being compulsory, with flexibility beyond that. Under such a scheme everyone might be required to take four weeks' holiday and invest in a minimal pension, but be allowed freedom to determine whether or not they wished to benefit from private health insurance, gym membership, discounts on company products, etc. Typical plans also permit some choice of the make and model of car.

A third approach is administratively simpler but is more restrictive in terms of employee choice. This involves ‘prepackaging’ a number of separate benefits menus designed to suit different groups of employees (rather like a pre-set banquet menu in a Chinese restaurant). Employees must then opt for one package from a choice of five or six, each having the same overall cash value. One is typically tailored to meet the needs of older staff, another is for those with young families, a third for new graduates and so on.

A number of disadvantages with flexible benefits systems can be identified which may well explain their slow development in the UK. These are summarised by Smith (2000b) as follows:

Objections include difficult administration; problems connected with handling individual employee choices; the requirement for complex costing and records; difficulty in getting employees to make effective choices; employees making mistakes (for example leaving themselves with inadequate pension cover); employees’ circumstances changing over time leaving his or her package inappropriate and giving the employer the costly headache of re-designing the package; and finally the possible hiring of expensive specialist or consultant skills and financial counselling to support the move to flexibility.

Uncertainty about the future tax position may also be a deterrent, especially where changes have the potential to throw a whole system out of kilter (as happened in 1997 when the Chancellor of the Exchequer substantially extended taxation on pension fund investments). Good advice about how to overcome these obstacles, together with examples of UK-based schemes in operation, is provided in IDS (1998). A case study outlining the approach taken by Lloyds TSB, which operates one of the largest UK schemes, is provided in IRS (2003b).

## SUMMARY PROPOSITIONS

- 29.1** Between 20 per cent and 50 per cent of the typical employer’s pay bill is spent on the provision of supplementary benefits. Evidence suggests that most employees do not appreciate the true financial value of such benefits.
- 29.2** Occupational pensions are a tax-efficient means of providing funds for retirement in excess of what is provided by state and personal pension schemes.
- 29.3** Occupational pensions take one of three forms: defined benefit, defined contribution and hybrid. Employers can choose as an alternative to set up a group personal pension or to provide a stakeholder pension under the government’s scheme.
- 29.4** Employers are required to facilitate the payment of statutory sick pay to employees who are away from work as a result of an illness. Most pay occupational sick pay in addition either as a result of moral obligation or in order to attract, retain and motivate their workforces.

- 29.5** Company cars are commonly provided by UK employers for senior staff. The tax regime introduced in 2002 aimed to discourage demand for larger cars which are not environmentally friendly.
- 29.6** In theory, flexible benefits plans have a great deal to offer employees. It is likely that their use will grow more widespread in the next few years.

### GENERAL DISCUSSION TOPICS

- 1 Why do you think so few people seem to have an appreciation of the value of their occupational pensions and other benefits? What could be done to raise awareness of the costs involved in their provision?
- 2 Draw up three flexible benefits packages; one aimed at new graduates, one at employees in their thirties, and one for those aged over 50.

### FURTHER READING

Chartered Institute of Personnel and Development

CIPD provides up-to-date information about organisational policy on pensions and benefits, as well as about priorities for benefits managers, in this annual survey (published in February each year).

CIPD (2002) *Pensions and HR's role: a guide*. London: CIPD

This useful guide reviews all the current pressures facing organisations seeking to offer decent occupational pensions for their employees and puts forward suggestions about possible ways forward from an HR perspective.

*Employee Relations*

A special edition of *Employee Relations* also focused on occupational pensions from an HR point of view.

Incomes Data Services

Industrial Relations Services

Extensive coverage to these issues is given in the IDS and IRS publications listed in the References below.

Smith, I. (2002a) 'Benefits', in G. White and J. Druker (eds) *Reward Management: A Critical Text*. London: Routledge

Smith, I. (2002b) 'Flexible plans for pay and benefits', in R. Thorpe and G. Homan (eds) *Strategic Reward Systems*. London: Financial Times/Prentice Hall

These two chapters provide the best introductions to flexible benefits in the UK context.

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An extensive range of additional materials, including multiple choice questions, answers to questions and links to useful websites can be found on the Human Resource Management Companion Website at [www.pearsoned.co.uk/torrington](http://www.pearsoned.co.uk/torrington).

