

Public Sector
Pensions Commission



Reforming Public Sector Pensions

Solutions to a growing challenge

July 2010



The report of the Public Sector
Pensions Commission

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Terms of Reference

The Public Sector Pensions Commission has been set up as a result of an initiative from the Institute of Economic Affairs, the Institute of Directors and other groups and is chaired by an independent actuary.

Its terms of reference are to improve transparency and public understanding of public sector pension costs and present to the new Government a realistic set of options for reform of the present public sector pension arrangements. It is increasingly clear that, with ever-increasing longevity, reform is necessary to ensure that public sector pensions remain financially sustainable for the long term.

We are grateful for all the ideas provided by the respondents to our call for evidence and to those who have reviewed and commented on earlier drafts of this report, in particular to Carl Emmerson, Nick Silver and Martin Weale. Naturally any errors or omissions are our own.

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Ros Altmann is an economist and pensions expert, working as an independent policy adviser. Having managed pension portfolios in the City for 15 years as Head of International Equities for Chase Manhattan and a Director at Rothschild and NatWest Investment Management, Ros then went on to advise government, private companies and trustees on pension issues. She was an adviser to the UK Treasury, Tony Blair's Number 10 policy unit and also the Lord Chancellor's Strategic Investment Board. Ros is a Governor of the London School of Economics and the Pensions Policy Institute, a Trustee of the Trafalgar House Pension Trust and the Age Employment Network. She has a Ph.D. degree in pension economics from LSE and was recently awarded an honorary Doctorate of Letters by the University of Westminster for her contribution to pension investment education. Ros is recognised as a leading independent authority on all aspects of pensions policy, speaks at industry conferences, writes for leading journals and newspapers and has won several major pension industry awards.

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Neil Record was educated at Balliol College, Oxford, Essex University and University College, London, from where he gained an MSc in Economics. His early career included a spell in the Economic Intelligence Department of the Bank of England, and in 1983 he founded Record plc, a currency risk and asset manager, now quoted on the London Stock Exchange. He is the author of *Sir Humphrey's Legacy* (IEA 2006) and *Public Sector Pensions – the UK's Second National Debt* (Policy Exchange 2009), which both analyse the costs and liabilities of the UK's unfunded public sector pensions. He is a Trustee of the Institute of Economic Affairs and visiting Fellow at Nuffield College, Oxford.

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Corin Taylor, Institute of Directors, Secretary

Corin Taylor is a Senior Policy Adviser at the Institute of Directors. He also sits on the Social Return on Investment Steering Group at the Centre for Social Justice and is a Senior Fellow at the Economic Policy Centre. He was previously a member of the Economic Dependency Working Group at the Centre for Social Justice, Research Director at the TaxPayers' Alliance, Political Secretary at the Tax Reform Commission and Economics Research Officer at the think tank Reform. He has also written for the Centre for Policy Studies, Civitas and Policy Exchange think tanks on a freelance basis.

Foreword

Pension provision is changing – not only in the UK but across a developed world accustomed to good provision for income in old age.

The principal reason for change is that populations in all advanced economies are living longer than their parents or grandparents could have dreamed when they set up pension plans as a way of funding for retirement. People expect to enjoy retirement for at least twice as long as previous generations could.

This rise in costs has been highly visible for funded private sector plans. Faced with increased funding demands from their plans, many employers have simply closed them and moved the risk on to their employees by setting up defined contribution savings arrangements instead. However, at least in the UK, the opacity of the cost of pensions in the public sector has meant that there have been only modest changes in public sector pension provision. As a result, there is now a stark divide between what public employees expect out of retirement and what their private sector equivalents can expect.

A major barrier to appreciation of the scale of the public sector challenge is the way in which the cost of providing pensions is hidden. The UK Government has hidden behind costings which pretend that the unfunded schemes earn a return on their “investment” well above what it costs the Government to meet obligations to pay out equivalent inflation-linked promises on its own bonds. A true assessment of the value of pensions in the public sector today suggests they are worth twice what the Government suggests in its calculation of the contributions that public sector employers pay. It is a matter both of justice and of good economics that public sector employers and employees should bear the full cost of their pension provision as it accrues.

So long as those contributions are sufficient to pay the public sector pensions of today, the cash flows in and out steadily and in balance. Of late, however, the amount the Treasury has to pay to top pensions up has risen and will rise still further into the future. Like an unstable Ponzi scheme, it will only work if tomorrow’s generations of new members and taxpayers is able to stomach a higher cost to pay tomorrow for the unfunded promises being made today.

Unless costs are recognised as they are incurred, poor decisions will be made as to the cost of recruitment and retention of public sector employees. The employees themselves will fail to appreciate the true worth of their pension promises.

This report starts from the premise that we must recognise first what pensions cost and are worth and then ensure that both accounting procedures and benefits are designed in such a way that costs that cannot be afforded by the current generation are not passed on to the next generation. Various options are costed and offered for discussion in the context of a careful review of the funding challenges for pensions in the public sector in the future.



Peter Tompkins

Chairman of the Public Sector Pensions Commission

Executive Summary

This paper presents the work of the Public Sector Pensions Commission, laying out a realistic set of options for reform of the present unfunded public sector pension arrangements. With ever-increasing longevity, reform is necessary to ensure that public sector pensions remain financially sustainable for the long term.

The case for reform

One reason why pension arrangements in the public sector need to be re-examined is that people are living longer and longevity is increasing faster than was expected a few decades ago. This is a welcome development, but it means that today pensions have to be provided to more people for a greater number of years than originally intended. The status quo is simply not an option:

- In 1951, most men working in manual jobs would not have lived long enough to claim the then-new basic state pension. Now, life expectancy for men and women is around 80, and people reaching the age of 65 are living almost another 20 years on average. In 50 years' time, life expectancy at 65 could reach 30-35 years. Certainly for individuals who retire at 60 – not unusual in the public sector – many people could spend longer retired than working.
- Official projections suggest that, in 50 years' time, it is possible that every person over 65 could be supported by just two people of working age, compared with four today, while there could be only one person of working age to support each dependent person (including children) overall.

Pensions have to be provided to more people for a greater number of years than originally intended.

There are six key problems with the present unfunded public sector pension arrangements. Some of these problems relate directly to increased costs. Other problems, though, relate to the way in which costs are accounted for – costs are hidden therefore obstructing rational decision making. The six key problems we have identified are:

- **Lack of transparency.** Firstly, the Government uses an artificial discount rate to report unfunded liabilities, based on AA-rated corporate bonds, rather than a more pertinent discount rate based on index-linked gilts (inflation-linked securities issued by the Government to finance its borrowing). Since the Government's chosen discount rate is higher, it has the effect of lowering the value of the outstanding liabilities. Secondly, public sector employers and employees are not charged the full current service costs of the liabilities the pension schemes are taking on each year: a completely different discount rate chosen by the Government is used to compute these. This also means that employees undervalue the benefit of a public sector pension. According to government numbers, the main unfunded schemes have combined employee and employer contribution rates of around 20 per cent of salary. The true value of such schemes, when measured using a discount rate based on the current yields (0.8 per cent) on index-linked gilts, is over 40 per cent of salary. Even when measured by discounting according to a long-term real gilt return of 2 per cent in line with economic growth at that level, the true value comes out at almost 30 per cent of salary.
- **Large unfunded liabilities.** The unfunded public sector pension liabilities are estimated at between £770 billion (HM Treasury – 31 March 2008, the latest published figure) and £1,176 billion (Towers Watson). We believe the true figure to be much closer to the larger estimate. While these liabilities will not need to be

paid off in one year, they are equivalent to or higher than the £777 billion national debt in 2009-10.

- **Large annual costs.** The annual costs of public sector pensions to taxpayers are already very large. In 2010-11, the Commission estimates that using the Government's methods of computation they will reach £18 billion, comprising £13.5 billion of employer contributions and £4.5 billion of Treasury top-up to meet payments to retirees (see Appendix B for the full calculation and methodology). However, this is not a proper measure of the true costs. Properly measured, the current service cost of public sector pensions is actually over £35 billion a year. It is this figure that the Treasury should be charging to public sector employees and employers, even though this may mean the Treasury has funds left over after paying today's pensioners. In other words, government cash flow need not change but the costs of employment would be properly recognised.
- **Disparity with the private sector.** In 2008, 94 per cent of public sector employees were members of a defined benefit pension scheme, compared with just 11 per cent in the private sector. In all public sector schemes except for the Local Government Pension Scheme (LGPS), the normal pension age for existing members is still 60 or below, compared with a state pension age of 65 and a normal pension age of 65 for most members of private sector occupational schemes.
- **Inequity within schemes.** There is a great deal of inequity between employees *within* final salary schemes. Older employees, those who stay within the public sector and those with higher earnings growth benefit far more than lower paid and younger employees.
- **Outsourcing of government services.** When public services are outsourced to private contractors, private employers have to offer pension benefits to employees to match the public sector. But private companies have to pay the real cost of the pension promises, not the artificially low cost charged to public sector employers. There is not a level playing field and this distorts outsourcing processes to the detriment of private companies.

In an age of rapidly rising longevity, and having faced growing regulatory and tax costs, businesses have had to go through the painful process of scaling back DB pensions. Reform has not been undertaken to anything like the same extent in the public sector. Recent reforms to the main public sector schemes were not only inadequate, but only applied to new members, leaving future accrual of existing members almost entirely untouched. This means that if, for example, a 20-year-old had joined the civil service in 2006, he or she could retire in 2046 at age 60 on a final salary pension, at a time when the state pension age under current policy will be 68.

It may have been previously right to argue that generous pensions in the public sector made up for lower pay, meaning that the overall package was a fair deal. But pay in the public sector is now higher than in the private sector at almost all levels. Even after adjusting for factors such as levels of qualifications, public sector employees are still slightly better paid than their private sector counterparts, with larger disparities outside of London and the South East. The oft-quoted argument for more generous pensions as a compensation for less generous pay does not any longer hold true. The question of why the majority of the workforce should be expected to pay through their taxes to support pensions that they cannot afford for themselves has to be raised.

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A pre-requisite for reform

Transparency

Any reform to unfunded public sector pension schemes has to start with transparency. This is not an option but an essential pre-requisite. An historical failure to account properly for the costs of the unfunded schemes

has undoubtedly made it easier to delay reform and means that employees undervalue the benefit, and employers undervalue the costs, of their pensions.

Transparency of costs is essential to understand the baseline from which reform can be measured as well as the costs of various reform options. Meaningful agreements between public sector employers and employees are not possible unless both sides understand the economic trade offs that are involved. With a proper understanding of costs, the Government can then take a more rational approach to setting public spending in this area and employers and employees can determine benefit packages to their mutual agreement.

A complement to reform

Decentralisation

It is also possible radically to decentralise the UK's approach to public sector pensions – and indeed to pay and conditions more generally. Individual public sector employers could agree pay and pension arrangements with their employees with budgets being delegated. This would allow regional variation and greater flexibility to meet local needs. Transparency is complementary to such a reform and employers would have to pay the full costs of the options they chose using delegated budgets. It is also possible, within such an arrangement, to have national structures into which local employers could buy in – as long as this was done at full actuarial cost.

The reform options set out in this report apply equally well to a national or a decentralised approach. With a decentralised approach, different public sector employers could choose different options.

Options for reform

Trade-off

There is an unavoidable trade-off. Either the unfunded public sector pensions will have to be reformed further to manage their cost to the taxpayer, or taxes will have to rise and/or other government spending be cut to pay for them.

As Greece has been experiencing, increases to retirement ages or cuts in benefits are not popular at the best of times, but implementing them as part of a package of crisis cuts is the least palatable option of all. It is essential that reforms are conducted early in a measured way rather than waiting until we have a crisis.

A simple and immediate way of altering the financial burden on the taxpayer is to increase employee contribution rates.

All reform to apply to new accrual

It is vital that any reforms apply not just to new members but to new accrual of pension for existing members as well. Previously accrued rights should generally be protected.

A menu for change

A simple and immediate way of altering the financial burden on the taxpayer is to increase employee contribution rates, as has occurred in Ireland. For illustration, a 2 percentage point across the board increase in employee contribution rates would reduce the Exchequer cost by up to £2 billion in the first year. But this would be no substitute for the longer-term reform options considered by the Commission.

Each of nine possible reforms assessed by the Commission has its pros and cons. But each option, on its own or in combination, could be a realistic way forward. For the DB options listed below, the chapters in Part II set out how reforms would affect the value of the pension to the employee, as a percentage of salary:

- **Increasing pension ages.** People are living longer, the state pension age is increasing, both in the UK and in other developed countries, and normal pension ages are rising in the private sector. Increasing normal pension ages for new accrual in the public sector would be fair, and would save a considerable amount.
- **Reducing accrual rates.** A proportionately less generous accrual rate allows a pension of the same annual amount to be accrued from a longer working life. A number of private sector companies that have retained defined benefit pensions have reduced the generosity of accrual rates.
- **Career average schemes.** Career average schemes would reduce the inequities arising from final salary arrangements, which benefit older employees and those whose salary rises rapidly before retirement. The career average approach would also be a better fit to today's labour market, encouraging older employees to remain in employment even on a lower salary. It is used across part of the public sector already; it is also used in some private sector DB schemes.
- **Salary ceilings.** A ceiling on the level of pensionable pay (not on the pension paid out, as has been suggested by the Conservatives) would only reduce the pension accrued by someone with a salary higher than the ceiling. It would therefore make no difference to the pension received by lower-paid employees, and would address the fact that the higher paid benefit to a greater extent from current public sector pension arrangements.
- **Reducing index-linking.** Capping the degree of inflation indexing of pensions would save money if inflation were to remain high, although it would also introduce a greater degree of risk to employees. In the public sector, full index-linking to the RPI is almost universal; most private sector schemes only index-link new benefit accrual up to 2.5 per cent a year.
- **National insurance and contracting-out.** Members of public sector pension schemes are generally contracted-out of the State Second Pension (S2P), as indeed, are some members of private sector occupational schemes. This means that members do not accrue S2P rights, but they pay a lower level of national insurance. The rationale for paying lower national insurance is that taxpayers will not have to pay for S2P in future years, because the employees' private pension scheme will provide that. However, with an unfunded public sector scheme, taxpayers will have to pay these costs in future anyway. In addition, it can be argued that, given that public sector pensions are generally payable from age 60 (for existing members), compared with 65 rising to 68 for S2P, public sector employees should either not be contracted-out, or should remain contracted-out but pay higher employee pension contributions.
- **Funded defined contribution.** A move to less generous funded DC in the public sector would save a considerable sum of money in the long term, would remove the disparity between public and private sectors, and would shift longevity risks away from the taxpayer. Employees, would, however, face greater risks and the shift from pay-as-you-go to funded pension arrangements would entail significantly higher spending in the short term, as contributions would have to fund individual DC accounts as well as paying today's pensioners. It was easier for the private sector to switch from DB to DC precisely because private sector pensions were funded. However, it should be noted that this significantly higher spending would only be apparent because the accrual of public sector liabilities is not currently properly recognised in public sector accounts.
- **Notional defined contribution.** The difference between funded DC and notional DC is that notional DC arrangements remain unfunded, so there is no problem of paying twice in the short term. Notional DC could also offer a degree of guarantee around investment returns, for example guaranteeing that the notional value of individual accounts would grow in line with general economic indicators. This

would reduce individual risk, although possibly also reduce individual return. Notional DC has been adopted in the state pension systems of a number of European countries.

- **Hybrid schemes.** Hybrid arrangements could usefully combine a number of the features of other types of pension arrangement, for example a core DB element with optional DC add-ons. Such schemes have been adopted in the private sector, and the public sector schemes also allow employee AVCs to be made.

There is no single right option, but several broad approaches could be adopted. A more sustainable DB pension, with a higher pension age, lower accrual rate, a move to career average and a ceiling on pensionable pay, could be adopted, or funded or notional DC reforms could be made.

Paying a fair share of costs

As a rough average, the current new entrant scales for the main public sector schemes are worth over 40 per cent of salary, but public sector employees and employers are only charged around 20 per cent of salary. If some form of DB scheme is maintained, it would be best to enact a combination of reforms. For example:

- A final salary benefit of 1/90 of earnings for each year of service payable from the age of 70 would be worth 20 per cent of salary to the employee on top of payment of contributions at 6.5 per cent to the NHS scheme.
- An RPI-linked career average benefit of 1/80 of earnings for each year of service payable from the age of 65 would also be worth 20 per cent of salary to the employee in the Civil Service scheme after payment of employee contributions.
- An RPI-linked career average benefit of 1/70 of earnings for each year of service payable to teachers from the age of 65, with pensionable earnings limited to £75,000 per annum and pension increases linked to RPI only up to 2.5 per cent per annum would be worth around 20 per cent of salary in excess of employee contributions.

The above examples show that there are a number of ways that the value to the employee of a public sector pension might be reduced to the 20 per cent that is currently contributed by employees and employers.

How much would be saved depends crucially on the changes enacted. We estimate the public cost of public sector pensions is currently £35 billion, although the taxpayer only actually pays £18 billion. A reduction of accrual rate to 1/80 or a switch to career average revalued earnings as the benefit structure would each save around £10 billion per annum and an increase to a pension age of 65 for all members would save around half of that. However, this would not affect the Government's present outlay if the taxpayer continues simply to meet the balance of cost of pensions now in payment (the £18 billion referred to above).

There are a number of ways that the value to the employee of a public sector pension might be reduced to the 20 per cent that is currently contributed by employees and employers.

Variable accrual rates?

If public sector pensions are to avoid attracting hidden subsidies, then their funding must accurately reflect the cost of pension accrual year by year. At market rates, which vary over time in relation to the real interest rate as reflected in index-linked gilt yields, this would mean costs rising and falling according to the cost of Government borrowing.

Any proposal for a resilient system must recognise this variability, and so will need to find a way which is acceptable to both employers and employees for adjusting either the annual contributions or the accrual rate

or, if settling on a constant rate of contribution and benefit, agreeing on how to reflect the varying costs when determining and reviewing contribution rates.

This Commission's view is that it would be both practically, and for budgeting purposes, extremely difficult to organise variable contributions; hence we would come down on the side of fixed contributions. Accrual rates might then be variable. Exactly the frequency and mechanism for the variability would be a matter for each scheme as indeed would be the frequency for review on the basis of changing longevity or other factors.

This would be a major complication for both members' understanding of the schemes, and for the schemes' systems. Of course, once an accrual is made, it would be fixed permanently. So with the passage of time, each employee would build years' worth of known accruals, and would approach retirement with a high level of certainty as to his or her prospective pension income.

A final note of caution

Public sector pension costs are under-accounted for perhaps by as much as half of their total cost. It is essential that this position ends as we indicate above. As such, even if the true underlying cost of providing public sector pensions were reduced by about 50 per cent, there would be no cuts to headline public spending and borrowing. The Government has to make radical reforms even to give the impression of standing still. Honesty in reporting public sector pension costs is essential, however. And it should also be noted that any scaling back of benefit costs will ultimately improve the Government's underlying budgetary position – it is just that the underlying budgetary position is currently obscured by various accounting sleights of hand.

Any change or reduction in the value of benefits being provided will have minimal immediate impact on Government finances since existing pensions need to be paid in full out of the employee and employer contributions and Treasury supplement to balance the total outlay on current pensions.

An increase in contributions from members of schemes to recognise the greater worth that the benefits have today would however have the capacity to reduce public spending. An across the board increase of 2 percentage points, for example, might reduce the Treasury balancing payments by up to £2 billion.

A major piece of missing evidence that one should ideally have is the trade-off between pay and pensions in attracting and retaining public-sector employees of suitable quality. If the taxpayer can get the current services at lower total cost by lowering pensions and increasing pay than that would be a good reform – but we don't know if this would be true (although the fact that the private sector goes for a different mix of pay and pensions is, at least, indicative).

Our argument for transparency feeds into this: how can we expect to be getting the best value for money out of pensions if we are not communicating to public sector employees their true value? Equivalently we can't expect public sector employers to make the right decisions without knowing the true cost.

Part 1: The Case for Reform

“Faced with the increasing proportion of the population aged over 65, society and individuals must choose between four options. Either (i) pensioners will become poorer relative to the rest of society; or (ii) taxes/National Insurance contributions devoted to pensions must rise; or (iii) savings must rise; or (iv) average retirement ages must rise.”

Pensions: Challenges and Choices, The First Report of the Pensions Commission, 2004

Over the past quarter of a century, the perceived cost of providing pensions for employees has risen considerably. Several factors are responsible. People are undoubtedly living longer so that the cost of paying out pensions to the retired has risen. In addition, the returns available on investments have fallen considerably, especially when measured under modern accounting standards which reveal the cost more clearly than in the past. As the costs of providing pensions have risen it is perceived that the risks have risen too – that is, the cost of providing pensions is more variable and unpredictable.

In the private sector, the reaction of many employers to this news – bringing major extra charges onto their balance sheets – has been to curtail the provision of pensions and replace old schemes with new ones, often funded by defined contributions rather than being linked to employees’ final salaries. In the vast majority of cases, the expected employer cost is much lower, which is likely to mean much smaller pensions to the employees of private sector companies.

In the public sector, however, the situation is very different. Improvements to life expectancy are no less an issue for public sector employees but falling investment returns are less likely to have been brought home to the managers of public sector schemes in the same way. Where public sector schemes are funded, there are often special rules relating to how contributions are set (as is the case in local government schemes). But in many cases, there is no funding because pensions become a charge on future taxpayers rather than being paid out from funds built up today.

Many commentators have analysed the way in which the large government-sponsored pension arrangements are costed or funded. There have been calls for greater transparency and a clearer method of working out how much pensions do cost government departments and ultimately the taxpayer. This report is less concerned with costing and funding the pensions that have now been promised than it is with suggesting ways in which public sector benefits might be reformed for the future.

I Longevity: the context of an ageing population

The reason why pension arrangements in any sector need to be looked at again is quite simple. The assumptions – especially relating to longevity – on which such arrangements were based when they were designed no longer hold good. People are living longer. Though this is obviously desirable, it does necessitate a re-evaluation of whether people can expect to retire at ages that have been normal hitherto.

1.1 Life expectancy

The two charts below, showing historical life expectancy at birth and at age 65, show clearly how pensions have migrated from their original purpose as an *insurance* product:

- Overall life expectancy rose significantly in the late 19th century and early 20th century as infectious disease was significantly controlled.
- In the most recent half-century there has been a much more marked improvement for those over 65 as health improvements focused more on the survival of the elderly from diseases of later life. Overall, between

CHART I.1

Life expectancy at age 20 – 1841-2001¹

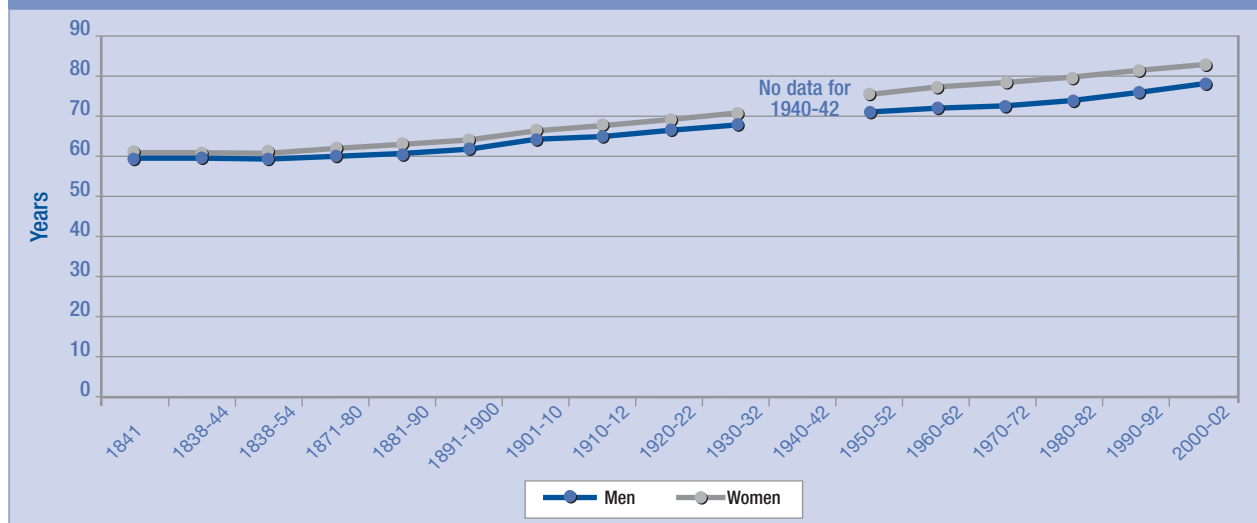
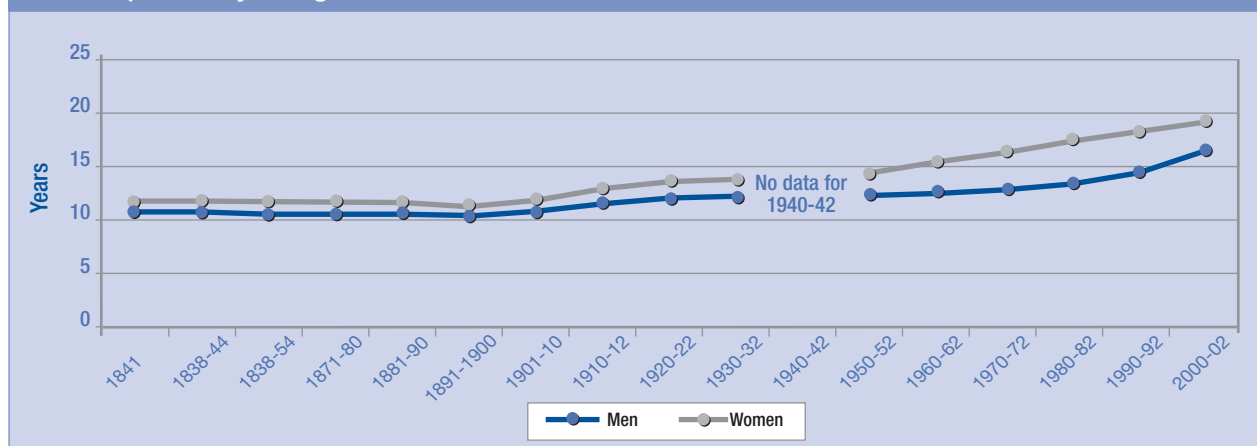


CHART I.2

Life expectancy at age 65 – 1841-2001²



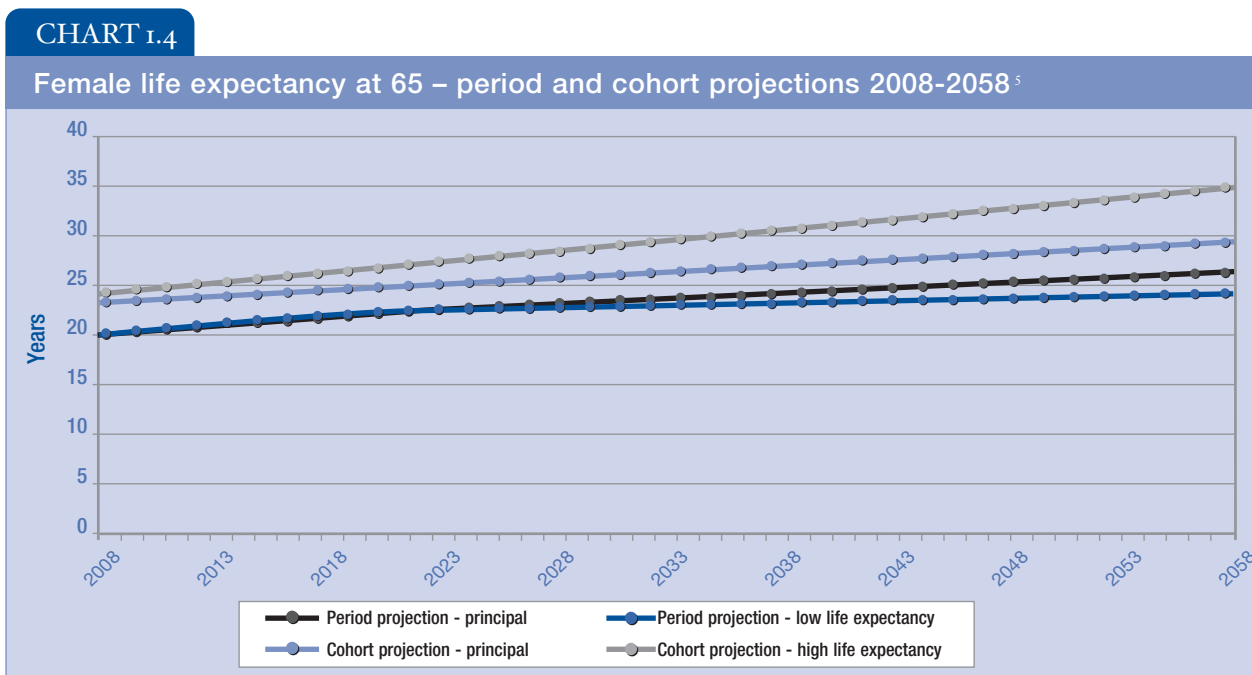
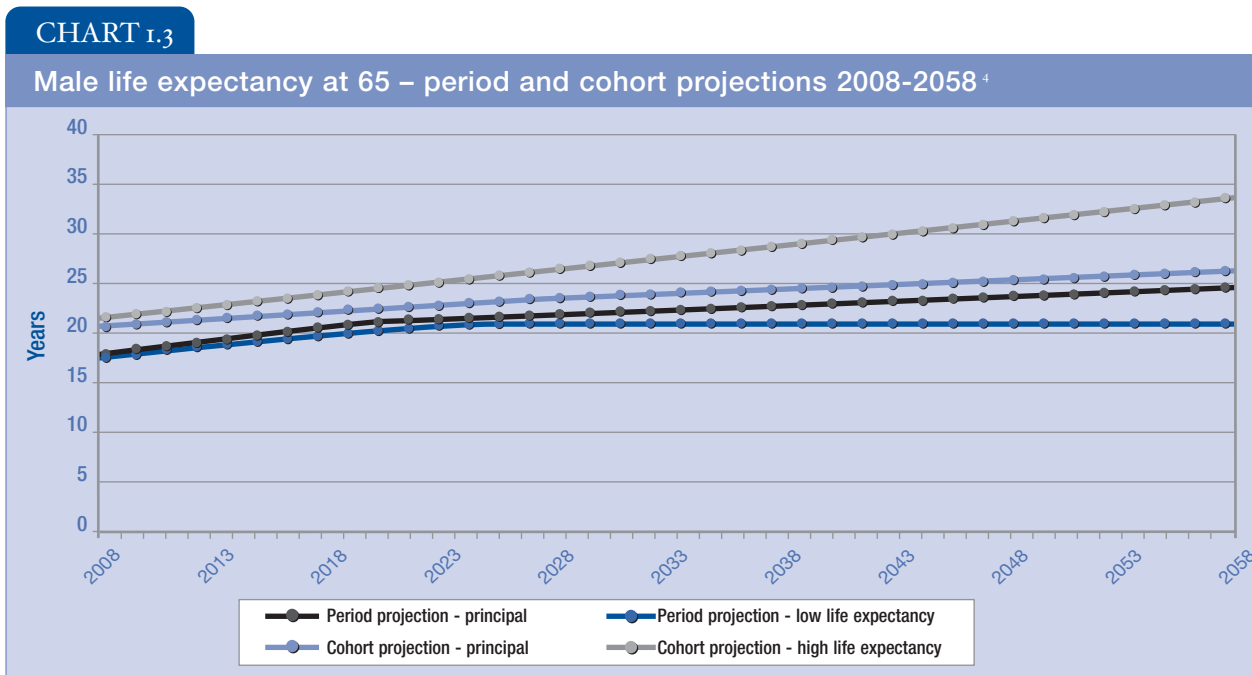
¹ Office for National Statistics, English Life Tables, Nos. 1-16. NB. We have shown the expected age at death.

² Office for National Statistics, English Life Tables, Nos. 1-16

1841 and 2001, life expectancy at age 65 increased by 47 per cent for men and 66 per cent for women.

- In the immediate post-war period, a high proportion of men, in particular in heavy industries, would not have reached the age of 65 to become a claimant for the new basic state pension. In other words the pension was insurance against living “too long”. A pension now represents a process of income shifting across the lifecycle so that individuals can enjoy what is normally a prolonged period of leisure after formal work ends.

Looking forward, there are a number of official projections of longevity, which, as shown in the following charts, give different results,³ but they almost all point towards a continuing increase in life expectancy:



³ Period projections with low life expectancy assumptions give the smallest longevity increases, while cohort projections with high life expectancy assumptions give the largest.

⁴ Office for National Statistics, 2008-based Period and Cohort life expectancy tables

⁵ Office for National Statistics, 2008-based Period and Cohort life expectancy tables

- On average, once future improvements are factored in, men are already living around 20 years beyond 65, while women are living slightly longer. In 50 years' time, life expectancy at age 65 could increase to 30-35 years. A retirement lasting 30-40 years could soon become the norm for those who reach retirement age. In other words, people might be retired for as long as they work, with obvious implications for the sacrifices that have to be made from salaries in order to provide pensions.

1.2 Dependency

As a result of rising life expectancy, the UK's dependent population is set to increase quite dramatically:⁶

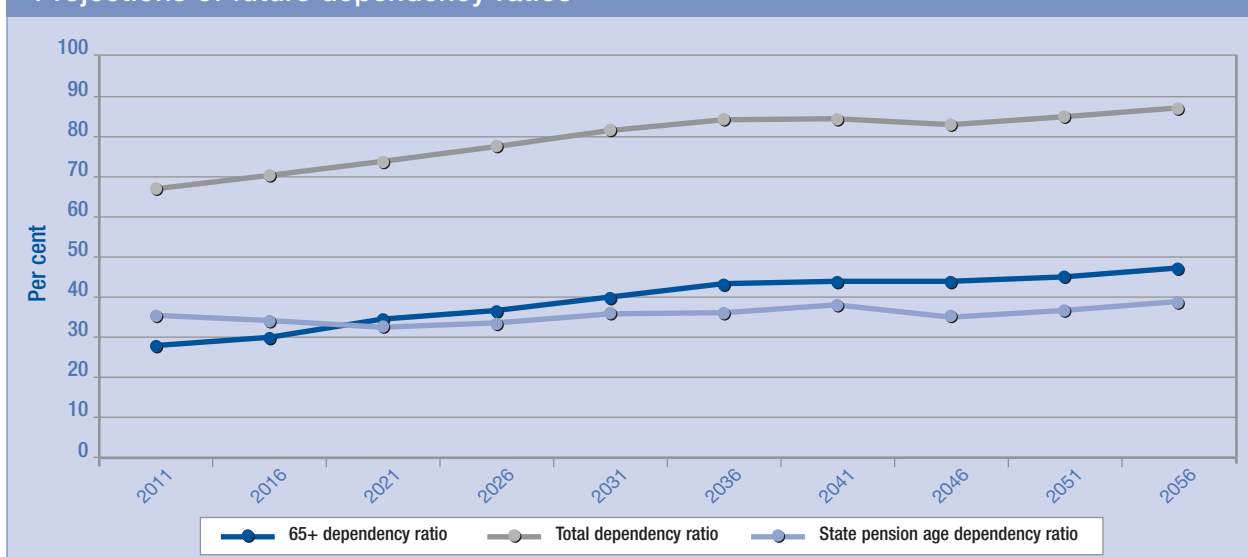
- The *65+ dependency ratio*, which measures the population aged 65 and above as a percentage of the population aged 20-64, is projected to increase from 27 per cent today to between 47 per cent and 49 per cent in 50 years' time.
- The *total dependency ratio*, which measures the 65+ and the 0-19 population as a percentage of the 20-64 population, is expected to rise from 67 per cent today to between 83 per cent and 94 per cent in 50 years' time.

In other words, in 50 years' time, it is possible that every pensioner will be supported by just two people of working age, compared with four today, while there could be only one person of working age to support each dependent person overall.

Future increases to the state pension age, however, do alter the picture to some extent. Under current policy the state pension age for women is rising from 60 to 65 in a phased manner between 2010 and 2020. Then the state pension age for men and women will increase from 65 to 66 in a phased manner between 2024 and 2026, from 66 to 67 between 2034 and 2036 and to 68 between 2044 and 2046 (although the coalition Government plans to review the timing of these increases, possibly bringing the timing forward). The increase in the *state pension age dependency ratio* therefore looks somewhat different:

CHART 1.5

Projections of future dependency ratios⁷



⁶ There are a number of official population projections in addition to the principal projection. These range from a low population variant, which assumes low fertility, low life-expectancy and low net migration, and a high population variant, which assumes high fertility, high life-expectancy and high net migration. They show broadly similar dependency ratio results. But given political and economic uncertainties about future migration policy, such estimates need treating with some caution.

⁷ Office for National Statistics, 2008-based National Population Projections, Principal projection; Public Sector Pensions Commission calculations

- Under current policy the state pension age dependency ratio, which measures the population over the state pension age as a percentage of the population aged between 20 and the state pension age, is set to increase from 34 per cent today to between 38 and 40 per cent in 50 years' time. This represents a very small increase compared with the projected rise in the 65+ dependency ratio. However, it should be noted that other retirement ages – including in schemes for public sector employees – do not necessarily follow the state pension age.

Chart 1.5 shows the principal projections for the three dependency ratios described above.

The demographic trends provide us with two key lessons:

- Firstly, in the absence of reform, expected demographic changes would be likely to increase the cost of defined benefit schemes in the private sector significantly and lead to unsustainable levels of taxpayer subsidy for public sector schemes.
- Secondly, increases in the state pension age show how reform can mitigate the impact of demographic changes.

However, it has to be noted that the state can do something with regard to the national insurance benefits that it provides, that employer or public sector pension schemes cannot generally do. The increase in the state pension age defers the date any pension can be taken for all workers, thereby saving substantial costs. It is generally felt that rights in other pension schemes cannot be changed for past service as a consequence of contract law, pensions law and the treatment of property rights under human rights legislation. It therefore takes many more years to make similar savings.

Rather than this being a reason for not reforming public sector pensions, it makes the issue ever more urgent as savings take a much longer time to come through. We simply cannot avoid taking a fresh look at pension arrangements in the public sector and we cannot delay.

2 The cost of public sector pensions

Unfunded public sector pension liabilities are growing rapidly, threatening to lead to unsustainable annual costs unless reforms are undertaken. Already, taxpayers are paying around £18 billion a year towards meeting payments to public sector retirees in the unfunded schemes.

Many public sector schemes are unfunded, which means that the cost of meeting pensions is a liability on future taxpayers and the full cost today of providing benefits for tomorrow may not be fully understood by managers in the public sector or by today's taxpayers. In general, there is no capital fund – backed by assets – to meet future public sector pensions, though there are some exceptions.

Those public sector schemes which are funded, such as the many local government pension schemes, are facing similar rises in cost to those met by private sector employers. Council taxpayers may be cushioned in the short term from the full extent of those costs by current funding rules; yet in the long term the falls in investment income and rises in life expectancy threaten to impose major financial constraints on future council taxes.

2.1 Outstanding liabilities of unfunded schemes

With the principal exception of the Local Government Pension Scheme, most public sector pension schemes, including those for the civil service, NHS, teachers and uniformed services, are unfunded pay-as-you-go arrangements. This means that the Government collects contributions from public sector employees and charges their public sector employers a notional contribution which purports to cover the cost of the future pension benefits earned each year. The money coming in is then used to pay the pensions of current public sector retirees, with the Treasury making up any shortfall.

The “outstanding liability” is the sum of all the future payments that a pension scheme is committed to make, whether or not the employee has retired. That sum is always calculated at a particular point in time, so any pension liability calculation has to have a date on it. All payments to be made in the future are then “discounted” to the calculation date.

To understand discounting, suppose a pension scheme has a promise to pay a 55 year-old £100 in ten years' time when he or she retires. Today's discounted value of the £100 is the amount that, if invested in a ten-year fixed rate investment with the interest reinvested, would equal £100. The interest rate used, the “discount rate”, is crucial to the calculation of how much money is needed today to be able to afford the future pension promise:

- At a 1 per cent per annum interest rate, today's discounted value of £100 in ten years' time is £90.53 and this is the sum that has to be invested to meet the promise.
- At a 2 per cent per annum interest rate, £82.03 has to be invested today to meet the future promise.
- At a 4 per cent per annum interest rate, £67.56 has to be invested today to meet the future promise.

There is a conceptual difficulty here. The public sector schemes with which we are concerned are not funded and no assets are purchased. As such, the concept of “the amount of money that we need to invest in order to meet the pension” is harder to understand. But, we should, in fact, use a discount rate to determine the total public sector pension liability today and also the cost of new promises that the Government is making every year as public sector employees accrue more pension rights.

When the Government makes a pension promise and takes a contribution from the employer and employee (for example, a particular hospital), the Government is making a commitment to provide a pension in the future. We can think of this in two ways.

- Firstly, this commitment is an asset to the employee which is every bit as valuable as an index-linked gilt.⁸ When calculating the value of a pension it is therefore reasonable to discount the amount of the pension at the rate of return from index-linked gilts.
- Secondly, the Government is using the money from pension contributions to pay for current spending – it is doing this instead of borrowing using, for example, index-linked gilts. As such, the rate of return it should pay should be the same whether it borrows by taking pension contributions from public sector employers and making pension promises in return or by issuing index-linked gilts.

This could all be resolved if the Government set up a separate agency to manage public sector pensions. The Government could then issue index-linked gilts to fund the additional borrowing that would be necessary if pension contributions were not used by the Government for current spending, but instead invested. Those pension contributions could then be invested in those index-linked gilts. This would then provide a fund which would meet future pensions. Everything would then be clear – including the Government's total pension liabilities. It would also be clear that the rate of interest that should be used for estimating public sector pension costs would be the rate of return that could be earned on those index-linked gilts.

In estimating the total outstanding liabilities of the unfunded public sector pension schemes, this discount rate assumption is of great importance. Other assumptions, of course, are also significant, such as longevity, and expected salary growth (which, for a final salary pension, will determine the annual amount of pension to be paid).

The estimates of the outstanding public sector pension liabilities made by the Government differ greatly from those made by independent experts. A key reason for this is the choice of discount rate (which in the case of the Government has been confused and confusing), for which there are essentially three approaches in use:

- **Government Reporting Rate.** The Government's discount rate for reporting on pension costs and liabilities is chosen each year by the Financial Reporting Advisory Board (FRAB, a Treasury quango which decides on the presentation of Government finances). Until 2005, the Government used a fixed real discount rate of 3.5 per cent per annum, "based on a review of long-term historical patterns of real rates on gilts".⁹ From financial year 2005-06 onwards, the FRAB decided to adopt a discount rate based on yields of AA-rated corporate bonds of more than 15 years maturity. This was reported to be in line with the FRS17 and IAS19 private sector accounting standards for funded schemes, which require an employer's pension costs and liabilities to be measured using market rates of return from AA-rated bonds. In the context of unfunded public sector pensions, this has no objective justification, other than to try to compare like with like when looking at public sector and private sector benefits. However, private sector benefits are at far more risk of default than public sector pensions and it appears incorrect to suggest that the benefits are therefore comparable using private sector accounting treatment.
- **Government Funding Rate.** Like any pension provider, the employer (in this case the Government) chooses a rate of discount for determining the level of employer contributions. This has most recently been 3.5 per cent in excess of inflation, even though the Government borrows money at a much lower rate (around 0.8 per cent above inflation at the current time). The Government's approach makes the cost of public sector pension benefits look only a fraction of their real cost to present and future taxpayers. For reasons which have never been explained, despite the change to the Reporting Rate above, the 3.5 per cent above inflation approach continues to be the one which determines the artificial contribution rates in place in the public sector.
- **True Economic Cost.** The Government is promising index-linked pensions to public employees in the future with the same certainty as it promises to pay bondholders the interest on Government borrowing by way of gilts. The only true economic comparison must be made using consistent

⁸ In fact, it is more valuable because a pension also provides insurance against "living too long" but we will ignore that here.

⁹ Financial Reporting Advisory Board, Seventh Report, June 2004, Section 2.10

discount rates, in other words around 0.8 per cent in excess of inflation, which is what is paid out when index-linked gilts are sold. In practice, the yields on gilts vary from day to day and some people would argue that in the interest of stability and having a long-term assessment of the value of public sector pensions, a long-run average yield on index-linked stock might be used instead. We show for comparison the values which might be derived were index-linked stocks yielding 2 per cent above inflation in line with long-term GDP growth of that rate.

- **Other Analyses.** In its most recent analysis, the Pensions Policy Institute (PPI) defends the Government's use of corporate bond yields by suggesting that it aids comparability and that the existence of the Pension Protection Fund means the security of private and public sector pension benefits is almost equivalent.¹⁰ However, since entry to the Pension Protection Fund entails often substantial reductions in the value of final salary pension benefits, both in terms of the initial pension paid and the ongoing loss of inflation linking over time. It is, therefore, in our view, appropriate to reflect the extra value of a secure pension in the public sector pension costs by using Government bond yields, rather than corporate bond yields, as the discount rate. The PPI in its paper illustrates all three of the discount rates described above, showing that, using the true economic cost derived from Government bond yields, the employer cost of public sector pensions is in excess of 40 per cent (over 70 per cent in the case of the uniformed services). In our work we use this approach, while showing the far lower figure which currently applies in the Government's own world view.

Using the true economic cost derived from Government bond yields, the employer cost of public sector pensions is in excess of 40 per cent.

The Government's choice of a real discount rate has been consistently more than a percentage point higher than the real yield on gilts.¹¹ This has the effect of lowering the perception of the value of the outstanding liabilities.¹² Consequently, there has been a number of authoritative estimates of outstanding public sector pension liabilities made by organisations outside government, often based on a discount rate equal to index-linked gilt yields (i.e. how much it really costs the Government to borrow the money it needs) and using more credible mortality assumptions, which provide much higher totals than the Treasury's estimates.

TABLE 2.1

Most recent estimates of outstanding unfunded public sector pension liabilities¹³

Source	Latest year covered	Outstanding liabilities, £bn	Percentage of 2008 GDP	£ per household
HM Treasury	2007-08	770	53.3%	30,000
Policy Exchange using HM Treasury assumptions	2007-08	794	54.9%	31,000
CBI	2009-10	1,010	69.8%	39,000
Institute of Economic Affairs	2006-07	1,071	74.1%	41,000
Policy Exchange	2007-08	1,104	76.3%	43,000
Towers Watson	2009-10	1,176	81.3%	45,000

The official and independent estimates are given in Table 2.1 and Chart 2.1. Estimates of outstanding liabilities range from £770 billion to £1,176 billion – between 53 per cent and 81 per cent of 2008 GDP and between £36,000 and £45,000 per household in the UK.

¹⁰ Pensions Policy Institute, *Public sector pension schemes: policy objectives and options for the future*, March 2010

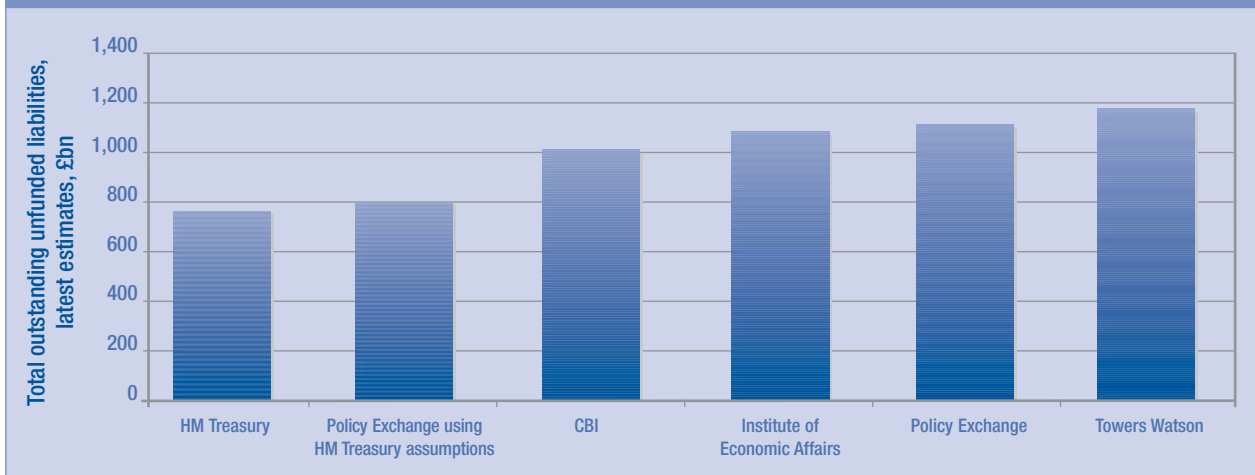
¹¹ Debt Management Office and HM Treasury data, cited in Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 8

¹² The sensitivity of the total outstanding liabilities to the discount rate is approximately a 20 per cent change in liabilities for each one percentage point change in the discount rate.

¹³ HM Treasury, *Long Term Public Finance Report*, December 2009, Box 6.B; Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 87 and Graph 9; CBI, *Getting a grip: The route to reform of public sector pensions*, April 2010, Exhibit 2; Neil Record, *Sir Humphrey's Legacy: An Update*, Institute of Economic Affairs, January 2008; Towers Watson press release, 22 March 2010; Office for National Statistics, *Blue Book 2009*, Table 1.2 (GDP at market prices); Office for National Statistics, *Regional Trends*, December 2009, Table 10.16 (number of UK households)

CHART 2.1

Estimates of outstanding unfunded public sector pension liabilities¹⁴



Three observations can be made about the data shown above:

- Firstly, whether the Government’s estimate or the independent estimates of outstanding liabilities are used, the total amount is larger than the pre-economic crisis level of government debt; indeed, if the future debt for pensions is included, public debt could well have been over 100 per cent of GDP before the economic crisis began. With net government debt now increasing rapidly, outstanding public sector pension liabilities are significant and cannot be ignored.
- Secondly, the outstanding liabilities themselves are also growing rapidly. This has been due to: the “unwinding of the discount rate”, which reflects the fact that each year, future pension promises are one year closer to needing to be met; the fact that new liabilities are being taken on which have a greater value than the contributions that are being made in respect of the new accrued liabilities; and the declines in both the Government’s artificial discount rate and the market rate for index-linked gilts. While a future increase in the discount rate would lower the outstanding liabilities, if liabilities continue to grow at their present rate they could well present unacceptable levels of burden on future taxpayers.
- Thirdly, life expectancy has continued to increase, which further adds to the costs.

2.2 Annual costs of unfunded schemes

A review of the outstanding liabilities of the unfunded public sector pension schemes must be balanced by a discussion of the annual costs of these schemes. Outstanding liabilities will not need to be paid off in a single year, but if they continue to grow, they would lead to very high annual costs that would largely fall on taxpayers. If, as discussed in Chapter 1, the ratio of workers to pensioners falls, these annual costs may well become intolerable.

There are two ways essentially of considering annual costs:

- The first is by assessing them as if they were debt servicing of outstanding pension debt (the liabilities detailed in Section 2.1, considered in this section).
- The second is as a charge on year-by-year GDP (the way future costs are considered in Section 2.3).

To understand these annual costs, we must examine how the annual payments to current retirees are met. Because the schemes are unfunded, payments this year to retirees are met by this year’s employer and employee contributions, with the Treasury making up the difference.

¹⁴ Ibid.

The table below gives the most recent Treasury data. In 2010-11, payments to retirees in the unfunded public sector schemes are projected to total over £25 billion, of which £20.5 billion will be made up by employee and employer contributions with the remaining £4.5 billion paid by the Treasury. It is noteworthy how much larger the Treasury payment has become in recent years and, as a result of costs being hidden in order to keep employer contributions low, this payment is likely to become a great deal larger in future unless employee/employer contributions rise to cover the costs of benefits being earned.

TABLE 2.2

Payments to retirees in the unfunded public sector pension schemes and how these are met¹⁵

Year	Pensions in payment, £m	Of which employer and employee contributions, £m	Balancing Treasury contribution, £m
2003-04	16,080	14,279	1,801
2004-05	16,377	15,119	1,258
2005-06	17,641	17,368	274
2006-07	19,080	17,934	1,147
2007-08	21,356	19,066	2,290
2008-09 (estimated)	22,562	19,500	3,062
2009-10 (projected)	24,151	20,033	4,118
2010-11 (projected)	25,286	20,684	4,602

The underlying burden on taxpayers is greater than the “balancing Treasury contribution” column (see Appendix B for more details), since around two thirds of the “employer and employee contributions” column comes from the employer (for example the 14.1 per cent employer contributions from a school’s salary budget, compared with the 6.4 per cent from a teacher’s own salary). While employee contributions are not directly a burden on taxpayers, since they are a proportion of the employee’s salary,¹⁶ the contributions from employers are an extra cost to taxpayers.

This balancing Treasury contribution is not a subsidy in the economic sense – it is simply ensuring that the cash flows of contributions from employers and employees match up to the pensions that have to be paid out.

The underlying picture, however, is worse than this. The contributions being paid by employers do not represent the full balance of cost between the proper value of the benefits provided to employees each year and the contributions paid by the employees. It is the value of benefits that we promise to current employees that should be costed each year, not the benefits that we are paying out today as a result of past decisions. This is basic to all sound accounting processes. So there is a further hidden cost which will only appear as a future increase in balancing Treasury contributions when those employees retire.

Table 2.3 compares the percentage of salary paid out in employee and employer contributions with a more realistic value of the benefits provided (see Chapter 3 for further explanation of the value of a public sector pension).

So far, we have mainly looked at the annual costs of pensions. We should also be interested in how the stock of pension liabilities changes over time. There are two factors that are likely to cause the total of outstanding liabilities to continue growing:

¹⁵ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1

¹⁶ To the extent that salaries are increased to take account of the employee contributions, employee contributions would also be a burden on taxpayers, but for the purposes of this section, we assume that this does not occur.

TABLE 2.3

Employee and employer contributions compared to proper value of benefits ¹⁷

	Employee contribution rate, %	Employer contribution rate, %	Total contribution rate, %	Proper value, % (index-linked gilt yield)
Civil Service – new members	3.5%	17.1-26.5%	20.6-30.0%	
Teachers – new members	6.4%	14.1%	20.5%	41.0%
NHS – new members	5.0-8.5%	14.0%	19.0-22.5%	
Police – new members	9.5%	24.2%	33.7%	
Firefighters – new members	8.5%	14.2%	22.7%	71.0%

- The first is the new liabilities that are accrued each year. This is known as the “current service cost” and equals the pension contributions needed to pay for pensions accrued in the year. As was explained in the previous section, the figure for liabilities accrued in the year will be very sensitive to the choice of discount rate.
- The second is the interest cost or “unwinding of the discount rate”, which reflects the fact that, each year, pension liabilities are one year closer to being paid. As we calculate the size of the liabilities by discounting them, when we get closer to paying pensions, their value rises. At a 2 per cent per annum discount rate, the discounted value of £100 to be paid in year 10 is £82.03 in year 1, £83.68 in year 2, £85.35 in year 3, and so on. The unwinding of the discount rate is effectively interest on the implicit debt that is represented by pensions, but because the schemes are unfunded, it is rolled up into the liabilities. But, in reality, the Government is borrowing to pay pensions and imposing a debt on future generations, and each year it effectively has to pay interest on that borrowing. Again, this figure is very sensitive to the choice of discount rate.

TABLE 2.4

Unfunded public sector pension schemes' current service costs ¹⁸

Year	Current service cost – HM Treasury, £m	Current service cost – Policy Exchange, £m	Employer and employee contributions received, £m	Current service cost in excess of contributions – HM Treasury, £m	Current service cost in excess of contributions – Policy Exchange, £m
2003-04	15,357	23,400	14,279	1,078	9,121
2004-05	15,309	25,300	15,119	190	10,181
2005-06	20,918	29,300	17,368	3,550	11,932
2006-07	21,074	33,700	17,934	3,140	15,766
2007-08	24,426	34,100	19,066	5,360	15,034
2008-09	25,504	-	19,500	6,004	-
2009-10	21,915	-	20,033	1,882	-
2010-11	22,744	-	20,684	2,060	-

¹⁷ Cabinet Office, *Employer Pensions Notice 183; Teachers Pensions Guide*, September 2008; *NHS Pension Scheme Guide* and *New NHS Pension Scheme Guide*; *New Police Pension Scheme Guide*; Home Office, Circular 021 / 2008; *New Firefighters' Pension Scheme Guide*; Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 8

The liabilities have also risen in the recent past because of the high level of pay increases in the public sector. Because of the final salary nature of these schemes, an increase in pay levels increases the value of the whole of the accrued pension that an individual has earned in his or her career to date – because not only the current year of pension membership accrues at the higher salary but all previous years of membership do as well.

Table 2.4 compares the current service cost of the unfunded schemes as recorded by the Treasury using a discount rate based on AA-rated corporate bonds, and by Policy Exchange using a discount rate based on the yield on index-linked gilts. In 2007-08, the difference between the two estimates was over £10 billion, around 40 per cent of the Treasury figure.

Crucially, as the following chart shows, under either estimate liabilities are accruing each year faster than contributions are being paid. In order to explain properly the cost of providing public services, the Government should be charging public sector employers the full current service cost for the liabilities the pension schemes are taking on each year, but even using the Treasury's artificial discount rates, it is failing to do so.

CHART 2.2

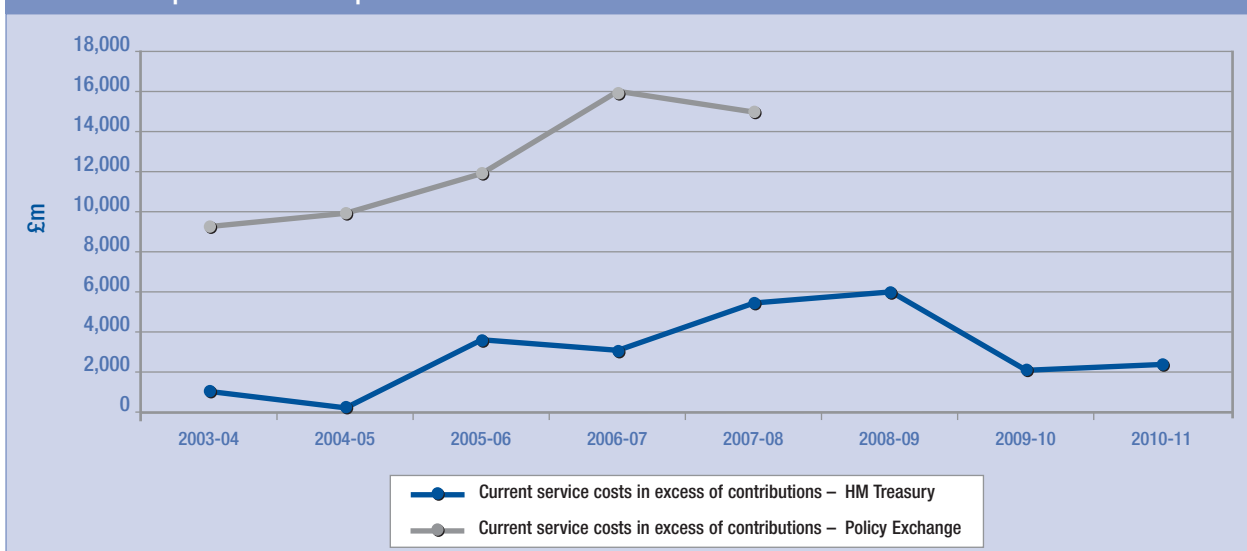
Unfunded public sector pension schemes' current service costs in excess of contributions¹⁹

Chart 2.3 illustrates how the pensions paid to retirees, and the taxpayer share of these, has been growing rapidly in recent years (see Appendix B for a full explanation of the taxpayer costs). It also shows how the current service costs, properly measured, are far greater still.

At the same time, the interest cost, or “unwinding of the discount rate”, is increasing rapidly. Table 2.5 compares the unwinding of the discount rate, as recorded by the Treasury using a discount rate based on AA-rated corporate bonds, and by Policy Exchange using a discount rate based on gilts. In 2007-08, the difference between the two estimates was around £12 billion, over a third of the Treasury figure.

As Chart 2.4 shows, on either measure, the unfunded public sector pension interest costs are almost always higher than the interest costs on the explicit national debt.

These issues of calculating properly the cost of unfunded pension provision matter greatly, in particular for the following reasons:

¹⁸ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1 (“Change in gross liability”); Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 16

¹⁹ *Ibid.*

CHART 2.3

The cost of pensions paid to retirees in the unfunded public sector pension schemes and the current service cost ²⁰

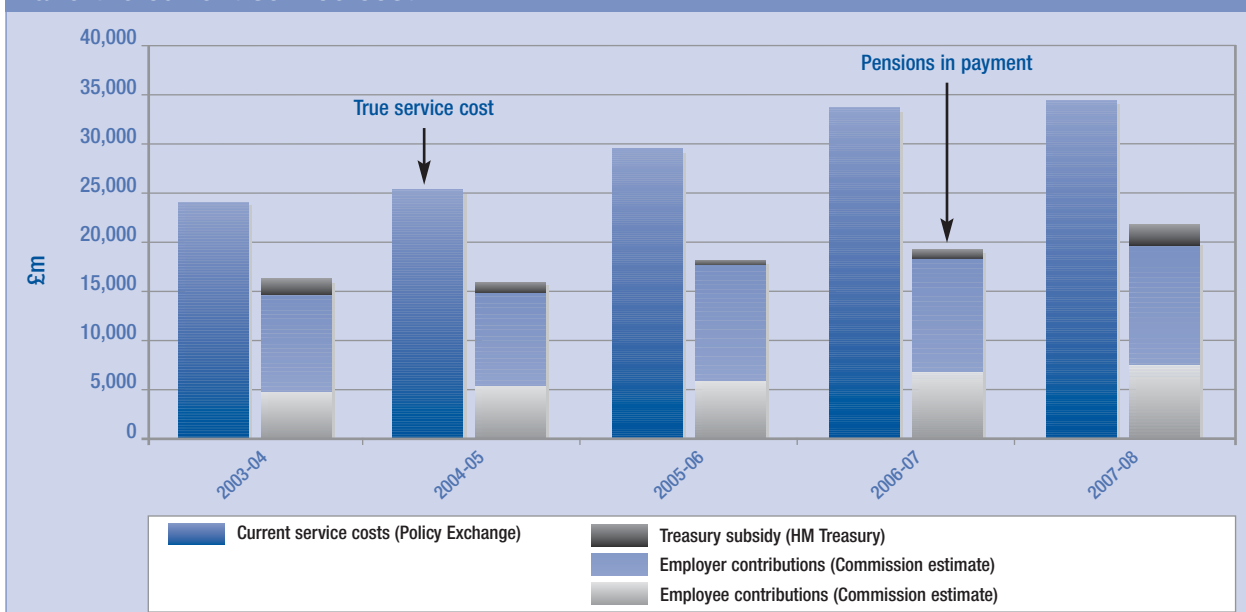


TABLE 2.5

Unwinding of the discount rate estimates compared ²¹

Year	Unwinding of the discount rate – HM Treasury, £m	Unwinding of the discount rate – Policy Exchange, £m
2003-04	22,303	20,700
2004-05	24,102	29,000
2005-06	27,378	35,900
2006-07	29,545	34,700
2007-08	32,805	45,200
2008-09	36,727	-
2009-10	38,404	-
2010-11	40,826	-

- The public have a right to know the true value of outstanding liabilities.
- The public have a right to know, as far as is possible, the true level of public spending – including the best estimate of public sector pension costs year by year.
- Public sector employers will make better hiring decisions if the best estimate of the cost of pensions is paid by them.
- Employers and employees will take better decisions about the composition of their benefit packages if the true cost of a pension is revealed to them.
- Employees should understand the true value of pensions when taking decisions about whether to work in the public sector and at what salary level.

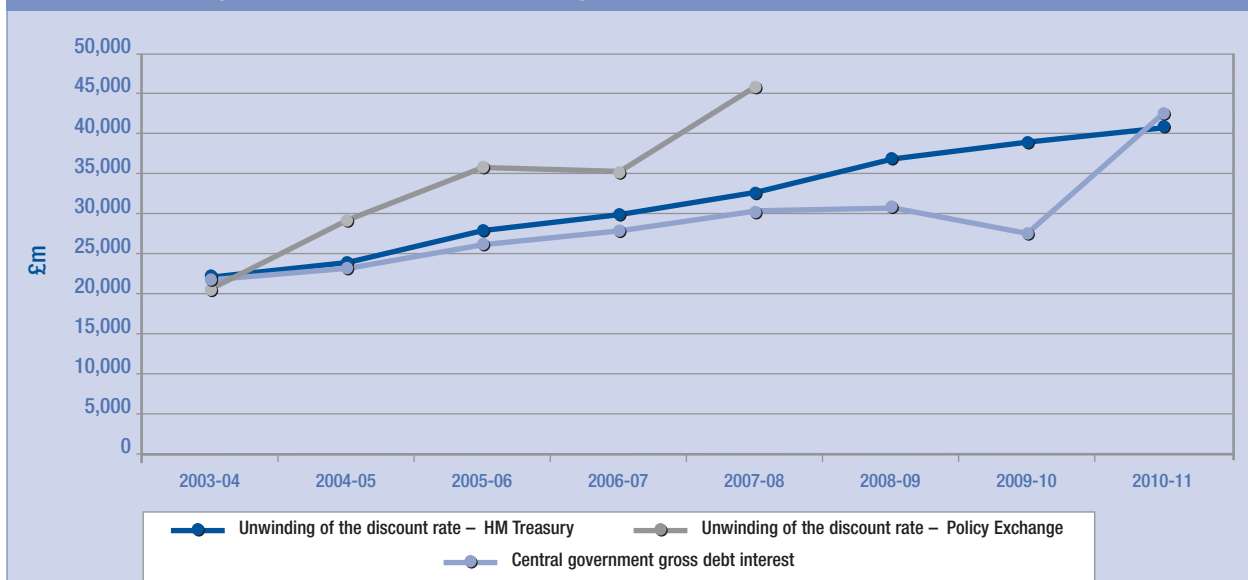
²⁰ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1.; Office for National Statistics, *Private pension contributions: updated estimates 1995-2007*, February 2009, Table 3; Public Sector Pensions Commission calculations using methodology from Corin Taylor, *The cost of public sector pensions to taxpayers in 2009-10*, Institute of Directors, September 2009; Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 16

²¹ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1.; Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 17

- As noted in Chapter 6, decisions on whether to outsource public services will not be made rationally if the full cost of public sector pensions is not factored in.

These problems are not trivial given the scale of misunderstanding of the value of public sector pensions.

CHART 2.4

Public sector pension interest costs compared with interest on the national debt ²²

2.3 Future projections for unfunded schemes

As the previous two sections have shown, there is a wide variety of estimates of the precise magnitude of the total outstanding liabilities and the annual costs. What is not in doubt, however, is that the liabilities are large, and growing, and hence the annual costs, which are already sizeable, will continue to grow.

The Treasury has produced future projections of the total annual costs of unfunded public sector pensions, while the Pensions Policy Institute, using the Treasury's assumptions, has projected the future annual costs to taxpayers i.e. excluding employee contributions. The following table shows that the annual cost is projected to peak in 2027-28 at around 2 per cent of GDP in total (£28 billion at 2007-08 prices and level of GDP) and 1.4 per cent of GDP excluding employee contributions (£20 billion at 2007-08 prices and level of GDP).

TABLE 2.6

Future projections of annual cost of unfunded public sector pensions ²³

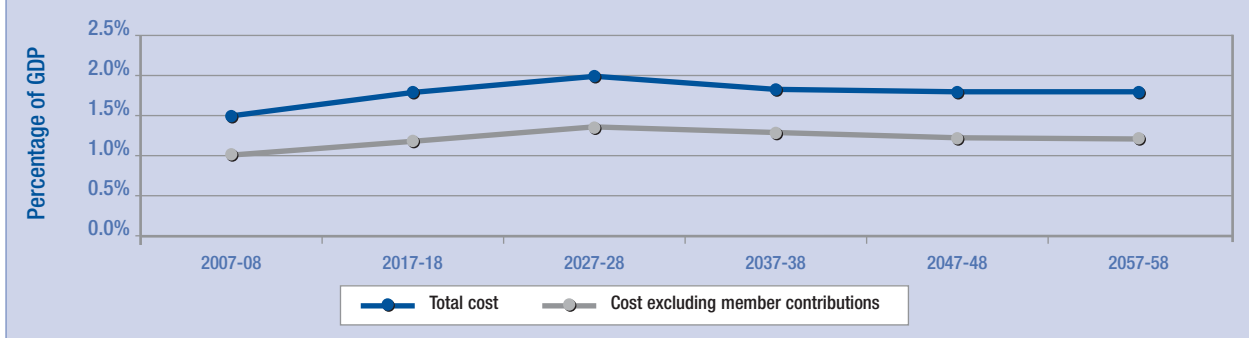
Year	Total cost, % of GDP	Total cost, £m, 2007-08 prices	Cost excluding employee contributions, % of GDP	Cost excluding employee contributions, £m, 2007-08 prices
2007-08	1.5%	21,300	1.0%	14,200
2017-18	1.8%	25,560	1.2%	17,040
2027-28	2.0%	28,400	1.4%	19,880
2037-38	1.9%	26,980	1.3%	18,460
2047-48	1.8%	25,560	1.2%	17,040
2057-58	1.8%	25,560	1.2%	17,040

²² HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table 1.1 and Table D.1; Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 17

²³ HM Treasury, *Long Term Public Finance Report*, March 2008, Table 4.1; Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Chart 8; HM Treasury, *Budget 2009*, Table C1. NB: The Treasury's 2009 Long Term Public Finance Report chooses not to display total costs in a table, but rather in a small-scale graph. In addition, the Pensions Policy Institute based its calculation of the taxpayer costs on the Treasury's 2008 Long Term Public Finance Report. Hence the Treasury's 2008 figures are used here, although they are not materially different from the 2009 figures.

CHART 2.5

Future projections of annual cost of unfunded public sector pensions ²⁴



The National Audit Office (NAO) has also summarised projections made by the Government Actuary's Department (GAD), on behalf of the Treasury, of payments from the unfunded public sector pension schemes over the next 50 years. Unsurprisingly the percentage of GDP costs are as described above, but the NAO also expresses the figures in 2008-09 prices and at 2008-09 earnings. It is important to remember that the NAO is not using assumptions that are different from those of the Treasury, although the NAO questioned whether the Treasury's assumption of zero workforce growth in the public sector was realistic (a bigger workforce would increase costs):

- In 2008-09 prices, under the assumptions used by GAD, payments to retirees in the unfunded schemes will rise from £25.4 billion in 2009-10 to £79 billion in 2059-60.
- Expressed at 2008-09 earnings and using the Treasury assumption of 2.0 per cent real annual earnings growth across the economy as a whole, payments are projected by GAD to rise from £24.9 billion in 2009-10 to £29.4 billion in the early 2030s, before falling slightly.²⁵

The peak in annual costs as a share of GDP in the 2020s occurs largely as a consequence of the demographic shape of the population – the retirement of the “baby boom” of the 1960s leads to a gradual subsequent decline over the following years. However, if GDP growth is lower than assumed by the Treasury, the absolute percentage could be higher than around 2 per cent at its peak and remain higher than today's 1.5 per cent for the indefinite future.

There are considerable doubts that growth will return to its previous trend of 2.5 per cent in real terms per annum, or that the Treasury is correct in projecting future long-term trend growth at 2.5 per cent per annum.²⁶ Future tax rises and increasing regulation are likely to reduce the quantity and quality of labour and capital relative to its pre-recession rate of increase, and the high net immigration of the last decade, which boosted labour supply, is unlikely to be repeated.

Other forecasts suggest that trend growth may be lower. The Institute of Directors, for example, believes that trend growth is between 2 and 2.25 per cent per annum, and that further tax rises to close the deficit could push trend growth below 2 per cent.²⁷ Economic forecasting is far from a perfect science, but there is a significant degree of risk that the future annual costs of public sector pensions as a share of GDP will be higher than the Government's assessment.

However if GDP does disappoint then private sector wage growth is likely to be lower than the 2 per cent assumed above, which should also lead to public sector wage growth – and therefore public service pension liabilities – increasing by less than otherwise expected.

²⁴ Ibid.

²⁵ National Audit Office, *The cost of public service pensions*, March 2010

²⁶ HM Treasury, *Long-term public finance report: an analysis of fiscal sustainability*, December 2009, Table 5.B

²⁷ Institute of Directors, *Where do we go from here? An economic recovery plan for the UK*, December 2009

It is also important to remember that, while the future cost projections laid out by the Treasury (and by the NAO using Treasury/GAD assumptions) are based on economic growth estimates that may be at the high end of the range, they are also based on cost assessments that are at the low end of the range. Put the two together – lower GDP growth than forecast and higher costs than forecast – and the burden could look far more worrying.

One has to question whether future taxpayers will be willing or able to fund a growing annual debt servicing burden, a growing age-related spending burden,²⁸ and a rising annual public sector pensions bill at the same time, without large cuts to public expenditure elsewhere, which could prove politically unacceptable.

If we wish to avoid such a situation, we have to control the unfunded public sector pension liabilities.

2.4 The Local Government Pension Scheme

Unlike most other parts of the public sector, local government pensions are funded, with Councils having to meet the difference between the level of assets and actuarial assessments of the liabilities every three years according to a regular national cycle. In England and Wales, these valuations were last conducted at 31 March 2010, though the results will not be available until later in the year.

The Local Government Pension Scheme is not actually a national scheme at all – it is a common set of rules used by all schemes for local government employees, each authority or group of authorities having the same benefit structures but responsibility for their own investments. Where there are not unitary authorities in existence, County Councils generally run schemes for the benefit of the County Council, the local District Councils and also for other public bodies in the local area which are admitted to participate.

As a result of this fragmentation, both of assets and administration, each council pays a different level of contribution, depending on the current health of its own funding. The risk of increases in contribution levels in the future is one to which local council taxpayers are exposed. The discipline of funding is therefore similar to that experienced in private sector funded pension schemes where investment performance and changes in likely future longevity have led to significant increases in employer contributions in recent years.

For local councils, increased costs lead, in the absence of explicit increases to government funding for local authorities, either to higher levels of Council Tax or lower spending on other areas of local government. Rates of employer contribution are now often as high as 20 per cent or more of pensionable pay. Most importantly for local authorities, the change in pension costs as a proportion of Council Tax can be very significant given that Council Tax is only a small proportion of the total income which Councils receive for their expenditure – and one of few discretionary sources of income.

Funding is an important discipline and reveals costs at the time they are incurred. But the issues facing the financing of local government pensions are to some extent the same as for the unfunded schemes: affordability as a proportion of GDP needs to be addressed.

We note that a high number of the respondents to our call for evidence from the local authority sector have been concerned by the implications for their sector of the impact of higher costs, as they are immediately and directly felt.

One has to question whether future taxpayers will be willing or able to fund a growing annual debt servicing burden, a growing age-related spending burden, and a rising annual public sector pensions bill at the same time.

²⁸ On state pensions, health care and long term care, for example.

3 Public and private sector pensions compared

There is an enormous and growing divide between the quality of pensions on offer to the 20 per cent of the workforce in the public sector and those that the remaining 80 per cent can expect to enjoy. The question of why the majority of the workforce should be expected to pay through their taxes to support pensions that they cannot afford for themselves has to be raised. This is not an argument in favour of levelling down as such, but members of public sector pension schemes should be aware of how valuable they really are. This chapter also considers the oft-quoted argument for more generous pensions as a compensation for less generous pay.

In an age of rapidly rising longevity, and having faced growing regulatory and tax costs,²⁹ businesses have had to face up to reality and go through the painful process of scaling back defined benefit pensions. The public sector has not gone through anything like the same process, precisely because the pensions are unfunded. Chapter 4 provides details of the reforms to public sector pensions that have been implemented in the last few years.

3.1 Scheme membership

Over the last decade, active membership of defined benefit (DB) pensions has collapsed in the private sector, while it has increased in the public sector:

- In 2008, the latest year for which data is available, 94 per cent of public sector employees were actively earning entitlement to a DB pension, compared with just 11 per cent in the private sector.

The private sector numbers disguise the real extent of the change because most of those who are still members of DB schemes are in schemes now closed to new members. Research from the Association of Consulting Actuaries suggests that nine out of ten private sector DB schemes are closed to new entrants, with nearly one in five of those closed to future accruals.³¹

94 per cent of public sector employees are actively earning entitlement to a DB pension, compared with just 11 per cent in the private sector.

TABLE 3.1

Defined benefit scheme membership in public and private sectors³⁰

	2000	2004	2006	2007	2008
Number of active members of public sector DB schemes (thousands)	4,400	5,000	5,100	5,200	5,400
Number of active members of private sector DB schemes (thousands)	4,600	3,600	3,000	2,700	2,600
Public sector employment (headcount – thousands)	5,270	5,745	5,811	5,766	5,750
Private sector employment (headcount – thousands)	22,259	22,679	23,218	23,433	23,741
Percentage of public sector workforce in a DB scheme	83.5%	87.0%	87.8%	90.2%	93.9%
Percentage of private sector workforce in a DB scheme	20.7%	15.9%	12.9%	11.5%	11.0%

But most private sector employees have not moved over from a defined benefit to a defined contribution (DC) pension. The staff of the majority of employers in the private sector are not and never have been members of an occupational or employer-sponsored pension at all:

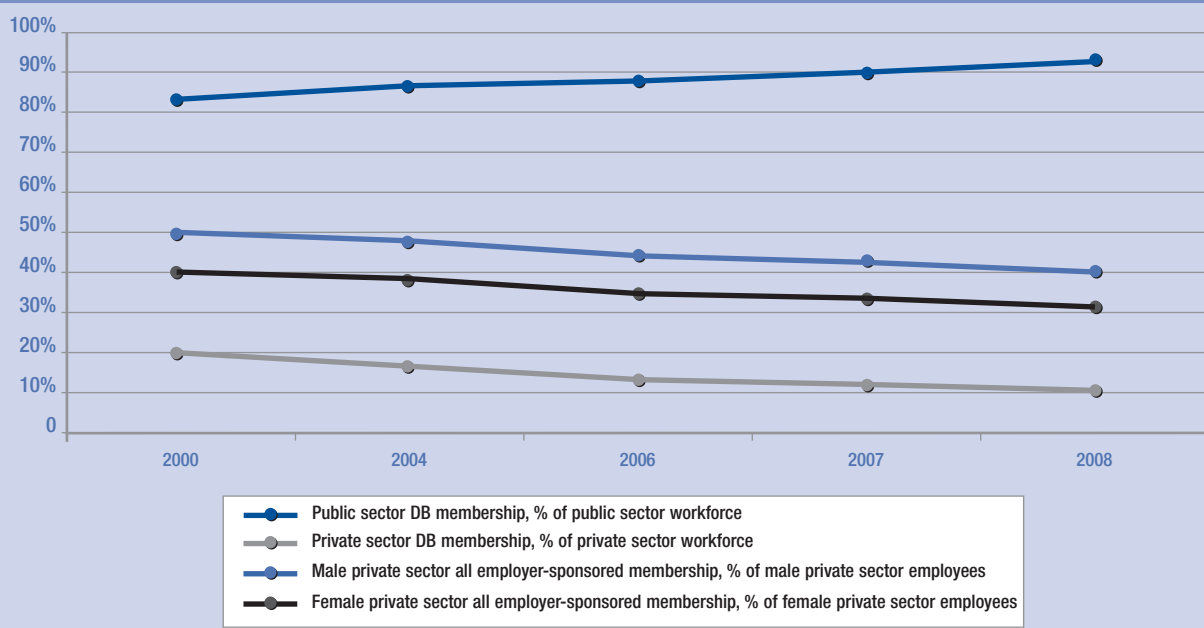
²⁹ According to a calculation by Terry Arthur, Fellow of the Institute of Actuaries, the reduction and abolition of repayable tax credits on dividends in the 1990s is estimated to have cost pension funds £150-£225 billion in lost dividends and growth: Terry Arthur and Corin Taylor, *The UK Pensions Crisis*, The TaxPayers' Alliance, November 2008

³⁰ Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 2.1 and Table 2.3; Government Actuary's Department, *Occupational Pension Schemes Survey 2000*, Table 3.1; Office for National Statistics, public sector employment time series data, private sector employment time series data

³¹ Association of Consulting Actuaries, *2009 Pension Trends Survey*, September 2009

- In 2008, 42 per cent of male private sector employees were members of an employer-sponsored pension scheme.
- In the same year, the figure for female private sector employees was just 31 per cent.
- Although the survey methodology changed slightly in 2005, the corresponding figures for 2000 were 50 per cent and 40 per cent respectively.³²

CHART 3.1

Public and private sector pension membership compared ³³

The divide is even starker for those working in the SME sector. Recent research from the Association of Chartered Certified Accountants (ACCA) in this market found that 95 per cent of employees of the smallest micro businesses (with under five employees) had no employer pension arrangement of any description, although, of course, participation in pension saving remains an employee choice at present.³⁴

It has often been argued that private sector directors enjoy pensions that they do not offer to their staff, but recent survey evidence shows that that is not a widespread occurrence. A poll of almost 1,000 members of the Institute of Directors found that 45 per cent have no occupational or employer-sponsored pension at all. Just 12 per cent of directors are members of DB schemes, a figure that is almost exactly the same as for the private sector as a whole.³⁵

Across both the public and private sectors, there is certainly an issue of lower-paid part time employees not taking up their rights or saving into a pension.³⁶ Less than half of those earning less than £100 a week in the public sector are active members of a pension scheme. But, as the chart below illustrates, the problem is far, far worse in the private sector.

³² Office for National Statistics, *Pension Trends*, Chapter 7, May 2009, data for Figure 7.

³³ NB: Comparative data is not available for 2001, 2002, 2003 and 2005. Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 2.1 and Table 2.3; HM Revenue and Customs, Table 7.4 and Table 7.5; Office for National Statistics, public sector employment time series data, private sector employment time series data; Office for National Statistics, *Pension Trends*, Chapter 7, May 2009, data for Figure 7.6

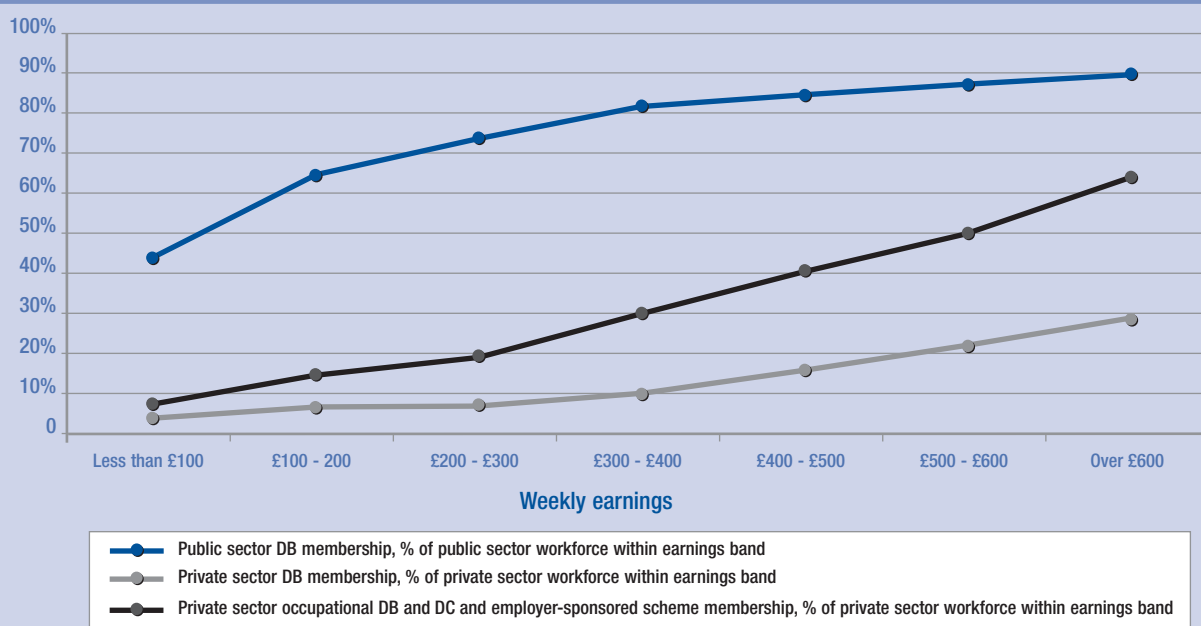
³⁴ Association of Chartered Certified Accountants, *Pensions and SMEs: Encouraging Savings Among SME Employees*, 2008

³⁵ Institute of Directors, Policy Voice survey of 980 Institute of Directors members, February 2009

³⁶ Indeed, for many lower paid employees, saving into a pension would deliver a negative return given the loss of means-tested Pension Credit.

CHART 3.2

Public and private sector pension take-up by earnings, 2008 ³⁷



3.2 Pension ages

The table below shows the normal pension ages for the main public sector pension schemes, both for existing members and for members who joined following the reforms of the last few years. The table does not include early retirement provisions, which are present to a greater or lesser extent in most public sector schemes. Early retirement, often on ill-health grounds, has been a persistent feature of many public sector schemes, although the incidence of ill-health has been declining recently and reforms to generous early retirement rules have been a major way of making cuts in recent years.³⁸

TABLE 3.2

Public sector normal pension ages ³⁹

Scheme	Pre reform	New members
Civil Service	60	65
Teachers	60	65
NHS	60	65
Local Government (reformed for all members)	65	65
Police	50	55
Firefighters	55	60
Armed Forces	55	55

The comparison with the private sector is quite stark:

- 56 per cent of active members in the public sector are members of schemes with a normal pension age of 60, compared with just 25 per cent of active members of occupational DB and DC schemes in the private sector.

³⁷ Office for National Statistics, *Annual Survey of Hours and Earnings Pensions Analysis*, 2008, Table P2.1; Office for National Statistics, public sector employment time series data, private sector employment time series data

³⁸ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table A6 and Chart A1

³⁹ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

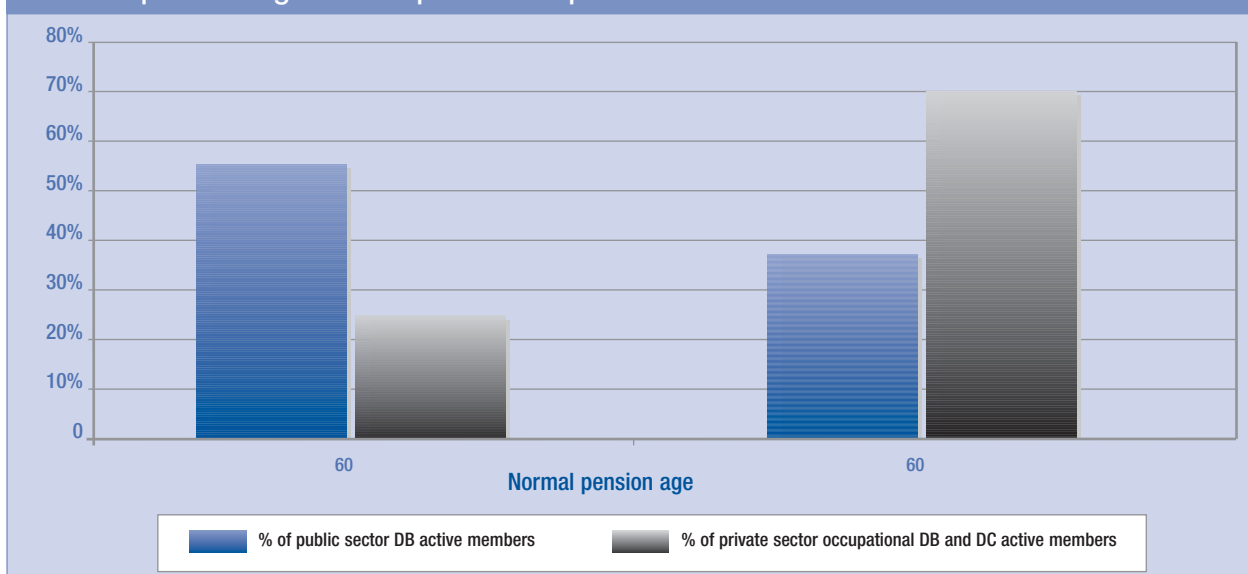
- 69 per cent of active members of private sector occupational DB and DC schemes are members of schemes with a normal pension age of 65, compared with just 37 per cent in the public sector.

It should be added that retirement ages in DC schemes are often just notional. Members may often choose to defer retirement if their funds are insufficient to buy an annuity or draw their pension before retirement if they need the flexibility. In reality, therefore, pension ages in the private sector are likely to be even higher, relatively, than their public sector counterparts, than is indicated by these figures.

The reason for this discrepancy in pension ages is simple:

- In the private sector, pension age increases (typically 60 to 65) have applied to all members for future service; only past service at the time of change has been protected from the increase.
- In the public sector, existing members have had their pension ages protected for past and future service.

CHART 3.3

Normal pension ages in the public and private sectors ⁴⁰

3.3 Contribution rates

Employer and employee contribution rates are broadly similar for private sector DB schemes and the main public sector DB schemes.⁴¹ But this is not a fair comparison, as the private sector contributions cover the cost of both the pension accrued for service in the year and the scheme's deficit, while the public sector contributions are less than the cost of meeting the benefits, as was explained in Chapter 2. DB schemes in the private sector are funded and are therefore obliged to charge the full current service cost for the liability the pension scheme takes on each year.

In 2008, on average, a total of 21.6 per cent of salary was contributed to private sector DB schemes, and 9.0 per cent of salary to private sector DC schemes.⁴² Table 2.3 of this report showed that combined employer and employee contribution rates in the main public sector schemes are also around 20 per cent of salary, although this report draws attention to the fact that the true cost of public sector schemes is very much larger.

Section 3.4 assesses the value of a public sector pension as a percentage of salary, which represents a fairer comparison with the private sector contribution rates.

⁴⁰ Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 2.19

⁴¹ NB: It is not possible to make a general comparison that includes the Local Government Pension Scheme, as employer contribution rates are different for each of the 400-plus local authorities in the UK.

⁴² Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 3.2

3.4 Value of pensions

As was explained in Chapter 2, estimates of public sector pension liabilities are sensitive to the choice of discount rate, as a lower discount rate, other things being equal, means that more will have to be put aside today to fund the same promise tomorrow. The same is clearly true of the value of a public sector pension.

There are several estimates of the value of public sector pensions to their membership. The following table gives the Pensions Policy Institute estimates based on the Government's accounting convention of an investment return of 2.5 per cent per annum. The average effective employee benefit rates range from around 35 per cent of salary for existing members of the uniformed services schemes to around 19 per cent for new members in the NHS and Teachers schemes.

TABLE 3.3

Average effective employee benefit rates based on government accounting discount rate ⁴³

Scheme	Pre reform, % of salary	New members, % of salary
Civil Service	28%	21%
Teachers	22%	19%
NHS	22%	19%
Local Government (reformed for all members)	20%	20%
Police	35%	29%
Firefighters	35%	24%
Armed Forces	39%	38%

Market value estimates are higher. The Pensions Policy Institute has also provided estimates of the average effective employee benefit rates based on index-linked gilt yields (rather than AA corporate bond yields), finding that the average effective benefit rate across the public sector is 44 per cent of salary. The Pensions Policy Institute applied the calculation to new members only, so the pre-reform schemes would see even higher average effective benefit rates.

TABLE 3.4

Average effective employee benefit rates based on index-linked gilt yields, new members ⁴⁴

	% of salary
Main four public sector schemes (NHS, Civil Service, Teachers, LGPS)	41%
Uniformed services schemes (Police, Firefighters, Armed Forces)	71%
Overall public sector	44%

It is argued by some (including the Government) that real index-linked gilt yields are currently very low and that this overstates the value of public sector pensions. It was put to us that a real return of 2 per cent consistent with real GDP growth at that level in the long-term might be an interesting comparison and the table below shows how much less benefits would be worth if index-linked gilt yields were at the higher level.

⁴³ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Chart 2 and Chart 3

⁴⁴ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 8

TABLE 3.5

Average effective employee benefit rates based on index-linked gilt yields of 2 per cent⁴⁵

	% of salary
Main four public sector schemes (NHS, Civil Service, Teachers, LGPS)	25%
Uniformed services schemes (Police, Firefighters, Armed Forces)	46%
Overall public sector	27%

For Policy Exchange, Neil Record has calculated that public sector pensions are worth 35 per cent of salary on average, rising to 48 per cent of salary on average for someone who has paid into a scheme for 40 years:

“At the moment the Government asks employees for a contribution, on average, of 6 per cent of pay and employers for an additional 14 per cent in order to help meet the pension promises it has made, i.e. 20 per cent of total employee pay. But over 40 years a typical public sector worker needs to have 48 per cent of his salary paid into his scheme in every year of his career in order to pay for the pension payouts at the end of it. The Treasury covers this annual 28 per cent gap. Even taking into account people who take career breaks and do not stay for long in the public sector, the whole public pension system requires annual contributions of 35 per cent of pay each year to fully cover the cost of new pension promises”⁴⁶

Comparing public and private sector pensions using the same discount rate, the Institute for Fiscal Studies (IFS) has estimated that median one-year accruals of DB pension rights are 25.5 per cent in the public sector, compared with 18.9 per cent in the private sector, a gap of 6.6 percentage points⁴⁷ that will only be compounded by the lower discount rates that should be applied to the public sector.

Considering the generosity of the pension from the employee point of view, if one thought that public and private sector pension promises were equally secure (which may be true to the extent of the partial protection provided by the PPF), then the same discount rate could be used. If public service pensions are more secure then they should be discounted at a lower rate. This doesn't mean they would cost the taxpayer more, but it would mean that we would want to value this extra security when considering the package being offered to public sector employees and comparing it to the package offered to private sector employees.

The IFS has also calculated that, for the period 2001-2005, average earnings grew 3.5 per cent faster in the public sector than in the private sector, but that including pension accrual increased this difference to 4.7 per cent. Interestingly, the IFS estimated that, had an increase to the normal pension age to 65 for all future pension accrual (i.e. not just limited to new members) in the public sector been implemented, average growth in total remuneration over this period would have been almost the same in the two sectors.⁴⁸

Overall, the IFS has calculated that relatively generous public sector pension arrangements mean that a public sector employee is on average around 12 per cent better off than a private sector employee on the same basic salary.⁴⁹

3.5 Pay comparison

Previously, it may have been right to argue that generous pensions in the public sector made up for lower pay, meaning that the overall package was a fair deal. This cannot now be argued with any degree of credibility. In recent years, pay growth in the public sector has outstripped the private sector, and it is no

⁴⁵ Public Sector Pensions Commission estimates

⁴⁶ Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, p.6

⁴⁷ Richard Disney, Carl Emmerson and Gemma Tetlow, *What is a Public Sector Pension Worth?* Institute for Fiscal Studies, published in the November 2009 issue of the *Economic Journal*

⁴⁸ Rowena Crawford, Carl Emmerson and Gemma Tetlow, *Occupational pension value in the public and private sectors*, Institute for Fiscal Studies, April 2010

⁴⁹ Institute for Fiscal Studies, *Green Budget*, January 2008, p.4

longer the case that public sector employees are worse paid than their private sector counterparts.

The raw comparison for annual pay and for hourly pay, for both full time and part time employees, shows that earnings in the public sector are higher for most employees:

- For full time employees, gross annual pay is higher in the public sector for all but the top 25 per cent, while for part time employees only the bottom 10 per cent are better paid in the private sector.
- Gross hourly pay is higher in the public sector for all but the top 10 per cent of full time employees, while for part time employees, gross hourly pay is higher at all levels in the public sector.

The oft-quoted argument for more generous pensions as a compensation for less generous pay does not any longer hold true.

The raw pay gap is clearly not the complete story, since public sector employees do tend to be better qualified than their private sector counterparts, though the risks of job loss are also different in the two sectors. The Institute for Fiscal Studies (IFS) has found that, controlling for education, age and qualification, the public sector hourly wage premium falls from a raw gap of 19 per cent to 2 per cent for men, and from a raw gap of 26 per cent to 7 per cent for women.⁵⁰ We also note that the IFS data reveals a large regional disparity, with public sector employees paid considerably more than their private sector counterparts outside of London and the South East.

Overall, after adjusting for the different characteristics of the public and private sector workforces, public sector employees earn slightly more than their counterparts in the private sector. The oft-quoted argument for more generous pensions as a compensation for less generous pay does not any longer hold true.

⁵⁰ Institute for Fiscal Studies, *Green Budget*, February 2010, Table 9.3

4 The failure fully to reform public sector pensions

Reforms to all the main public sector pension schemes came into effect between 2005 and 2008. But they were significantly watered down from original plans. As explained in the previous chapters, even after the reforms, the pensions divide – and the cost of public sector pensions – has not gone away. Further reform is urgently needed.

4.1 How reform could be applied and how it has been applied

There are three areas to which reform could apply:

- Existing accrual.** In general existing accrued pensions should be left alone unless there are implicit or explicit contractual provisions that allow it to be altered in certain circumstances. Sometimes, though, existing accrued pension has been altered. For example, when sponsors of DB pension schemes have become insolvent in the private sector, existing rights have been watered down, as Pension Protection Fund compensation to members does not cover the full value of accrued rights. Nor have existing basic state pension promises always been honoured – increasing the state pension age and reducing annual increases from earnings to prices are two examples where they have not. Unfunded public sector employers cannot become insolvent in the same way as private sector employers can, but were pensions to become completely unaffordable, there may be a trade-off between protecting existing accrued rights and greatly reducing future accrued rights. Nevertheless, it would seem fairest to leave existing rights untouched.
- New accrual of existing members.** There has been much disagreement on this area, but for the sake of sustainability and while protecting past accrued rights, it would be fairest to change the rights that can be built up by existing members in the future. An increasing number of DB pension schemes in the private sector are closed to new accrual as well as new members. The alternative is to have employees side-by-side with pension arrangements with widely differing values and to create a situation whereby the cost of public sector pensions can only be changed at an unacceptably slow rate.
- New members.** Clearly, pension schemes can be changed for new members, who can evaluate the pension on offer as part of the total employment package, and who can decide whether or not to apply for the job.

The reforms that have come into effect over the last few years were applied in the following ways:

- Existing accrual.** This was largely untouched by the reforms.
- New accrual of existing members.** New accrual has also been left mainly untouched. The key reform – raising the normal pension age in most schemes – only applies to new members. The Government had originally planned to raise the normal pension age for new accrual of existing members from 2013, but backed down in 2005 in the face of a threat of widespread strikes by the public sector unions.⁵¹ Minor changes to employee contribution rates in the Teachers scheme (from 6 per cent to 6.4 per cent) apply to new accrual as well as new members. The Local Government Pension Scheme was reformed for all members, but the slightly higher employee contribution rate (6 per cent changed to 5.5-7.5 per cent) and the phase out of the Rule of 85 (allowing members to retire if age plus years of service was at least 85) was accompanied by the accrual rate changing from 80ths to 60ths and the lump sum being a slightly more generous conversion of part of the pension rather than an additional benefit of 3/80ths lump sum.⁵²

⁵¹ For a fuller discussion, see Pensions Policy Institute, *Briefing Note 25*

⁵² For more detail, see Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

- **New members.** The reforms applied in their entirety to all new members.

Overall, while it was right for the reforms to apply in their entirety to new members and to leave existing accrual largely untouched, the key failures in 2005 were the limited nature of reforms and the decision not to apply them to new pension accrual for existing members.

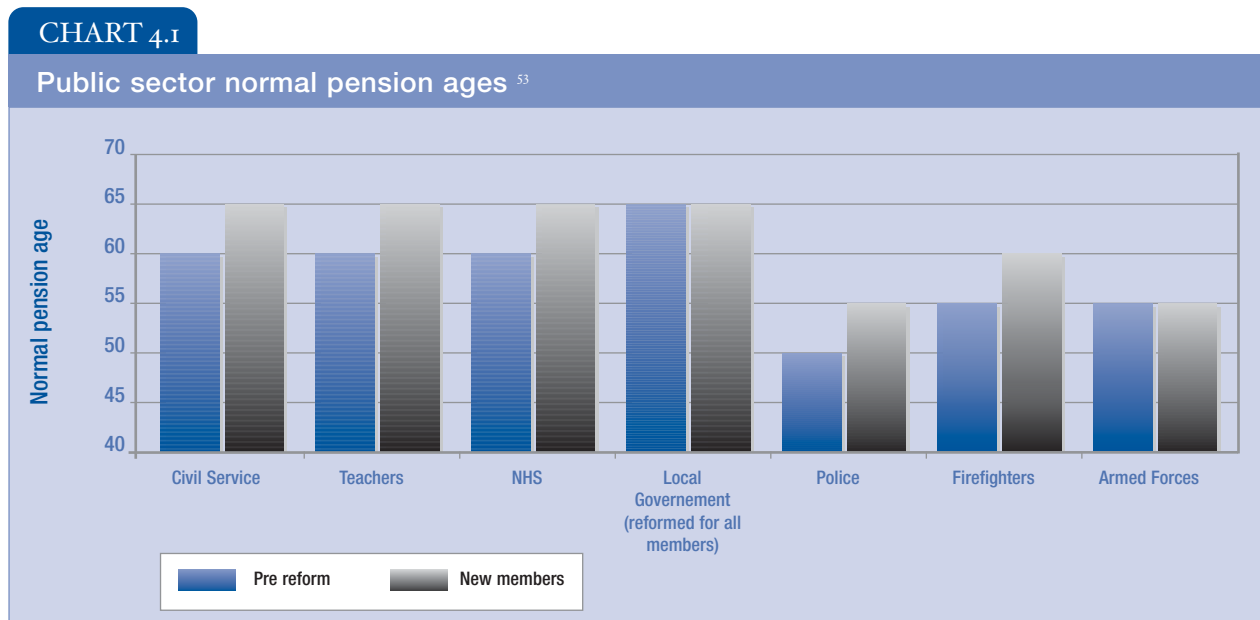
The key failures in 2005 were the limited nature of reforms and the decision not to apply them to new pension accrual for existing members.

4.2 The limited scope of reform measures for new entrants

While the reforms should have been applied to new accrual, the other problem was that the changes even for new members were limited. The most important changes were to normal pension ages and accrual rates (for full details of the changes, see Appendix C). Some of the discussion below relates to the Local Government scheme which is not in general part of our brief. However, it helps to set the wider context.

Normal pension ages

Chart 4.1 shows the normal pension ages for existing employees and new members, although it does not include early retirement provisions. In most schemes the normal pension age has increased by five years.



While the normal pension age for new employees in most public sector schemes has now risen to 65, with the exception of the Local Government Pension Scheme it remains at 60 or below for existing employees. This means that if, for example, a 20 year-old joined the civil service in 2006, he or she could draw an unreduced pension in 2046 at age 60, at a time when the state pension age under current policy will be 68. By the time this person retires their life expectancy at 60 might be 30 years or more. Even when the majority of public sector employees are retiring at 65, there will still be a three-year gap between the age at which they retire and the state pension age.

Accrual rates

At the same time as increasing normal pension ages for new employees, the reforms have generally also made accrual rates more generous. To some extent, the Government has taken away with one hand only to give back with the other. In many cases, however, lump sum accrual was replaced with commutation

⁵³ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

⁵⁴ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Chart 4

⁵⁵ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

(although the opposite change occurred to the Police Pension Scheme – hence why the accrual rate became less generous), meaning that the increases in accrual rates were not as generous as they look.

For example (using the Government's artificial discount rate), for the NHS scheme, the increase in the normal pension age reduced the effective employee benefit value by 4 percentage points, the more generous accrual rate increased the effective employee benefit value by 2 percentage points, and the move to commutation and the higher employee contribution rate each reduced the effective benefit value by 0.5 percentage points – the net effect was a 3 percentage point reduction in the effective benefit value.⁵⁴

The table below gives the accrual rates before and after the reforms.

TABLE 4.1

Accrual rates before and after reforms⁵⁵

Scheme	Pre reform	New members
Civil Service	60ths	2.3% (43.5ths) – now career average revalued earnings (CARE)
Teachers	80ths	60ths
NHS	80ths	60ths
Local Government (reformed for all members)	80ths	60ths
Police	60ths (30ths after 20 years)	70ths
Firefighters	60ths (30ths after 20 years)	60ths
Armed Forces	69ths (91ths after 22 years)	70ths

The only scheme to move away from final salary to career average for new members has been the Civil Service scheme.⁵⁶ But the accrual rate is so high for new members that a civil servant can now accrue a pension of half of his or her career average salary from just 22 years of service.

Value of pensions

The IFS has estimated that the reforms to the Teachers' Pension Scheme reduced the value of the scheme at the median from 14.7 per cent of salary to 11.2 per cent. The paper used a real discount rate of 2.5 per cent, which was the official rate used by the Treasury to value the unfunded liabilities in 2008.⁵⁷

As the Commission has argued throughout this report, this is an unrealistic discount rate to use. Indeed, the IFS paper points out that, under a lower discount rate, the estimated value of accumulated rights is much larger, and hence the value of the pension as a proportion of salary is also much larger. The IFS paper also points out that a lower discount rate also leads to a smaller percentage reduction in the value of the Teachers' Pension Scheme as a result of the recent reforms.

A realistic discount rate would therefore provide a better measure of both the value of a public sector pension as a proportion of salary and the effect on that value of the recent public sector pension reforms.

⁵⁶ Nuvos, the new Civil Service Scheme, is based on career average earnings, with each year's earnings revalued in line with increases in prices (RPI). This has the effect of under-weighting the earlier years' earnings in the averaging, as RPI generally runs at about 2 per cent per annum lower than national average earnings, and about 5 per cent per annum less than individual career earnings. The high accrual rate attempts to compensate for this effect. The revaluation mechanism also introduces a complexity that breaks the intuitive link between earnings and pensions for employees.

⁵⁷ Richard Disney, Carl Emmerson and Gemma Tetlow, *The Value of Teachers' Pensions in England and Wales*, Institute for Fiscal Studies, 2010

4.3 Cost savings from the 2005-2008 reforms

The recent reforms are not expected to reduce costs very much. The previous Government expected the reforms to the NHS, Teachers' and Civil Service schemes to save £13 billion over a 50 year period,⁵⁸ which is far less even than the value of a single year's payments to public sector retirees.

In addition to the very modest savings cited above, cost sharing and cost capping agreements have been made with respect to the NHS, Civil Service and Teachers' schemes, with the Local Government Pension Scheme possibly following suit. These agreements mean that additional costs arising in the future will be shared 50:50 between employers (taxpayers) and scheme members. They also include an overall cap on employer contributions, meaning that employees may have to bear more than 50 per cent of cost increases, either through increases in employee contributions or reductions in benefits.

The announcement of the cap may lull the general public into a false sense of security about the future taxpayer cost burdens. However, the cap may not deal adequately with future accrual problems for a number of reasons:

- Firstly, the cap agreements generally only apply to cost increases that are the result of changes to demographic assumptions, i.e. people living longer than previously predicted. They will generally not apply to cost increases resulting from changes to financial assumptions (such as the discount rate), changes in salary or from changes to the actuarial valuation methodology.
- Secondly, the cap only refers to unanticipated increases in costs. The cost increases resulting from the ageing population (as described in Chapter 1) will not be subject to cost sharing or cost capping, as the demographic changes have already been predicted.
- Thirdly, the agreements work both ways. If there are cost decreases as a result of unanticipated demographic changes, i.e. people not living as long as previously predicted, they will also be shared between employees and employers (taxpayers).⁵⁹
- Finally, a major problem with these schemes is that existing costs are not properly accounted for in the first place.

The agreements do make the future cost more predictable, but they also effectively "lock in" the enormous cost of public sector pensions to taxpayers, now and in the future, that is currently projected.

As the Institute for Fiscal Studies has concluded:

*"All in all, these are very modest reforms which will, for new entrants only, close about half the gap between the average generosity of public and private sector schemes. They will not, of course, make any difference to the gap in coverage between public and private sector."*⁶⁰

Indeed, the Commission would feel that this is a generous interpretation of the reforms for the reasons discussed above.

⁵⁸ Evidence given to the Treasury Select Committee on 8 December 2005 by the then Chancellor of the Exchequer Gordon Brown

⁵⁹ For a fuller discussion of the cost-sharing and cost-capping agreements, see Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, pp.29-32

⁶⁰ Institute for Fiscal Studies, *Green Budget*, February 2010, p.235

5 Inequity within public sector schemes

Public sector pensions (and indeed defined benefit pensions in general) do not offer identical levels of benefit to all members. The value of a pension to an individual employee varies greatly according to such factors as length of pension membership and real salary growth. Broadly speaking, younger employees and “low fliers” subsidise older employees and “high fliers”, although another way of putting it would be that taxpayers subsidise the old and the high fliers much more heavily than the young and the low fliers.

5.1 Relative generosity

As shown in Chapter 3, the value of a public sector pension as a percentage of salary does depend on the discount rate used. The lower the discount rate, other things equal, the higher the contributions that will be needed to fund the same pension promise, and hence the higher the value of the same public sector pension. This does not, however, affect the fact that the relative values will still vary according to factors such as length of service and salary growth.

A recent Policy Exchange report looked at these disparities and made the following estimates.⁶¹ Both assume a real discount rate of 1 per cent:

- For a male employee with a 40-year career, the contributions needed as a constant percentage of salary to meet the pension promises of a typical public sector scheme vary from around 25 per cent with zero real salary growth to almost 60 per cent with 5 per cent per annum real salary growth.
- For a male employee with real annual salary growth of 3.7 per cent (the base case for male public sector employees according to the Government Actuary’s Department), the contributions as a variable percentage of salary rise from 20 per cent were the employee to leave after 1 year, to 72 per cent were the employee to leave after 40 years. Note that in this case, the contributions are variable. It is not the case that, for the employee who stays in position for 40 years, the contributions are 72 per cent of salary each year; rather the pension becomes increasingly valuable the longer the employee remains in the scheme.

The Policy Exchange study also showed how the combination of higher salary growth and a longer career increased the value in contributions needed to fund a typical public sector pension. The following excerpt again assumes a real discount rate of 1 per cent:

“Suppose two people start work 40 years apart on the same starting salary in today’s money – say, £15,000 pa. The contribution for their first year of pension is £3,060, or 20.4 per cent of their £15,000 pay. One, the low flier, experiences 2 per cent pa real growth to his salary over 40 years. The other, the high flier, experiences 5 per cent pa real growth in his salary over 40 years. The low flier’s final year contribution would be £17,234, or 53.1 per cent of his £32,471 final salary; the high flier’s would be an amazing £86,422, or 85.9 per cent of his £100,571 final salary.”⁶²

A final salary pension scheme is more generous as a percentage of salary to those whose earnings increase quickly – particularly in their final years – and who remain in the scheme for longer.

5.2 Effect of moving from final salary to career average

The move from final salary to career average salary for new entrants to the Civil Service Pension Scheme reduces considerably the disparities described above.

⁶¹ Neil Record et al., *Public Sector Pensions: The UK’s Second National Debt*, Policy Exchange, 2009, Graphs 3, 4 and 5

⁶² *Ibid.*, p.18

The Pensions Policy Institute has calculated the effects of the move to career average for new joiners to the Civil Service Pension Scheme. The PPI made the following findings. Note that these findings include the more generous accrual rate that accompanied the move to career average, but the point being made in this chapter is about relative, rather than absolute, generosity. Compared with final salary:

- A new entrant who remains in the scheme for 10 years or less would be up to 40 per cent better off, no matter whether his or her salary growth is low or high.
- A new entrant who receives no real salary growth over a 40 year career would be almost 40 per cent better off.
- A new entrant with medium salary growth (defined as 3.3 per cent in real terms per annum) would be better off provided he or she remained in the scheme for no longer than 12 years.
- A new entrant with high salary growth (defined as 4.3 per cent per annum in real terms) would be better off for the first 10 years of scheme membership, but would be around 25 per cent worse off if he or she remained in the scheme for 40 years.⁶³

The absolute numbers cited above are of course sensitive to the change in accrual rate. But they are less important for the purposes of this chapter than the relative changes brought about under a move to career average:

- The previous section showed that final salary pensions are more generous as a percentage of salary to those whose earnings grow more quickly and/or who remain in the scheme for longer.
- Compared with final salary, a move to career average is relatively better for those whose earnings grow slowly and/or who remain in the scheme for a shorter time. It is relatively worse for those whose earnings grow quickly and/or who remain in the scheme for longer.

A move to career average therefore reduces what might be perceived as unfair differences within public sector schemes between “high flyers” and those who move on or have low rates of salary increase. It is also worth noting that a career average scheme is less susceptible to manipulation of salaries before retirement than a final salary scheme. In the latter, where corporate governance is weak – as it is typically in the public sector – it may be relatively easy for senior managers to negotiate promotions or pay increases just before retirement that will increase their pension for the rest of their lives.

⁶³ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, p.19 and Chart 5

6 Outsourcing of public sector contracts: mis-pricing public sector pensions

The pricing of public sector pensions can be an academic exercise, when the purpose is reduced to an analysis of whether the Government pays explicitly today or the balance of cost in future years. Nevertheless, as we have seen, there are important issues relating to employment decisions which can be seriously distorted by not accounting properly for public sector pensions.

Where it is also far from academic is the situation where the public sector is seeking to outsource some of its services to the private sector and the private contractor has to offer pension benefits to employees to match the public sector, either under TUPE rules or their deemed application by the public authority letting the contract.

If the Government prices pensions on the basis of returns on risky investments and claims that the benefits are worth (say) 20 per cent of salary, contractors may start from the premise that they need 20 per cent of salary in their payroll budget. When, however, they look at the risk-free nature of the existing promise and try to replicate that with a new pension arrangement of equivalent value, they may realise that the benefits were really worth (say) 40 per cent of salary. The contractor may therefore not be able to compete with an in-house tender because of the under-pricing of the pension element of the public sector salary package. This leads to inefficient outcomes and genuine problems for private sector companies.

On the other hand, if the Government were to use the right discount rate for valuing the cost of providing unfunded public sector pensions, then the private sector would be able to make its comparisons using the right discount rate for its own benefit provision. If the Government prices pensions using an inappropriate discount rate then it is not possible to compare on a like-for-like basis and when the private sector attempts to compete with the public sector one or the other will be wrongly disadvantaged.

In the same way, the Government may offer a bulk transfer of value for past pension promises already earned. The contractor may be looking for value for the risk-free promise the Government scheme offered, whereas the Government is only offering a fraction of this value and is passing risk on to the contractor.

Such paradoxes can work themselves through, in many cases through an adjustment to what the contractor is prepared to accept as the terms for the contract. It may be, however, that the pricing for the pension uncertainty leads to an imperfect striking of the price for the outsourced service. It may also lead to problems when the efficiency of using private contractors is being analysed and when the private sector and public sector are in competition.

The contractor may not be able to compete with an in-house tender because of the under-pricing of the pension element of the public sector salary package.

Part II: Options for Reform

“Relatively generous public sector pensions mean that a public sector worker is on average around 12 per cent better off than a private sector worker on the same basic salary. This gap has grown over the past decade as a result of private sector retrenchment. The Government has made modest progress on reform, but unfunded public pension liabilities continue to grow. The gap between public and private sectors does not look sustainable. The case for further reform is strong.”

Institute for Fiscal Studies, Green Budget, January 2008

The Commission’s terms of reference are to improve transparency and public understanding of public sector pension costs and present to the new Government a realistic set of options for reform of the present public sector pension arrangements. The emphasis on options is important: there is not a single “correct” way to reform public sector pensions, but a number of trade-offs and considerations that need to be made. There are several approaches to reform that are consistent with our basic remit which may be attractive to those of different political or economic perspectives.

This part sets out a number of options for reform, which must be underpinned by the most important reform which involves full transparency of the costs of public sector pensions. The reform options do not form an exhaustive list, but do contain the principal measures that could be taken, either individually or in combination. Before explaining the pros, cons and possible cost savings of each of the options, Chapter 7 sets out the need for transparency and the essential yardsticks by which reform should be measured.

7 Key considerations

7.1 The need for full transparency

Any reform to unfunded public sector pension schemes has to start with transparency. This is not an option but an essential pre-requisite for further reform as well as being important in its own right. As Chapter 2 showed, the true costs of the unfunded schemes, and the true value of a public sector pension to an employee, are not properly expressed or understood. Failure to account properly for the costs of the unfunded schemes has undoubtedly made it easier to delay reform. It also means that employees undervalue the benefit.

To understand the future costs of public sector pensions, and the value of these pensions as a proportion of an employee's salary, there is no reason to do other than to look at the way other government debt is valued.

Transparency of costs is essential to understand the baseline from which reform can be measured as well as the savings from various reform options. With a proper understanding of costs, the Government can then take a more rational approach to setting public spending in this area and employers and employees can determine benefit packages to their mutual agreement.

The Bank of England offers its employees a non-contributory funded final salary scheme very similar to the unfunded public sector schemes. Interestingly, in 2005 the Bank revised the discount rate that it uses to calculate the current service cost and the employer contributions in order to make the costs of the scheme transparent. The Bank now uses index-linked gilt returns as its discount rate, which meant that the contributions now required to finance new accrual for Bank staff rose to 44.3 per cent of pensionable payroll. As it happens, the Bank's pension fund now holds most of its assets in index-linked gilts.⁶⁴ Transparency of the costs of the Bank of England scheme rapidly led to reform.

This Bank of England contribution rate is remarkably similar to the valuation of new pension accrual in the main government unfunded schemes when index-linked gilt yields are used to compute the cost: the Pensions Policy Institute, for example, has put the figure at 41 per cent of salary;⁶⁵ the Bank of England's scheme bears an additional 3 per cent of payroll as an administration cost – the underlying 'current service cost' is reported by the bank to be 41.3 per cent. But the broad point remains: if the main public sector unfunded schemes were properly valued, they would be worth around 40 per cent of salary. This is significantly higher than the current combined rates of employer and employee contributions, which are around 20 per cent for the NHS and Teachers' schemes, and 20-30 per cent for the Civil Service Scheme. Some particular schemes, such as the armed forces and police, should have much higher contribution rates than 40 per cent – see Chapter 3.

It is an essential reform that the cost of public sector pensions, for each employee group, is properly computed using index-linked gilt yields and charged to public sector employees (after deducting the employer contribution). Other reforms will come as a reaction to this "price signal" being sent to public sector employers and employees.

One option which should have serious consideration, if transparent costs are used to determine contribution rates, is to have higher contributions and use the surplus over pension outgo to start a proper pension fund. This could have trustees or managers to exercise independent financial discipline over future contribution levels.

It is an essential reform that the cost of public sector pensions, for each employee group, is properly computed.

⁶⁴ NB: The Bank of England scheme is funded, and its 2005 actuarial review found that, valued at gilt rates, the scheme was only 84 per cent funded. To make up this gap, actual contributions from the Bank are currently significantly higher than 44.3 per cent of pensionable payroll. For a more detailed description of the Bank of England's measures, see Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, p.51

⁶⁵ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 8

7.2 Decentralisation

It would be possible radically to decentralise the UK's whole approach to public sector pensions. Such a process of decentralisation would be compatible with other policies in the area of public service provision (for example, the creation of Foundation Hospitals) and would allow approaches to pension provision to be adopted that responded more closely to the particular needs of employees and employers.

Once there was full transparency regarding the cost of pension provision, public sector employers could – in negotiation with employees – choose the kind of pension arrangements that they preferred. They would, of course, pay the full costs of the arrangements that they chose. Under such a framework, public sector employers could choose among the approaches discussed below and could combine elements of more than one approach. Hybrid arrangements could, for example, contain a core DB pension with flexible DC add-ons. The right type of pension could then be determined at the local level.

Such an approach would have several advantages:

- It would allow flexibility within the public sector and innovative local approaches could be tried.
- Different types of pension arrangements may be more suitable in different parts of the public sector.
- There is a degree of precedent for such a move. The Local Government Pension Scheme is comprised of a large number of funds administered locally, with varying employer contribution rates, although the employee contribution rates and the benefit rules (normal pension age, accrual rate, early retirement provisions etc) are set centrally.
- It might be politically easier, since opposition to reforms at the public sector-wide level would be harder.
- Trade unions could play a positive role in the design and management of pensions at a local level.

There would, however, also be disadvantages:

- It might be seen as passing the problem down – though arguably it would be passed down to the level at which it would be best solved.
- The UK is a very centralised country. Just 5 per cent of tax revenue, for example, is set at the local level.⁶⁶ While this may be an argument for a greater degree of local decision-making and responsibility, it also means that it would be a major departure from current practice, and might therefore be difficult to implement.

However, the approach is not as fanciful as might be first thought. When Foundation Hospitals were brought into being, it was only as a result of a last minute change of mind that they were not given responsibility for determining their own pay and conditions. Furthermore, many organisations combine together for the purpose of pension provision and there would be nothing to stop schools or hospitals doing that (for example, schools in a particular locality could create one scheme or voluntary aided schools of a particular faith could have their own arrangements). Much of this kind of practice already goes on with regard to the current public sector Teachers' scheme (which private schools are allowed to join) and the (non-public sector) Universities' scheme.

There could also be a national arrangement which individual public sector employers could opt into and out of – an approach that could work as long as all pension arrangements were provided at fair actuarial cost. Indeed, other policy initiatives over the coming decade could easily take us down the route of radical decentralisation of health and education provision and it would be anomalous for new, independent providers

⁶⁶ Council tax is the only tax set by local authorities, although there are centrally-set limits to council tax increases. In 2009-10, council tax revenue was £24.8 billion, 4.9 per cent of the £507.5 billion of total tax revenue. Source: HM Treasury, *Budget 2010*, March 2010, Table C6

not to be responsible for their own pension arrangements. It is also worth mentioning that the average school, hospital etc. has far more employees than the average private sector firm.

This approach would, of course, be more difficult to implement in the civil service and the armed forces but it has the potential to be applied to all other areas. The key requirement is that the employee and employer between them are responsible for the costs of the pensions that they provide as they accrue. As such, the approach of decentralisation is compatible with that of transparency. It is also compatible with local employers choosing any of the arrangements discussed below.

7.3 The key trade-off

Before setting out the yardsticks by which reform should be measured, there is an unavoidable trade-off which is worth describing.

The key assumptions behind this trade-off are that the population will age as described in Chapter 1 and the annual cost of the unfunded public sector schemes as a share of GDP will increase at least as much as projected by the Treasury, described in Chapter 2. If the population ages to a lesser extent (or if economic growth is higher than predicted by the Treasury) the trade-off described below would be eased, but not eliminated. Conversely, if the population ages to a greater extent than predicted by the Government Actuary's Department, the trade-off would be even more important, although in this case cost-sharing and cost-capping agreements would provide some mitigation.

With an ageing population:

- Either public sector pensions will have to be reformed further to manage their cost;
- Or taxes will have to rise and/or other government spending cut to pay for higher employer contributions and/or a higher annual balancing contribution from the Treasury.

7.4 Objectives and yardsticks

The primary objectives of the Public Sector Pensions Commission proposals are two-fold:

- Firstly, to introduce full transparency into the cost of unfunded public sector pensions.
- Secondly, to recommend reforms which will result in 100 per cent of unfunded public sector pension costs being financed by employee and employer contributions each year.

These objectives then give rise to three yardsticks by which other reforms should be measured:

- Firstly, the absolute costs of public sector pensions, relative to their current baseline as a percentage of earnings, properly measured.
- Secondly, the relative costs among different employees in the same schemes.
- Thirdly, the relative costs of public sector schemes compared with private sector schemes.

The key is for public sector pensions to be seen as more affordable and for contributions to reflect costs.

With an ageing population, either public sector pensions will have to be reformed further to manage their cost or taxes will have to rise and/or other government spending cut to pay for higher employer contributions and/or a higher annual balancing contribution from the Treasury.

⁶⁷ For more details, see Institute for Fiscal Studies, Green Budget, February 2010, Box 9.2

7.5 Contribution levels

Recent reforms have included small increases to employee contribution levels, as well as the prospect of future rises if longevity improves more than expected. Even so, employees still only pay less than a fifth of the full cost of the benefits being provided.

A simple and immediate way of altering the financial burden on the taxpayer is to increase employee contribution levels, as many private sector pension schemes have done when keeping defined benefit schemes open. This reform was also adopted in Ireland, as a response to the economic crisis. In February 2009, the Irish Government introduced a pension levy for public sector employees, reducing take-home pay by between 3 per cent and 9 per cent depending on earnings level.⁶⁷

For illustration, a 2 percentage point across the board increase in employee contribution rates would reduce the Exchequer cost by up to £2 billion in the first year.⁶⁸

7.6 Coverage of reforms

There is a further question that needs addressing – the coverage of any reforms. As Chapter 4 explained, recent reforms to public sector pensions generally left future accrual, as well as existing accrual, largely untouched. It is desirable that future reforms leave existing accrual untouched, as all governments have promised and continue to promise. However, it is essential for reforms to cover new accrual of pension to existing members as well as affecting new members. There are two key reasons for this:

- Cost.** If reforms are only applied to new members, it will take far longer for cost savings to accrue.
- Equity.** If reforms do not also cover future accrual, a two-tier workforce will develop, with people doing exactly the same jobs accruing pensions of different value. The recent reforms did not address the two-tier workforce problem; it is essential that future reforms do. This is a serious issue given the very high value of public sector pensions. If reforms do not apply to future accrual for existing employees, the effective salary discrepancy between existing and new employees could be very large.

In each section which follows we examine, for the four major public sector schemes (Civil Service, NHS, Teachers and Local Government), the costs of the existing scale of pension provision – for new entrants today and for protected existing members on any previous scale of benefits – and compare these costs with the options which we consider, to provide an indication of what savings might be associated with each change we examine. We do not provide calculations for the uniformed services, as the benefit structures vary considerably between them, with special rules for early retirement or different ranks. Similar principles apply but different retirement ages are likely to be appropriate in their circumstances in any case.

The costings we adopt are intended to show the true value of the benefits on the basis that pension promises are risk-free government promises equivalent to inflation-linked government stock payments and so the pension promises are valued on the same basis as the yields on such stocks, which we have taken as 0.8 per cent for our calculations, though of course the yield itself varies day by day.

In order to focus on the relative costs of current scales of benefit and potential changes, we have not updated recent government calculations for possible future more significant improvements in longevity than those used in government valuations.

⁶⁸ This calculation is based on a 33 per cent increase to the 2007 (latest year available) level of employee contributions to unfunded pension schemes (all the major public sector schemes with the exception of the LGPS), less the extra tax relief that those extra contributions would attract. Office for National Statistics, *Private pension contributions: updated estimates 1995-2007*, February 2009, Table 3. NB: The title is slightly misleading as the ONS makes clear that the data on unfunded pensions relates almost exclusively to the public sector.

8 Increasing pension ages

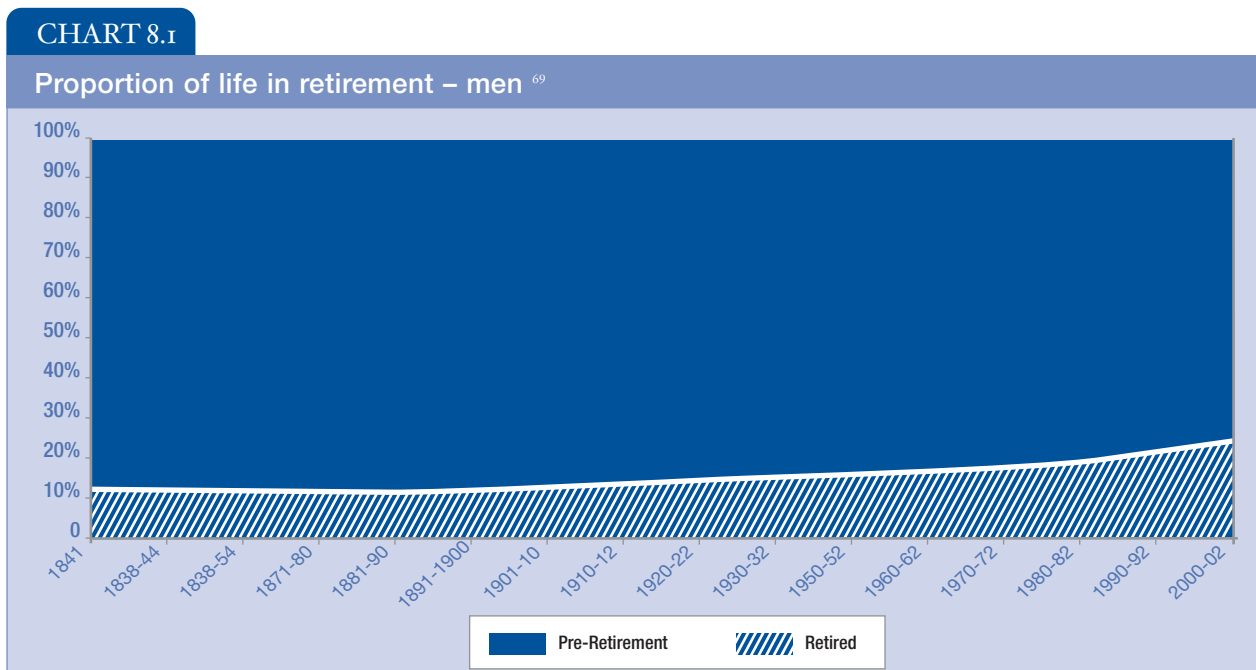
8.1 Why should this option be considered?

There are three reasons in favour of raising normal pension ages in public sector schemes: people are living longer; the state pension age is rising; and the normal pension ages within the private sector have also increased.

Chapter 1 set out how life expectancy has risen and is set to rise in the future. There is no need to repeat its analysis here, but it is worth making the point that there does need to be a balance between the length of time spent working and the length of time in retirement.

Notwithstanding the unfunded nature of most public sector pension schemes, it is during their working lives that people pay for their retirement income, either directly by funding a pension or indirectly by earning the promises made by their employers. We have to ask whether it is feasible for an individual not to start work until he or she is 21 or 22, then work for 38 years (perhaps with gaps for career breaks, illness, paternity leave and maternity leave) and then retire aged 60 with a life expectancy of 30 years or more. In other words, is it possible for people to earn sufficient during (say) 35 years of a working life to keep them throughout a lifespan of 90 years?

The chart below illustrates, for a male with average life expectancy in each period, the percentage of adult life (from age 18) spent not in retirement and in retirement, assuming retirement at 65. The second chart provides the same illustration for women (also assuming retirement at 65 for the purposes of comparison). The charts show how retirement as a proportion of adult life has increased greatly over the past 50 years, and will continue to do so in the future unless retirement ages increase. It should also be noted that the average age of starting work has increased.



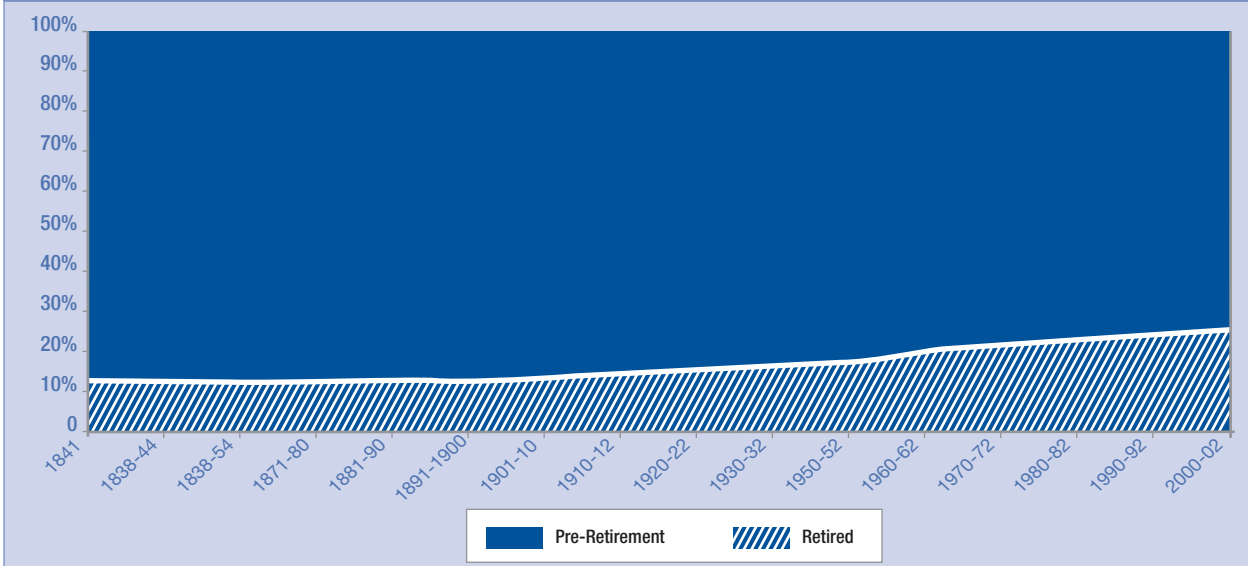
The picture is much starker when allowance is made for the continuing high increases in life expectancy forecast by the ONS for the current population. A man entering the workforce today in 2010 at the age of 18, even with a retirement age of 68, can expect to spend around 30 per cent of his adult life in retirement. For a woman, the equivalent figure is around 33 per cent.

In the public sector, while the normal pension age for new employees in most schemes has now risen to 65,

⁶⁹ Office for National Statistics, English Life Tables, Nos. 1-16

CHART 8.2

Proportion of life in retirement – women ⁷⁰



with the exception of the Local Government Pension Scheme it remains at 60 or below for existing employees. This means that if, for example, a 20 year-old had joined the civil service in 2006, he or she could draw an unreduced pension in 2046 at age 60, at a time when the state pension age under current policy will be 68. As the table below shows, even when the majority of public sector employees are retiring at 65, there will still be a three-year gap between the age at which they retire and the state pension age.

TABLE 8.1

The gap between the public sector normal pension age (for most schemes) and the state pension age ⁷¹

Year	Public sector normal pension age (for most schemes)		State pension age	Difference	
	Closed group	New members		Closed group	New members
2006	60	60	65/60	5/0	5/0
2020	60	65	65	5	0
2026	60	65	66	6	1
2036	60	65	67	7	2
2046	60	65	68	8	3
	(virtually no existing employees)			(virtually no existing employees)	

Given that the state pension age is increasing, there may be a case for increasing normal pension ages in the public sector. There is a difference of application, however. When state pension ages were changed, this applied to the whole of a pensioner’s state pension; when occupational pension ages are changed, the benefits earned for service before the change are regarded as sacrosanct and so the reduction in benefits is only applied for future service if at all.

⁷⁰ Office for National Statistics, English Life Tables, Nos. 1-16

⁷¹ NB: The normal pension age for existing Local Government Pension Scheme employees is already 65. For the armed forces, police and fire services, the normal pension age shown above applies to early leavers only – for those that do not leave early, the normal pension age is lower

8.2 Where has it been tried?

State pension ages are increasing above 65 in many developed countries, including in the UK, as shown in the table below.

TABLE 8.2

State pension ages above 65 in OECD countries ⁷²

Country	State pension age
Denmark	65 → 67
Germany	65 → 67 (63 with 35 years' contributions)
Iceland	67
Norway	67
UK	65/60 → 68
US	66 → 67

In addition to the countries listed above, Spain is planning to increase its state pension age from 65 to 67, although at the time of writing it is not clear whether the proposed increase will be enacted, and France is considering an increase to its very low pension age from 60 to 62. It is also important to note that the future increases to the state pension age listed above generally apply to new accrual as well as new employees – indeed, past accrual is also generally affected (insofar as the concept of accrual is relevant for state pensions).

Greece is another country that is being forced to raise its state pension retirement age – from 61 to 63 – as a result of its fiscal crisis. It is also having to address generous early retirement terms and reduce the indexation provision for pensions. While 63 would still remain a relatively low retirement age, the difficulties the Greek Government is experiencing illustrate both how hard it can be to raise retirement ages, and how it is better to do so in a measured way, rather than as part of a series of crisis cuts.

Normal pension ages in the private sector are higher than in the public sector. As Chapter 3 showed, 69 per cent of active members of private sector occupational DB and DC schemes are now members of schemes with a normal pension age of 65. By comparison, this is true of just 37 per cent of active members in the public sector. This is largely due to the fact that in the private sector, pension age increases have invariably applied to new accrual as well as to new members, whereas in the public sector the approach has been to protect existing members' expectations.

8.3 How much would it save?

The table below shows our assessment of the average value of pension benefits as a percentage of salary, after deducting employee contributions, under the various scenarios listed.

TABLE 8.3

Value of pension (percentage of salary) with different retirement ages – index-linked gilt yields of 0.8 per cent

	Civil Service	NHS	Teachers	LGPS
Pre-Reform Benefit Scales	54%	45%	45%	42%
Current New Entrant Scales – Pension Age 65	40%	40%	40%	42%
Pension Age 66	39%	39%	39%	41%
Pension Age 67	38%	38%	38%	39%
Pension Age 68	36%	37%	36%	38%
Pension Age 69	35%	35%	35%	36%
Pension Age 70	34%	34%	34%	35%

⁷² OECD, *Pensions at a Glance 2009*, Country profiles

The first table shows the values of benefits as a percentage of salary on the basis of a current index-linked bond yield of 0.8 per cent.

As a comparison, if index-linked gilt yields moved higher, say to 2 per cent per annum real, this table would become:

TABLE 8.4

Value of pension (percentage of salary) with different retirement ages – index-linked gilt yields of 2 per cent

	Civil Service	NHS	Teachers	LGPS
Pre-Reform Benefit Scales	35%	28%	28%	26%
Current New Entrant Scales – Pension Age 65	25%	25%	25%	26%
Pension Age 66	24%	24%	24%	25%
Pension Age 67	23%	23%	23%	24%
Pension Age 68	22%	21%	21%	23%
Pension Age 69	21%	20%	20%	21%
Pension Age 70	20%	19%	19%	20%

The alternative figures currently used by the Government for justifying employer contributions to unfunded schemes, based on a 3.5 per cent per annum real return on “investments” are shown in the table below.

TABLE 8.5

Value of pension (percentage of salary) with different retirement ages – 3.5 per cent real discount rate

	Civil Service	NHS	Teachers
Pre-Reform Benefit Scales	20%	15%	15%
Current New Entrant Scales – Pension Age 65	14%	13%	13%
Pension Age 66	14%	12%	12%
Pension Age 67	13%	11%	11%
Pension Age 68	12%	10%	10%
Pension Age 69	11%	9%	9%
Pension Age 70	10%	9%	9%

In the following sections, we just show figures on current index-linked gilt yields of 0.8 per cent and on the Government figures showing 3.5 per cent real.

9 Benefit accrual rates

9.1 Why should this option be considered?

The key reason for reducing the generosity of accrual rates is affordability. It is a reform that fits well with an increase in the normal pension age, since a proportionately less generous accrual rate allows a pension of the same annual amount to be accrued from a longer working life. Alternatively, a lower pension could be received from the same age.

A reduction in the accrual rate, together with an increase in the normal pension age, simply means working longer for the same pension:

- For example, in a final salary scheme offering a 60ths accrual rate, a pension of two-thirds of final salary can be accrued from 40 years' service. If the normal pension age was increased to 65, and the accrual rate reduced to 67.5ths, a pension of two thirds of final salary would be accrued from 45 years' service.
- Conversely, if in the above example the normal pension age were increased to 65, but the accrual rate was left unchanged, a pension of three quarters of final salary could be accrued from 45 years' service.
- If the accrual rate were reduced, but the normal pension age left unchanged, the effect would simply be a reduction in the proportion of final salary that could be accrued. In the above example 40 years' service at a 67.5ths accrual rate would allow a pension of 59.25 per cent of final salary to be accrued.

The table below provides an illustration.

TABLE 9.1

Pension accrued from various combinations of accrual rate and retirement age

Age starting career	Retirement age	Accrual rate	% of final salary pension accrued
20	60	60ths	66.6%
20	60	67.5ths	59.25%
20	65	67.5ths	66.6%
20	65	60ths	75%

9.2 Where has it been tried?

A good private sector example of a reformed DB pension scheme offering a less generous accrual rate is BAE Systems. BAE closed its final salary scheme to new members in April 2003, although it continued to leave it open to new accrual. New members are offered a less generous final salary pension:

- In the previous scheme, the “Levels 125, 167, 187 and 200”, the accrual rate varied from 1.25 per cent a year (80ths) to 2 per cent a year (50ths) depending on the level of employee contribution.⁷³
- The accrual rate for the new scheme, “Level 100+”, is 1 per cent a year (100ths).⁷⁴

In addition to a less generous accrual rate, BAE made further changes to its pension scheme, which are described in Chapter 16.

In the public sector, the recent pension reforms tended to increase the generosity of accrual rates (although pension accrual rate changes in the public sector must be considered alongside changes to lump sum accrual

⁷³ BAE Systems, Pension Scheme guide, Levels 125, 167, 187 and 200 http://dev.baesystemspensions.com/CMS/allDocuments/Main_Scheme_booklet_21.04.08_fnl.pdf

⁷⁴ BAE Systems, Pension Scheme guide, Level 100+ http://dev.baesystemspensions.com/CMS/allDocuments/Level_100_Plus_booklet_24_04_08_fnl.pdf

as well), although the accrual rate for the Police Pension Scheme changed from 60ths (30ths after 20 years) to 70ths.⁷⁵ It is not unprecedented, therefore, for accrual rates to become less generous in the public sector.

9.3 How much would less generous accrual rates save?

The table below shows our assessment of the average value of pension benefits as a percentage of salary, after deducting employee contributions, under the various scenarios listed.

The first table shows the values of benefits as a percentage of salary on the basis of a current index-linked bond yield of 0.8 per cent.⁷⁶ Note that the Civil Service benefit scale is “career average” which is why its financing cost is lower than for the other schemes.

TABLE 9.2

Value of pension (percentage of salary) with different accrual rates – index-linked gilt yields

	Civil Service ⁷⁷	NHS	Teachers	LGPS
Pre-Reform Benefit Scales	54%	45%	45%	42%
Current New Entrant Scales	40%	40%	40%	42%
Accrual Rate 1/60th	28%	40%	40%	42%
Accrual Rate 1/80th	20%	29%	29%	30%
Accrual Rate 1/100th	15%	22%	22%	23%

The alternative figures currently used by the Government for justifying employer contributions to unfunded schemes, based on a 3.5 per cent per annum real return on “investments” are shown in the second table.

TABLE 9.3

Value of pension (percentage of salary) with different accrual rates – 3.5 per cent discount rate

	Civil Service	NHS	Teachers
Pre-Reform Benefit Scales	20%	15%	15%
Current New Entrant Scales	14%	13%	13%
Accrual Rate 1/60th	9%	13%	13%
Accrual Rate 1/80th	6%	8%	9%
Accrual Rate 1/100th	4%	5%	5%

⁷⁵ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

⁷⁶ NB: The change in the value of pension benefits for civil servants is so much greater than for the other schemes because the Civil Service Pension Scheme moved to career-average with an accrual rate of 43.5ths for new entrants.

⁷⁷ The Civil Service scheme is a career average revalued earnings (CARE) scheme, and the current accrual rate is 1/43.5.

10 Career average

10.1 Why should this option be considered?

A career average scheme is one in which the benefits are earned each year in line with a member's salary but instead of being linked to a future final salary level, they are linked to an average over the whole of the member's working life.

Normally, the averaging is done after adjusting for inflation so that the benefits are linked to price inflation rather than to the individual's own salary inflation. For the purpose of our consideration, we have assumed that career average is simply linked to generally prevailing prices at RPI measures.

More generous schemes can be devised which link the benefits to RPI plus a margin, or to National Average Earnings and these would be correspondingly more expensive or would require a lower accrual rate to be equivalently expensive.

There are four reasons to consider a move to career average schemes in the public sector: affordability, fairness, today's labour market, and to avoid manipulation.

The argument for affordability is quite simple. The average salary over a person's career tends to be lower than their final salary, and so the pension paid out (assuming the same accrual rate and normal pension age) will on average be lower, although this depends on whether it is uprated with prices or average earnings.

The fairness question was addressed in Chapter 5. To briefly re-cap, a final salary pension disproportionately benefits those who stay in position for longer and those who enjoy faster salary growth than the average. Within a scheme, broadly speaking, younger employees and "low fliers" subsidise older employees and "high fliers".

Another way of putting this is that taxpayers subsidise older and higher-paid employees more than younger and lower-paid ones. Compared with final salary schemes, a younger and lower-paid employee is *relatively* better off, even though he or she may be worse off in *absolute* terms (which will depend on such factors as the accrual rate). A disproportionate share of the cost savings will therefore come from higher-paid employees, who arguably will be less affected by a less generous pension than the lower-paid. A move to career average schemes will also benefit, relatively speaking, those employees who move in and out of jobs more frequently, or women with interrupted career patterns, who will tend to be lower-paid.

There are issues here related to the need to ensure that public sector employees are paid competitively in the labour market: it is not our intention to pursue an agenda of greater equality of pay and conditions across the public sector. However, the additional cost of the pensions to higher paid public sector employees is not appreciated by employers or employees for reasons we have discussed. It therefore seems sensible to look at options that favour those with high wage growth who stay with their employer to a lesser degree than current arrangements.

A third reason for introducing career average is the nature of today's labour market. It is often no longer the case that an older worker wishes to work full time at the peak of his or her career on Friday, and then stop working completely on Monday. Encouraging older workers to work part-time, or at a lower level of responsibility, in the later years of their career, and perhaps after the normal pension age, will surely be beneficial.

Final salary pensions discourage older workers from reducing their activity in their last years (although final salary arrangements that are based on the highest salary over the final few years provide some mitigation but are open to abuse in other ways). Given that final salary arrangements for older workers are also more costly for the employer, they might in theory discourage the hiring of people whose experience would be of benefit

to the organisation, although the charging of a single artificial contribution rate to employers in the public sector hides this higher cost.

Career average pensions are no more expensive for employers employing older workers than younger workers, and nor do they discourage part-time or less intensive work during the last years of a career. They are a better fit to today's labour market.

Finally, career average schemes prevent large salary increases being awarded to employees just about to retire, which in a final salary scheme result in a disproportionate increase to the pension – a cost that is borne by the Treasury and not the public sector employer making the decision. For example, an employee earning £50,000 a year aged 59 might expect to retire on two thirds of final salary (£33,000). To take an extreme example, if he or she were promoted and his or her salary doubled to £100,000, the two thirds final salary pension would also double and would now be worth around £66,000, not for one year but for every year of retirement. The public sector employer would pay the salary and pension contribution for one additional year but the extra pension (in capital value worth perhaps £700,000) would be paid for life.

Some – but not all – schemes have restrictions to prevent abuse, but these tend to be ineffective with pension being determined by salary in the last two or three working years. It is still possible for managers to “play the system” and reward a senior member of staff with salary increases just before retirement.

Such cases may be rare, but a system which allows this to happen is surely flawed. There is evidence of large pay rises (though not as large as in the above example) being awarded at the end of the careers of senior public sector employees. Remuneration committees do examine the impact of final years' salary adjustments on senior staff, particularly where the bill is picked up by central government and not by the local NHS trust, school or college. Career average would prevent “manipulation” from occurring.

10.2 Where has it been tried?

The only main public sector scheme to have moved to career average for new members is the Civil Service scheme. But the accrual rate was changed to 2.3 per cent (43.5ths),⁷⁸ which means that a civil servant can now accrue a pension of half of his or her career average salary from just 22 years of service. The cost of this reformed scheme is similar to the cost of the previous final salary arrangement; the benefit structure of the scheme has simply been rearranged so that some people benefit a little more and others a bit less. This may be a more desirable scheme arrangement for employers and employees alike – however, it has not dealt with the basic problems of transparency of costs or the extent of costs.

Other small public sector schemes use career average, including the GP's scheme. The Local Government Pension Scheme also has elements of career average accrual:

- Membership of the NHS Pension Scheme is open to GPs, although pay is calculated on a career average basis. The scheme guide states: “We take your pensionable pay for each year of membership and uprate it by the increase in the retail price index (RPI) plus a fixed 1.5 per cent. Then we add the uprated amounts together. Your yearly general practitioner pension is 1.87 per cent of the total.”⁷⁹
- The Local Government Pension Scheme provides pensions to elected councillors (whose allowances rise and fall – or disappear altogether when they lose their seats) on a career average basis.
- The Universities' Superannuation Scheme (USS) – though not a public sector scheme – is also worth mentioning. This scheme has a career average underpinning as a form of additional option to protect those with falling later-year salaries. The USS guide states: “We calculate your annual salary for each period of 12 months, while you have been a USS member, over a maximum of 13 years prior to your retirement and

⁷⁸ Pensions Policy Institute, *An assessment of the Government's reforms to public sector pensions*, October 2008, Table 1

⁷⁹ New NHS Pension Scheme Guide

revalue each salary, except the last 12 months, according to the movement in the Retail Prices Index. Your pensionable salary is either the highest revalued annual salary during the last three years or your highest revalued salary averaged across any three consecutive years over the last 13 years.”⁸⁰

In addition, the State Earnings Related Pension (SERPS) was based on the average earnings on which a person paid national insurance contributions over their working life. SERPS has now been replaced by the State Second Pension (S2P) and, although existing SERPS accrual is protected, S2P is moving towards a flat rate.

A good private sector example of a career average scheme is Tesco. In 2001, Tesco closed its final salary scheme, with a 60ths accrual rate, to new members. It was replaced by a career-average DB pension with an accrual rate of 1.5 per cent a year (67ths).⁸¹

10.3 How much would a move to career average save?

The table below shows the average value of benefits as a percentage of salary, after deducting employee contributions, under the various scenarios listed.

The first table shows the values as a percentage of salary on the basis of a current index-linked bond yield of 0.8 per cent.

TABLE 10.1

Value of pension (percentage of salary) with different career average accrual rates – index-linked gilt yields

	Civil Service	NHS	Teachers	LGPS
Pre-Reform Benefit Scales	54%	45%	45%	42%
Current New Entrant Scales	40%	40%	40%	42%
Career Average 1/60th	29%	28%	28%	30%
Career Average 1/80th	21%	20%	20%	21%
Career Average 1/100th	16%	14%	14%	15%

The alternative figures used by the Government for determining employer contributions, based on a 3.5 per cent per annum return on “investments” are shown in the second table. Note that using the Government’s artificial discount rate, a reduced pension of 1/100 of career average salary for each year of service would be entirely covered by NHS and teachers’ own employee contributions.

TABLE 10.2

Value of pension (percentage of salary) with different career average accrual rates – 3.5 per cent discount rate

	Civil Service	NHS	Teachers
Pre-Reform Benefit Scales	20%	15%	15%
Current New Entrant Scales	14%	13%	13%
Accrual Rate 1/60th	7%	5%	5%
Accrual Rate 1/80th	4%	2%	2%
Accrual Rate 1/100th	3%	0%	0%

⁸⁰ Universities Superannuation Scheme Guide <http://www.uss.co.uk/Guides%20and%20Booklets/Guide%20For%20USS%20Members.pdf>

⁸¹ www.pensionwebsite.co.uk

II Salary ceilings

11.1 Why should this option be considered?

There are two key reasons to introduce limits on pensionable pay: affordability and, some would say, fairness.

Before giving an explanation of these reasons, it is worth pointing out that a cap on pensionable pay is a very different proposition to a cap on the actual pension to be paid out. There have been several proposals to put a cap on the annual pension that can be paid out to public sector retirees, and limits such as £50,000 have been suggested by the Conservatives in their pre-election manifesto.

Such a cap on pension would not work for a number of reasons. Firstly, a cap of £50,000 in annual pension would affect very few retirees and hence save very little money. Secondly, it would be inequitable given that it would impact differently on people in the same job but with different lengths of service. It is not the right approach. As the Institute for Fiscal Studies has pointed out:

“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 per cent 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.”⁸²

A cap on pensionable pay, however, is a very different proposition. It would clearly save money, since for higher earners a pension would be being accrued on only part of their salary.

It could be argued that it would be a “fair” reform, since it would have no impact at all on the pension of anyone whose salary was below the ceiling. It would only impact those who earned more, who would have the means to make their own pension arrangements in addition to their occupational scheme. And given that, relatively speaking, the contributions of lower-paid public sector employees subsidise the pensions of higher-paid public sector employees, 100 per cent of the cost saving from this measure would come from the higher-paid.

However, we should be careful in putting too much store by this principle of “fairness”. The public sector has to compete in the market for all employees – whether senior managers, clerks or catering staff. It is the package of benefits that has to be competitive and to reduce the value of part of that package for a particular group may lead to a need to increase other parts of the benefits package. The problem faced in the public sector is that, because the cost of pensions is not properly revealed and borne by those taking decisions, rational hiring decisions and benefit package structures are impeded. Nevertheless, it may be the case that, once a certain limit has been reached, employees value their pension less. As such, a pensionable salary cap is certainly worth considering.

Salary ceilings could also be introduced as part of a wider reform to introduce a more sustainable DB pension in the public sector. A later normal pension age, a proportionately less generous accrual rate, the introduction of career average and a cap on pensionable pay could, in combination, save a considerable sum of money. Such a package would disproportionately reduce the value of a pension to higher-paid employees and could have less impact on the lower-paid.

⁸² Carl Emmerson and Gemma Tetlow, *Pensions and Retirement Policy*, 2010 Election Briefing Note No. 16, Institute for Fiscal Studies, May 2010

11.2 Where has it been tried?

The Finance Act 1989 placed a limit on the level of earnings from which pension provision could be made under tax-approved pension schemes. The “Earnings Cap” was originally set at £60,000 and was automatically increased annually in line with RPI, unless Parliament determined otherwise.

Its main effect was to set a ceiling on the contributions that could be paid into, and the benefits that could be paid by, tax-approved pension schemes. It generally applied to people who contributed to a personal pension scheme, joined an occupational pension scheme set up after 14 March 1989 or joined any occupational pension scheme after 1 June 1989.

The Earnings Cap was abolished in April 2006, at which time it stood at £105,600, although it was retained by many occupational schemes. Its equivalent after April 2006 was the effective limit introduced by a lifetime pensions allowance of £1.5 million, equivalent to a pension of £75,000 per annum, roughly two-thirds of the old earnings cap.

A salary cap was a feature of SERPS, as SERPS was based on the band of earnings on which national insurance contributions were paid. Its replacement, S2P, although moving towards a flat rate, also has a salary cap, which is set at the Upper Earnings Limit for national insurance contributions (£40,040 in 2009-10). However, it should be noted that SERPs was not part of an employment contract but an attempt to provide a second, earnings-related layer of social security pension for all working people.

11.3 How much would it save?

To measure accurately how much would be saved would necessitate information on the distribution of pension scheme membership by both age and salary level. Despite Freedom of Information requests to government departments, we have not been able to obtain this data distributed by both factors.

To give an indication of how much could be saved in pension costs, we have therefore carried out approximate calculations based on the distribution of civil service salaries obtained from the Annual Civil Service Employment Survey.

For the NHS and Teachers, the distribution of salaries is likely to be very different and salary ceilings would have a different impact.

In the table below we show the reduction in levels of employer contributions on the basis that a salary ceiling is linked to average earnings inflation and that employers and employees pay contributions based on their capped salaries rather than their full earnings.

TABLE 11.1

Saving to value of pension with different salary ceilings

	% reduction in costs
Salary Ceiling £80,000	0.4%
Salary Ceiling £75,000	0.5%
Salary Ceiling £70,000	0.7%
Salary Ceiling £60,000	1.2%
Salary Ceiling £50,000	2.3%
Salary Ceiling £40,000	4.8%

Savings are fairly small as a percentage of total costs, particularly compared with some of the other options considered in this report. This is because despite a few prominent high salaries, at 31 March 2008 (the date of the data analysed), only 0.5 per cent of employees earned more than £75,000 per annum and fewer than 5 per cent of employees earned more than £50,000 per annum.

12 Removing index-linking

12.1 Why should this option be considered?

Benefits accrued at retirement are generally increased in the public sector by the rate of retail price inflation each year in order to preserve the real value of the annual payment. Changing the degree of index-linking of benefits could be another option to reduce the cost of DB pensions in the public sector.

Pension benefits could, for example, continue to be indexed to prices, but with an upper limit on the percentage increase, as is normal in the private sector. This would save money when inflation is high, but would introduce inflation risks to retirees. Alternatively, though it is not common practice anywhere, pensions could be index-linked only when inflation went above a certain level so that pensioners were only protected from extreme inflation risks.

The strongest argument against moving away from full price indexation is that pensioners' income becomes subject to monetary conditions entirely outside their control, and that pensioners' income needs typically rise with age as their health deteriorates. Even what seem to be quite generous caps (say 5 per cent per annum) in periods of benign inflation, can cause serious reductions in pensioners' real income in periods of high inflation. Two periods in the past 35 years (1975-76 and 1979-81) have seen annual inflation top 20 per cent in the UK, and one further (1990) has seen inflation top 10 per cent. This Commission believes that providing a stable real level of income for pensioners comes very high on the list of competing needs for a high-quality pension.

An argument against introducing a cap to the level of price indexation in the public sector is that the Government is willing to pay fully indexed returns to holders of index-linked gilts, and so it may be reasonable to continue to apply the same standard to pensioners.

An argument in favour of a policy other than full index-linking is that there can be a rise in the price level (though not continued inflation) as a result of what economists call a "supply shock" (for example, a rise in the price of oil or a grounding of all aeroplanes for three months as a result of a chronic volcanic ash problem). Under such circumstances, those who are working have to suffer a fall in their living standards. It might seem unreasonable for pensioners – whose pensions are paid by the taxes of those who are working – not to do so as well.

Finally, it is worth observing that in the private sector virtually all pensions now have a ceiling on the level of inflation protection (5 per cent or 2.5 per cent depending on the period when the pension was earned). Consistency and comparability with the private sector might be a desirable goal.

12.2 Where has it been tried?

In the public sector, full index-linking to the RPI (CPI from April 2011 following the announcement in the Budget) is almost universal. In the private sector, full index-linking is quite unusual. Most private sector schemes provide the minimum level of indexing that the law requires, both in the period between leaving and retirement and during pension payment. In 1997, that entailed indexing to RPI with a 5 per cent cap; in 2005, the cap was reduced to 2.5 per cent for future accrual. In particular, newly privatised industries generally adopted limited price indexing for new employees after privatisation, sometimes by using two explicitly different pension schemes.

These varying levels of year-by-year index-linking apply both to retirement, and to the period between leaving a pension scheme and retiring, so they can cover quite considerable periods of time, and, if inflation is high, make a considerable difference to the pension outcome in real terms.

12.3 How much would it save?

How much would be saved obviously depends on how high inflation is in the future. If inflation were to remain permanently under 2.5 per cent, then putting a 2.5 per cent cap on the level of index-linking would save nothing. If inflation rose either substantially or persistently above 2.5 per cent, the savings could be enormous, but at the same time, the real value of the level of pension, particularly for older retirees and those who had left the scheme before retirement, would be significantly lower.

It is worth noting that at the time of writing, RPI inflation now exceeds 5 per cent (April 2010) and private sector pensions linked to LPI (RPI up to 5 per cent or RPI up to 2.5 per cent) may well in the near future for the first time have some saving compared with the full index-linking in the public sector.

The Government Actuary's Department has estimated that LPI 5 per cent is likely in the long-term to be equivalent to a shortfall in inflation-linked increases on average of 0.75 per cent per annum and that LPI 2.5 per cent is likely to lead to a shortfall of an average of 1.75 per cent per annum.⁸³

On this basis, expressed as a saving to the cost of public sector pensions, introducing LPI limited to 2.5 per cent might save around 20 per cent of costs and LPI limited to 5 per cent might save around 10 per cent of costs.

⁸³ Government Actuary's Department, *Actuarial Assumptions for Assessment of Broad Comparability – Background note on the differential between RPI and LPI*, August 2005

13 National insurance and contracting-out

13.1 Why should this option be considered?

In 1978, the State Earnings-Related Pension Scheme (SERPS) was introduced in order to provide employees with an earnings-related additional pension, on top of the flat-rate basic state pension. After a number of reforms, this became the State Second Pension (S2P), which provides for a state earnings-related pension based on earnings each year (a career average) between two limits set by the Government – in 2009-10, between £4,940 and £40,040. National insurance contributions have been steadily increased to pay for the extra pension accrual above the basic state pension. S2P is now moving towards a flat rate payment.

The Government allowed some people to contract-out of this additional state pension, if their private pension scheme provided a pension broadly better than SERPS. If contracted-out, the employer and employee were allowed to pay lower national insurance contributions (NICs). Any comparison of the benefits provided to a member of such a scheme needs to reflect the lower contributions paid by the employee as a saving on their national insurance.

For employees, a rebate of 1.6 per cent off NICs between the limits is provided; for employers the rebate is 3.7 per cent. The total of 5.3 per cent is a lot less than the value of the guaranteed index-linked S2P benefits which are received if someone is not contracted-out, when valued in the same way as pension benefits are in this paper, by reference to the yields obtaining on government stocks. At the current time, the full value of the benefits offered by S2P is closer to 9 per cent of earnings.

The rationale for receiving a national insurance rebate was that the worker would not be receiving any additional state pension from taxpayers in future, as their private scheme would replace it. However, with an unfunded public sector pension scheme, the future taxpayers will still have to pay because the public sector scheme includes the replacement for the additional pension. Not only that, but this pension is guaranteed and cannot be reduced (unlike SERPS and S2P which have been reduced many times over the years) as well as being paid from a younger age than the national insurance pension age.

13.2 Where has it been tried?

There is no other major country which has introduced a system of contracting-out of its state pension into alternative arrangements. In the UK, many private sector schemes have now ceased to contract-out, since the terms offered by the Government have gradually worsened, to the point where the value of the national insurance rebate was clearly less than the alternative value of the additional SERPS that would be provided.

In the public sector, contracting-out continues unchanged. There is therefore an opportunity to reconsider the benefit structure and provide benefits on a non-contracted-out basis instead. The SERPS/S2P benefits would be provided at the same age as to other members of the population (from state pensionable age of between 65 and 68 over the coming generation). This contrasts with the provision of full benefits for the members of public sector schemes which commence normally at an earlier age.

13.3 How much would ending contracting-out in the public sector save?

Ending contracting-out would bring in extra revenue immediately, as public sector employees would be required to pay the full rate of national insurance. The saving would depend on how the change was introduced. If the schemes were not contracted-out of S2P then employers and employees would have to pay higher NICs. This would provide immediate extra income (and therefore a reduction in net cost) for the Government of 1.6 per cent NICs between the upper and lower earnings limits. The same effect could be achieved – at the same cost to the employee and employer – by maintaining contracting-out and increasing

contributions to reflect the true cost of the public sector pension – the 9 per cent rather than the 5.3 per cent which the NIC rebates imply is all it costs. It should also be noted that national insurance pensions are not costed on an accruals basis at all. There is therefore an apparent saving to the Government from this reform as a result of the S2P pension not being accounted for in government spending as it accrues.

This approach of removing the contracted-out status of public sector pensions could be an effective and pragmatic way of reducing the apparent net cost of the schemes to government. Suppose that the NHS scheme provided 1/80 of earnings for each year of service and ceased to be contracted-out. The change would be as follows (in relation to the earnings range to which S2P and contracting-out applies):

Existing Benefits

<input type="checkbox"/>	Employee Contributions	6.5%
<input type="checkbox"/>	Employer Contributions	14%
<input type="checkbox"/>	Total Value of Benefits	46.5%
<input type="checkbox"/>	<i>Shortfall in Contributions</i>	26%

Revised Benefits (Contracted-In)

<input type="checkbox"/>	Employee Contributions	6.5%
<input type="checkbox"/>	Employee NIC Rebate forgone	1.6%
<input type="checkbox"/>	Employer Contributions	14%
<input type="checkbox"/>	Employer NIC Rebate forgone	3.7%
<input type="checkbox"/>	Total Value of Benefits	35%
<input type="checkbox"/>	S2P Benefits	9%
<input type="checkbox"/>	<i>Shortfall in Contributions</i>	18.2%

In other words, there could be an improvement in the balance of finances of around 8 per cent of earnings if employees and the employer paid full rate national insurance and the benefits of the scheme were scaled back to allow for S2P payments in substitution for what is currently paid by the scheme.

14 A move to funded defined contribution schemes

14.1 Why should this option be considered?

There is a number of benefits that a move to defined contribution arrangements for new accrual and new members could bring:

- Firstly, the cost to the taxpayer would be reduced, assuming that wages don't rise to compensate for a less generous pension. The taxpayer would pay through the employer contributions into the employee's pension fund, with payments to retirees in the future depending on the value of their individual funds. It is highly unlikely that such contributions would be at the same rate as is necessary properly to finance defined benefit schemes.
- Secondly, longevity risks would be shifted from the taxpayer to the employee. Upon retirement, the employee would be likely to purchase an annuity, the value of which would depend on the value of the employee's fund at retirement. Annuity risks could therefore be insured by the employee at retirement but only by the purchase of annuities in the market. If longevity improved during a person's working life, this would be reflected by more expensive annuity rates, providing an incentive for the employee to continue working – thus a DC scheme has in-built self correcting mechanisms. This also assumes that wages do not rise to compensate for the transfer of risk.
- Thirdly, public sector pensions would not be unfunded in the future. Payments would be made by employees and employers into individual pension funds, which would then pay out at retirement. The Government would no longer be paying public sector retirees: all entitlements would be paid for as they were promised.
- Fourthly, DC arrangements may be a better fit to today's labour market, with frequent changing of jobs, and an increasing number of employees moving between the private and public sectors.
- Finally, individuals would receive benefits more closely related to the contributions that they had made.

An additional reason for moving to DC in the public sector is one of fairness when compared with the private sector. As shown in Chapter 3, 94 per cent of public sector employees are actively earning a DB pension, compared with just 11 per cent in the private sector. A move to funded DC in the public sector would therefore align pensions more closely between the two sectors.

There are, however, a number of drawbacks to DC:

- Firstly, there is an argument about levelling down, that must be considered. The closing of DB schemes may not have been a good development in the private sector, and so it may not be the best idea for the public sector either. It is important, though, to set this argument against the point that taxpayers are paying for pensions in the public sector which they often cannot afford for themselves.
- Secondly, investment risks would now sit with the employee, which many employees may not be comfortable with. Longevity risks would also be shouldered by the employee to a large degree.
- Thirdly, funded DC would save taxpayers' money in the long run, but replacing a pay-as-you-go arrangement with a funded one would entail significantly higher spending in the short term. This is because employer and employee contributions would go into the employees' individual pots, as well as going to pay the existing earned current pensions as at present. Given the scale of the UK's fiscal deficit, this may present a serious funding challenge in the short term. It was much easier for the private sector to move from DB to DC, precisely because private sector DB pensions were funded. In

the same way, DC might fit local government more easily than national government schemes. Having said this, our suggested moves to make all pension costs transparent considerably undermine the force of this argument.

- Fourthly, the vast majority of compulsory annuities bought in maturing DC schemes are nominal and flat-rate, not index-linked. They are chosen because they give much better early-years' income, but they suffer all the faults of a non-index-linked pension, most tellingly that pensioners' real income will fall consistently, and that their lowest real income will be at the end of their lives. For many middle- and low-income pensioners, their falling real pension income could push them below pension credit income levels, which throws the problem back on the taxpayer. It seems highly inappropriate for public policy to support such an arrangement.

There are, of course, many types of DC contribution arrangements that could be adopted:

- Matching contributions from the employer could ensure that employee contributions were matched £1 for £1. Employee contributions could be matched to differing degrees, for example £2 to £1 by the employer, or 50p to £1.
- There could be a minimum level of contributions from the employer, with employee contributions on top.
- There could be a high level of employer contributions and some form of matching arrangement on top.
- Employer contributions could be provided without any requirement for the employee to contribute. The employee could then make AVCs if desired, perhaps also with some form of matching from the employer.

One final point to note is the risk of a significant number of employees choosing not to join a new DC scheme, an issue that the new NEST scheme may also have to grapple with. What would a public sector employer do in such circumstances?

14.2 Where has it been tried?

In the UK, there are three areas where funded DC pensions have been introduced or expanded:

- In the private sector, DB has largely been replaced by DC, although most private sector employees do not have an occupational or employer-sponsored pension at all.
- The proposed new NEST scheme, which would auto-enrol most employees into a DC pension with contributions of 8 per cent of a band of salary, is scheduled to start operation in 2012, and to be covering the whole workforce by 2016, although it is currently being reviewed. As part of the new arrangements, employers would also be required to auto-enrol their employees into the company's existing occupational pension scheme (if the company has one), provided it is at least as good as the NEST scheme. It is likely that NEST would lead to a significant increase in the number of private sector employees enrolled in DC pensions, although there is a risk that employers may reduce the generosity of their existing schemes to the NEST minimum.
- Oral evidence presented to the Commission suggests that public sector employees are increasingly making use of AVC facilities in addition to their public sector DB pensions. AVCs are essentially "top up" DC pensions.

In addition, new civil servants can choose to join a DC pension (the "Partnership" scheme) instead of the DB scheme. The Partnership scheme is a stakeholder pension. The employer pays contributions of between 3

per cent and 12.5 per cent of salary depending on the employee's age. Employee contributions are not required, although the employer will match employee contributions up to 3 per cent of salary.⁸⁴

Perhaps not surprisingly, very few have joined the Partnership scheme. By 2009, only 7,400 had joined, despite the Partnership scheme having been open since 2002. By comparison, over 45,000 had joined the reformed DB scheme for new entrants by 2009, although it had only been open since 2007.⁸⁵ This equates to an annual joining rate of around 1,050 for the DC scheme, compared with 22,500 for the new DB scheme.

Funded DC is also used overseas. The state pension system in Denmark has a number of elements. The basic scheme consists of a fixed amount and an income-tested supplement, while a means-tested supplementary pension benefit is targeted at the lowest earners. A near-universal DC scheme is then added to the basic scheme.

The labour market supplementary pension (ATP) is a statutory, fully funded, collective insurance based, DC scheme. ATP provides a lifelong pension from the age of 65 and a survivors' lump sum benefit for dependents. As the OECD states:

“Technically, the old age pension of ATP is a guaranteed deferred annuity... Until 2002, each DKK 396 of contributions earned DKK 100 of pension benefits paid from 65 regardless of the age at which they were made. This implied an average (across all accruing cohorts) interest rate of around 4.5 per cent. From 2002, a nominal interest rate of 1.5 per cent has been assumed... The ATP scheme increases pensions in payment and pension rights alike if its financial condition allows. This is done in the form of bonus allowances. Increases are guaranteed as are earned rights... An entirely new ATP pension accrual system has been introduced as from 2008. The model is based on swap interest rates as opposed to a fixed nominal interest rate of e.g. 1.5 per cent.”⁸⁶

The Danish example shows that it is possible to combine a fully-funded DC scheme with a minimum rate of return, offering savers some certainty about their pension outcomes.

It is also worth noting that a range of insurance benefits could be provided with a DC scheme (widows' benefits, life insurance and so on).

14.3 How much would it save?

As Chapter 3 shows, total contributions to DC schemes tend to be on average less than half the value of total contributions to DB schemes. Although current levels of contribution to DB plans are boosted by the need to fund shortfalls in investments backing past service benefits, there is clearly a considerable saving being made by private sector employers on the back of a lower DC contribution level as well as low take-up by employees.

Contribution levels also vary hugely both in amount and in their structure. For example, some schemes have a core level of contribution provided by the employer regardless of whether or not the employee pays into the scheme. Others require employee contributions to qualify for the employer top-up. It is common in the UK to have matching pound for pound between certain limits. For instance, there might be a 2 per cent employer contribution, a 1:1 match for any contributions from the employee between 0 per cent and 6 per cent and then the facility for the employee to pay further contributions on top.

In other countries, for example the United States, matching tends to be more partial, for instance \$1 from the employer for every \$2 put in by the employee.

⁸⁴ Civil Service Pensions, Nuvos and Partnership scheme guide

⁸⁵ Cabinet Office, *Civil Superannuation Resource Accounts 2008-09*, July 2009, p.7

⁸⁶ OECD, *Pensions at a Glance 2009*, Denmark profile

NEST, which is scheduled to introduce personal accounts in 2012, has the provision that the employee puts in 4 per cent, the employer puts in 3 per cent and “tax relief” takes the employee’s 4 per cent up to 5 per cent, i.e. a total of 8 per cent.

At one extreme, to replicate the current cost to the Government – and the true value to the members – of providing DB pensions to public sector employees with a DC scheme would mean the employee paying in around 6 per cent and the employer putting in around 40 per cent, additional cash on top of the payment of past pensions accrued under a DB environment. However actuarially fair, Government finances would not permit the extra employer contribution to be made.

Replacing DB with a DC system would be likely to present serious short-term government challenges. A less expensive DC pension might necessitate more generous public sector pay to attract the right quality of workforce. Pension reform could come into conflict with a need to cut the current public sector deficit.

15 Notional defined contribution

15.1 Why should this option be considered?

The benefits of notional DC, or pay-as-you-go DC, are similar to those for funded DC described in Chapter 14. The key differences are around risk, transparency and the cash flow implications for the Government.

- Unlike a move from unfunded DB to funded DC, there is no problem resulting from the Government paying twice in the short term (that is, continuing to pay pensions in payment whilst also funding new commitments). The notional DC arrangements would remain unfunded, meaning that contributions from today's employees would still pay today's retirees. This does not change the costs in the long term but it does change the cash flow incidence of the costs.
- Notional DC could also offer a degree of guarantee around investment returns. For example, it could guarantee that the notional value of individual pension accounts would grow in line with general economic indicators rather than relying on investment values. This would reduce the risk facing individual public sector employees, relative to funded DC. Although overall returns may be lower compared with good investment performance, it would offer employees a more predictable level of funding for retirement, which is likely to be valued highly. It should be added that this approach does not lead to risk disappearing to nowhere – risks would, one way or another, have to be allocated between taxpayers and members of the schemes.
- A notional DC scheme should be transparent, ensuring that all commitments were on balance sheet.

Although the scheme would remain unfunded, it would be possible to ensure that it remained in financial balance. Either the “internal rate of return” that employees would earn or the contributions that employees make could be varied each year to ensure that the scheme remained sustainable. An automatic balancing mechanism such as this, especially if administered by an independent body, could help to take the political heat out of small changes to pension entitlements.

15.2 Where has it been tried?

Notional DC has been adopted by countries such as Sweden, Germany, Austria, Italy and Poland.⁸⁷

In Sweden, the pay as you go DB state pension system was replaced in the 1990s with a combination of earnings-related notional DC and funded DC arrangements, following the recommendations of an independent commission.

The notional DC element consists of contributions of 16 per cent of salary. The value of all contributions made in the course of working life is the basis for what savers receive as pensioners. The value of each notional account grows at around the rate of average wage increases.

At retirement, the accumulated notional capital will be converted into an annuity, using a calculation based on a coefficient depending on individual retirement age and life expectancy. In other words, the later the individual retires, the larger the annuity will be. After retirement, pensions are uprated with the increase in nominal average earnings less the imputed interest rate in the annuity divisor of 1.6 per cent.

There is also a balancing mechanism: if assets (the buffer fund plus the estimated value of assets in the form of contribution revenues) fall below liabilities (accrued notional pension capital and capital value of outgoing pensions), then indexation of pensions in payment and returns credited to notional accounts are reduced by

⁸⁷ CBI, *Getting a grip: The route to reform of public sector pensions*, April 2010

the ratio of assets to liabilities. Since contributions are fixed, these changes to indexation are the primary way of ensuring long-term stability.⁸⁸

The funded DC element consists of a further 2.5 per cent contribution paid into personal accounts (i.e. it is small relative to the unfunded bit), with some individual choice over where these funds are invested. At retirement, people have a choice over the way benefits are withdrawn. First, the pension can be converted into an annuity to avoid investment risk. Alternatively, a variable annuity can be chosen, where the fund continues to be invested by the chosen fund manager. These annuities do not have a guaranteed value.⁸⁹

15.3 How much would it save?

The same issues apply here as with funded DC – it is a choice of how much can be afforded in an alternative DC scheme compared with the costs of DB benefits.

The principal difference is that a notional DC arrangement may be better able to fit within government cashflow constraints compared with an externally-funded DC arrangement.

⁸⁸ OECD, *Pensions at a Glance 2009*, Sweden profile

⁸⁹ *Ibid.*

16 Hybrid schemes

16.1 Why should this option be considered?

A hybrid scheme could be a useful combination of the features of other types of pension arrangement. It could combine a core DB element, which would be far less generous than the current public sector DB schemes, with optional funded or notional DC add-ons.

There is a number of advantages to this approach:

- It would save money, similar to the more sustainable DB options.
- It would also entail a greater level of flexibility, as in the DC options.
- It would provide a core, though limited, guaranteed benefit, which would reduce the risk of poor investment returns for employees.
- There would be less need to pay twice in the short term, unlike a wholesale move to funded DC arrangements.

16.2 Where has it been tried?

There is a number of examples of hybrid arrangements in the UK:

- Currently, public sector schemes are effectively hybrids, as they allow employees to make AVCs, which are invested in DC funds. Oral evidence presented to the Commission suggests that public sector employees are increasingly making use of AVC facilities.
- Many private sector DB schemes, such as the Tesco scheme, allow AVCs to be made,⁹⁰ and so also effectively operate as hybrids.
- A good example of a private sector hybrid scheme is BAE Systems (also described in Chapter 9). The “Level 100+” scheme, which has been open since April 2003, combines a core final salary scheme with a 100ths accrual rate, with a DC “Retirement Account”. The Retirement Account is funded by a 2 per cent employer contribution together with any voluntary contributions from the employee, and its final value is dependent on the level of contributions and investment performance.⁹¹ In this way, employees are offered a core, though limited, protected benefit, and have the flexibility to top this up through DC.

16.3 How much would it save?

The amount of money that would be saved by a hybrid arrangement would depend on the type of scheme chosen, but there would be an element of the savings generated by the options listed in the previous chapters, to the extent that they were brought into the hybrid arrangement.

⁹⁰ www.pensionwebsite.co.uk

⁹¹ BAE Systems, Pension Scheme guide, Level 100+ http://dev.baesystemspensions.com/CMS/allDocuments/Level_100_Plus_booklet_24_04_08_fnl.pdf

Part III: Conclusions

“Many arguments used to attack public sector pensions are flawed. But the starting point often used by their enemies is true. Today’s typical employee in the public sector does have a better pension scheme than the typical worker in the private sector... The question is whether the right response to this gap is to level down public sector pensions or to make private sector pensions better.”

TUC, Decent pensions for all, 2009

This part contains our assessment of the various options described in Part II, and outlines three general approaches that the Commission believes could be taken – reformed defined benefit, defined contribution, and notional defined contribution. Certainly, other bodies will come up with different road maps, but the point is more about the approach taken rather than the precise reform option that is chosen. As Part II made clear, there is not a single “correct” way of reforming public sector pensions, but a number of different options, each with its own pros and cons. Different options can be followed by different public sector employers.

An argument that is often made is that the best way to reduce the gap between public and private sector pension provision is to improve private sector pensions rather than reform the public sector schemes. The Commission’s remit does not cover the private sector, or indeed the system of state pensions and means-tested benefits for pensioners, but the evidence that has been presented in this report demonstrates that, whatever happens to state and private sector pensions, further reform is likely to be needed to manage the growing costs of pensions in the public sector.

The overall size of any package for employees in any sector of the economy is largely decided by market forces and the division of any employment pay and benefits package between pay, pensions and other benefits is a matter for negotiation between employees and employers.

Whatever happens to state and private sector pensions, further reform is likely to be needed to manage the growing costs of pensions in the public sector.

17 Three approaches

The options set out in Part II can be crystallised into three main approaches to reform. Each approach has its pros and cons, but they do represent viable choices for the future of the unfunded public sector schemes. This chapter summarises, rather than repeats in great detail, the arguments for and against the reform measures explained in Part II. Firstly, the cost savings from the various options are compared.

One of the objectives of the Commission, highlighted in Chapter 7, is to recommend reforms which will result in 100 per cent of unfunded public sector pension costs being financed by employee and employer contributions each year. It is an important principle that you get what you pay for. Based on index-linked gilt yields, the table below shows how much the main public sector pension schemes are worth on average as a percentage of salary, both before and after the recent reforms, together with the combined employee and employer contribution rates.

TABLE 17.1

The value of the main public sector pensions and the combined employee and employer contribution rates ⁹²

	Civil Service	NHS	Teachers	LGPS	Armed Forces
Pre-Reform Benefit Scales	58%	51%	51%	48%	74%
Current New Entrant Scales	43%	47%	47%	48%	60%
Combined employee and employer contribution rate ⁹³	18.6-30%	19-22.5%	20.5%	Too many different LGPS schemes to make comparison	19.4-35.3%

As a very rough average, the current new entrant scales for the main public sector pension schemes tend to be worth around 45 per cent of salary, but employees and employers combined are only charged around 20 per cent of salary.

Using a transparent and appropriate method of valuing public sector pensions, it becomes clear that there is a large gap between what public sector employees are getting, and what they and their employers are paying for.

As an example of the challenge facing any attempt to manage the full costs of public sector pensions, the table below sets out how the value to employees of the main public sector pension schemes could be brought down to 20 per cent of salary on average, if only one of the various options were chosen.

There is a large gap between what public sector employees are getting, and what they and their employers are paying for.

TABLE 17.2

How the employee benefit value of the main public sector pension schemes could be brought down to 20 per cent of salary if only one option were chosen

	Civil Service	NHS	Teachers	LGPS
Retirement age	80	79	79	80
Benefit accrual rate	1/80	1/105	1/105	1/110
Career average benefit accrual rate	1/80	1/80	1/80	1/85

⁹² These percentages are higher than those shown in Part II, because we have included the value of employee contributions here.

⁹³ Cabinet Office, *Employer Pensions Notice 183*; *Teachers Pensions Guide*, September 2008; *NHS Pension Scheme Guide and New NHS Pension Scheme Guide*; Armed Forces Pension Scheme, *Resource Accounts 2008-09*, p.10

It becomes clear from this table that employing one reform option alone is often not realistic. Especially if some form of DB scheme is maintained, it would be far better to enact a combination of reforms. The following box gives examples if the aim is to keep government/employer contributions to a maximum of 20 per cent.

BOX 17.1**Example benefit structures costing 20 per cent of salary**

- A final salary benefit of 1/90 of earnings for each year of service payable from the age of 70 would be worth 20 per cent of salary to the employee after payment of contributions at 6.5 per cent to the NHS scheme.
- An RPI-linked career average benefit of 1/80 of earnings for each year of service payable from the age of 65 would also be worth 20 per cent of salary to the employee in the Civil Service scheme after payment of employee contributions.
- An RPI-linked career average benefit of 1/70 of earnings for each year of service payable to teachers from the age of 65, with pensionable earnings limited to £75,000 per annum and pension increases linked to RPI only up to 2.5 per cent per annum might be worth around 20 per cent of salary in excess of employee contributions.

The above examples show that there is a number of ways that the value to the employee of a public sector pension might be reduced if that were the desirable outcome.

17.1 A sustainable defined benefit pension

The first approach that could be taken is to maintain the existing shape of the unfunded public sector pension schemes, but to enact reforms that would reduce their cost to taxpayers. Reforms to the existing DB schemes should cover all new accrual, as well as new members, although existing accrual should be left untouched. This approach would recognise that other measures, such as increasing the pension age, are taking place in the UK with respect to state pensions, and are also taking place in a number of other countries.

A more sustainable DB pension in the public sector could take the following shape:

- An increase in the normal pension age to 65, with increases in the future to be linked to the state pension age. Given that increases in the pension age in public sector schemes are likely to be for new accrual only, it might be desirable to increase the pension age earlier than the higher state pension ages actually come into force.
- A proportionate reduction in the generosity of the accrual rate, so that a pension of the same (or lower) proportion of salary could be accrued after the longer period of service; or a larger reduction in accrual rate, from 60ths to, say, 80ths.
- Basing the pension on appropriately indexed career average earnings rather than final salary.
- A ceiling on pensionable pay, although we note that this saves relatively little cost unless imposed at a fairly low level.

Additionally, the rate of employee contributions could be reviewed, as part of a more general review of remuneration, as occurred in Ireland.

The advantages of this approach are several:

- Such a combination of reforms to the DB pension schemes would save a considerable sum of money.
- Some of the reforms would impact disproportionately on higher-earners in the public sector, who might have the means to make their own pension arrangements over and above their occupational scheme.

- Career average DB pensions would be a better fit to today's labour market than final salary schemes, and would not discourage the employment of older workers.
- Lower-earners would be less hard hit, as they would not be affected at all by the salary ceiling, and would be less impacted by a move to career average. The main impact on lower-earners would be the need to work longer for a given pension.
- Employees in the public sector would be protected from volatile investment returns.
- There would be no need to change the funding arrangements for public sector pensions, or to worry about how to build up individual funds for employees, whilst at the same time paying pensions to retirees.

A reduction of accrual rate to 1/80 or a switch to career average revalued earnings as the benefit structure would each save around £10 billion per annum and an increase to a pension age of 65 for all members would save around half of that.

There are also disadvantages:

- Public sector pensions would still be unfunded, meaning that today's workers would still be paying for today's pensioners, and in future this would remain the case.
- The gap between the public and private sectors would remain huge, with almost all public sector employees remaining in safer DB pensions and private sector employees either in more risky DC schemes or not in an occupational scheme at all.
- Depending on the extent of the reforms, there may still be a large degree of taxpayer subsidy.
- There are fewer control mechanisms than in DC schemes where, for example, an individual can react to an increase in annuity prices and a rise in longevity by working for longer.
- There are still likely to be cross subsidies within schemes.

How much would be saved depends crucially on the changes enacted. We estimate the public cost of public sector pensions is currently £35 billion, although the taxpayer only actually pays £18 billion. A reduction of accrual rate to 1/80 or a switch to career average revalued earnings as the benefit structure would each save around £10 billion per annum and an increase to a pension age of 65 for all members would save around half of that. However, this would not affect the Government's present outlay if the taxpayer continues simply to meet the balance of cost of pensions now in payment (the £18 billion referred to above).

17.2 A shift to defined contribution

A second approach could be to recognise that the big increases in longevity in recent years, together with further longevity increases predicted in the future, necessitate a very different approach to delivering pensions in the public sector. This approach would recognise that the private sector has had to face reality and close unaffordable DB schemes, and would also note moves to DC arrangements in other countries.

Combined employer and employee cash contributions in the public sector DB schemes are generally at least 20 per cent of salary (though we have shown that the value is more than twice this). A total contribution into a DC scheme of 20 per cent of salary would be very generous compared with private sector arrangements and with reasonable investment returns could deliver a large pension pot upon retirement. A DC scheme with a total contribution rate even of 15 per cent would also be well above the average in the private sector.

There would be several advantages of a move to funded DC:

- Today's employees would be building up their own pension funds, rather than paying for today's retirees and expecting future employees to pay for their retirement.

- In the long run, there would be no extra taxpayer subsidy of public sector pensions, and considerable savings would accrue to taxpayers.
- Public and private sector pensions would be more closely aligned, reducing the unfairness of people paying through taxes for pensions they cannot afford for themselves.
- Mobility between the public and private sectors would be encouraged relative to DB, as benefits for early leavers in DB schemes are almost always worth less than benefits for those who remain in the schemes, unlike DC.
- Taxpayers would no longer face risks such as longevity. These risks would be shouldered by the employee, who would have some degree of choice over when to retire.

The disadvantages are:

- Some would suggest that it would entail a “levelling-down” of pensions to the level pertaining in the private sector.
- It may not be seen as desirable for employees to shoulder a greater degree of risk and public policy needs may not be met if DC annuitants chose to buy nominal, not index-linked, annuities.
- It would be politically more difficult to enact, and there may be pressure for pay increases in the public sector to compensate.
- Most seriously, replacing pay-as-you-go arrangements with funded ones would entail paying twice for a period, and hence significantly higher spending in the short term, which may be difficult to fund. However, this arises at least in part because of the flawed approach to accounting for public sector pensions that currently exists.
- A significant proportion of employees may decide not to join a DC scheme – though this can be alleviated by offering a high employer contribution.

17.3 Notional defined contribution

The transitional costs of moving from pay-as-you-go DB to funded DC indicate that a move to pay-as-you-go DC, or notional DC, may be more practical. This is indeed the route that a number of countries, for example Sweden, have taken.

The advantages and disadvantages would be similar to a move to funded DC described above. There would, however, be several differences:

- There would be no need to pay twice in the short term, which would make a move to notional DC easier than a transition to funded DC. This is the key argument for notional DC – though the above point about accounting for pension costs should be noted as an important qualification of this advantage of notional DC.
- On the downside, today’s employees would still be paying for today’s pensioners.
- It would be possible to offer a degree of guarantee around investment return, for example, by allowing the notional accounts to grow in line with general economic indicators rather than relying on investment values. A less risky product may be more highly valued by employees, and may be an easier political sell. However, it would mean that employees’ pensions were not backed by saving and a capital fund.
- Although the scheme would remain unfunded, it would be possible to ensure it remained in financial balance through annual adjustments to rates of return or contribution rates.

17.4 Conclusions

There is no single “correct” way to reform public sector pensions. All of the three main approaches have their pros and cons, and within the broad approaches, there is a number of various options.

This report has attempted to demonstrate, however, that an essential pre-requisite to meaningful reform is full transparency over the true costs. An historical failure to account properly for the costs of the unfunded schemes has undoubtedly made it easier to delay reform, and has meant that employees undervalue the benefits of their pensions.

Transparency of costs is essential to understand the baseline from which reform can be measured as well as the savings from various reform options. With a proper understanding of costs, the Government can then take a more rational approach to setting public spending in this area and employers and employees can determine benefit packages to their mutual agreement.

The Commission has also argued that it would be possible radically to decentralise the UK’s approach to public sector pensions, with individual public sector employers, in negotiation with employees, choosing their preferred pension arrangements, and importantly, paying the full costs of the arrangements that they chose. The reform options set out in this report apply equally well to a national or a decentralised approach. The advantage of a decentralised approach is that different options could be used according to the local preferences and needs of employees and employers.

The total pay package could also be valued explicitly, to enhance transparency for employees and employers in the public sector, and if this were to be required in the private sector too, it could be beneficial to pensions in general.

What the Commission has not been able to investigate is the trade-off between pay and pensions in attracting and retaining public-sector employees of suitable quality. If the taxpayer can get the current services at lower total cost by lowering pensions and increasing pay then that would be a good reform – but we don’t know if this would be true (although the fact that the private sector goes for a different mix of pay and pensions is, at least, indicative). As stressed elsewhere, transparency is key to these considerations. How can we expect to be getting the best value for money out of pensions if we are not communicating to public sector employees their true value? Equivalently we can’t expect public sector employers to make the right decisions without knowing the true cost.

If the taxpayer can get the current services at lower total cost by lowering pensions and increasing pay then that would be a good reform.

Appendix A: Modelling

We have estimated the likely costs to the public sector employer and the value to the employee in two different ways:

- First, we have looked at the true economic cost of making an index-linked pension promise to a public sector employee, which is in effect the same nature of government promise as that made to the holder of an index-linked bond. We have priced contributions in a consistent manner using current real yields of 0.8 per cent on index-linked gilts and thus derived contribution and benefit values significantly higher than those that are suggested by other valuation approaches. We recognise that the yields on gilts vary over time and so the value of benefits may be higher or lower than we have calculated depending on the yield at the time.
- For comparison, we have shown the level of employer cost derived by the Government using a notional return on investments (which unfunded schemes do not, of course hold) of 3.5 per cent per annum above inflation. This higher discount rate has no objective justification and masks the true values derived above.

There is a third way of examining the costs, by reference to the accounting standards used for valuing private sector funded pension schemes. This measure makes an assumption that liabilities are backed by investment in AA corporate bonds. We do not believe such figures are relevant to our investigation, given that the main schemes in question do not hold investment funds.

We have estimated the values of adjusted benefit scales in a consistent manner with recent valuations of public sector schemes and with the analysis carried out in 2008 by the Pensions Policy Institute. As we do not have access to full enough data on the membership breakdown of the schemes by age and service and salary, these estimates are of necessity approximate.

In order to consider the potential effect of a salary ceiling, we have drawn on the publicly available data on civil service earnings and assessed how much pension accrual costs might reduce were the benefits to be limited to a salary cap.

Appendix B: Annual costs to taxpayers of public sector pensions

Outstanding public sector pension liabilities will not need to be paid off in a single year, but if they continue to grow, they would lead to very high annual costs that would largely fall on taxpayers. If, as discussed in Chapter 1, the ratio of workers to pensioners falls, these annual costs may well become intolerable.

To understand these annual costs, we must examine how the annual payments to current retirees are met. Because the schemes are unfunded, payments this year to retirees are met by this year's employer and employee contributions, with the Treasury making up the difference.

The table below gives the most recent Treasury data at the time of writing. In 2010-11, payments to retirees in the unfunded public sector schemes are projected to total over £25 billion, of which £20.5 billion will be made up by employee and employer contributions with the remaining £4.5 billion paid by the Treasury.

TABLE B1

Payments to retirees in the unfunded public sector pension schemes and how these are met ⁹⁴

Year	Pensions in payment, £m	Of which employer and employee contributions, £m	Balancing Treasury contribution, £m
2003-04	16,080	14,279	1,801
2004-05	16,377	15,119	1,258
2005-06	17,641	17,368	274
2006-07	19,080	17,934	1,147
2007-08	21,356	19,066	2,290
2008-09 (estimated)	22,562	19,500	3,062
2009-10 (projected)	24,151	20,033	4,118
2010-11 (projected)	25,286	20,684	4,602

The burden on taxpayers is, however, greater than the “balancing Treasury contribution” column, since around two thirds of the “employer and employee contributions” column comes from the employer. While employee contributions are clearly not a burden on taxpayers, since they are a proportion of the employee's salary,⁹⁵ the contributions from employers are an extra cost to taxpayers.

Further, the contributions being paid by employers do not represent the full balance of cost between the proper value of the benefits provided to employees each year and the contributions paid by the employees. So there is a further hidden cost which will only appear as a future increase in balancing Treasury contributions when those employees retire.

The Treasury does not provide a breakdown of employee and employer contributions, merely giving the aggregate figure (as shown in the table above). Despite this lack of transparency, it is possible to provide a robust estimate of the employer share. The Office for National Statistics (ONS) finds that employers contribute almost two thirds of the total contributions to unfunded occupational schemes.⁹⁶ Since, as the ONS

⁹⁴ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1

⁹⁵ To the extent that salaries are increased to take account of the employee contributions, employee contributions would also be a burden on taxpayers, but for the purposes of this section, we assume that this does not occur.

⁹⁶ Office for National Statistics, *Private pension contributions: updated estimates 1995-2007*, February 2009, Table 3. NB: The title is slightly misleading as the ONS makes clear that the data on unfunded pensions relates almost exclusively to the public sector.

states, “contributions to unfunded private sector pension schemes are rare and there is little information available on them”,⁹⁷ we can take this percentage as applying to the public sector. Further confirmation of this two-thirds/one-third split can be taken from an analysis of employee and employer contribution rates, with employer contribution rates at least double that of employees in the largest public sector pension schemes.⁹⁸

We can then apply the ONS’s calculation of the percentage employer share to the “contributions received” column in the table above to determine the amount contributed by employers.⁹⁹ The table below gives the annual costs to taxpayers of pensions paid to retirees in the unfunded public sector pension schemes.

In 2010-11, £18 billion is projected to come from taxpayers (£13.5 billion of employer contributions and £4.5 billion from the Treasury) and £7.5 billion from employees in these schemes. £18 billion is over £700 per household in the UK.

TABLE B₂Costs to taxpayers of pensions paid to retirees in the unfunded public sector pension schemes¹⁰⁰

Year	Percentage employer contributions	Employer contributions, £m	Employee contributions, £m	Treasury payment, £m	Cost to taxpayers (employer contributions + Treasury payment), £m
2003-04	67.1%	9,578	4,701	1,801	11,379
2004-05	63.2%	9,558	5,561	1,258	10,816
2005-06	63.8%	11,077	6,291	274	11,351
2006-07	63.9%	11,453	6,481	1,147	12,600
2007-08	64.7%	12,326	6,740	2,290	14,616
2008-09	64.5%	12,581	6,919	3,062	15,643
2009-10	64.5%	12,925	7,108	4,118	17,043
2010-11	64.5%	13,345	7,339	4,602	17,947

The estimates of taxpayer costs described above can be verified by reference to a recent report by the National Audit Office (NAO), which examined the annual taxpayer costs of the four largest unfunded schemes – NHS, Teachers, Civil Service and Armed Forces. As the NAO stated in its report, these four schemes account for over 75 per cent of total payments to retirees from unfunded public sector schemes. The NAO used a similar methodology to the one used above, making clear that the taxpayer cost was comprised of employer contributions and the balance paid by the Treasury:

- In 2008-09, the total cost to the taxpayer of the four largest public sector unfunded schemes was £14.9 billion. This was comprised of £12.5 billion of employer contributions and £2.5 billion paid by the Treasury (figures are rounded).¹⁰¹
- In the same year, Table B.2 shows that the taxpayer cost of all the public sector unfunded schemes was £15.6 billion. Given that the NAO report did not cover all unfunded schemes, the figures do seem broadly to match.

⁹⁷ Ibid, p.2

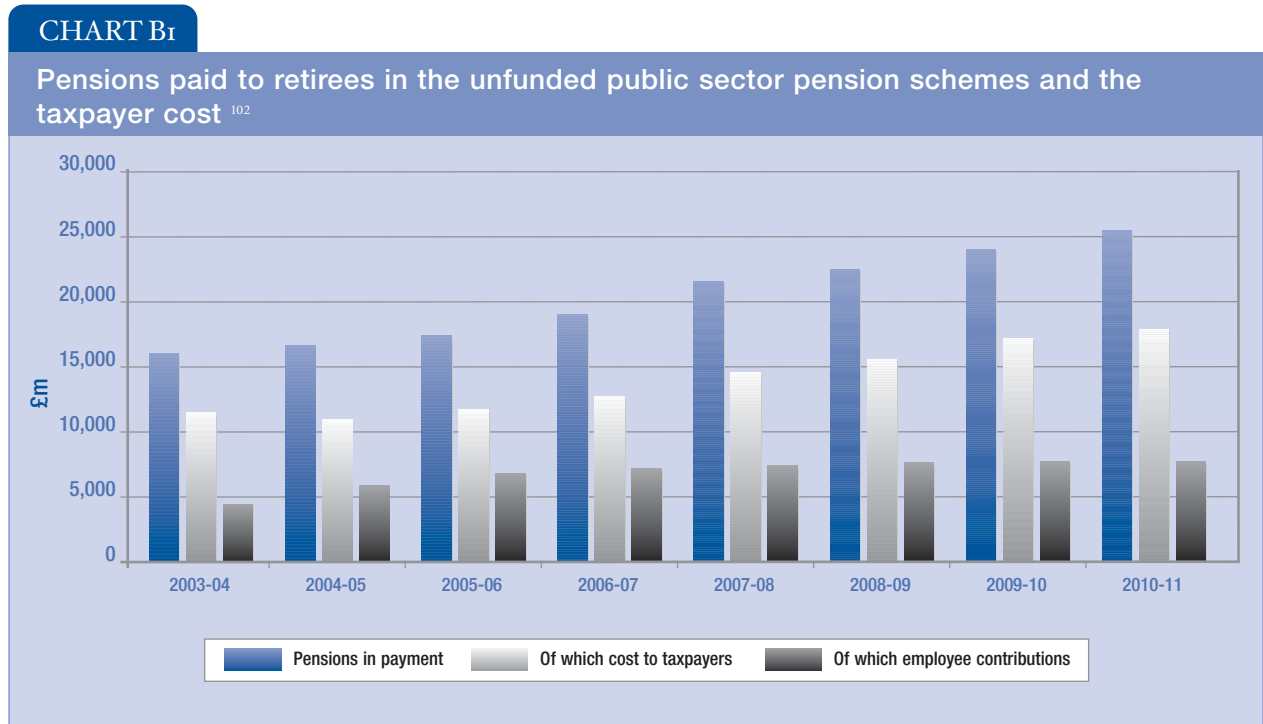
⁹⁸ For example, in the NHS, Teachers and Civil Service schemes, employee contribution rates are 5-8.5 per cent, 6.4 per cent and 1.5-3.5 per cent respectively, while employer contribution rates are 14 per cent, 14.1 per cent and 17.1-26.5 per cent respectively.

⁹⁹ Exact percentage share for each year 2003-04 to 2007-08; average percentage share from 2003-04 to 2007-08 for each year 2008-09 to 2010-11.

¹⁰⁰ HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1; Office for National Statistics, *Private pension contributions: updated estimates 1995-2007*, February 2009, Table 3; Public Sector Pensions Commission calculations using methodology from Corin Taylor, *The cost of public sector pensions to taxpayers in 2009-10*, Institute of Directors, September 2009

¹⁰¹ National Audit Office, *The cost of public service pensions*, March 2010, Figure 10

The chart below illustrates how the pensions paid to retirees, and the taxpayer share of these, has been growing rapidly in recent years.



¹⁰² HM Treasury, *Public Expenditure Statistical Analyses 2009*, Table D.1; Office for National Statistics, *Private pension contributions: updated estimates 1995-2007*, February 2009, Table 3; Public Sector Pensions Commission calculations using methodology from Corin Taylor, *The cost of public sector pensions to taxpayers in 2009-10*, Institute of Directors, September 2009

Appendix C: Recent reforms to public sector pensions

This Appendix reproduces, with kind permission, Table 1 of the Pensions Policy Institute's excellent October 2008 report, *An assessment of the Government's reforms to public sector pensions*. The table below details the changes that have been made over the last few years.

TABLE C1

Summary of the main elements of the reforms to public sector pension schemes (all reforms are for new joiners unless otherwise stated)

	NHS ¹⁰³	Teachers'	Civil Service ¹⁰⁴	LGPS (reformed for all members)	Armed Forces	Police	Fire
Normal Pension Age (NPA)	60 → 65	60 → 65	60 → 65	Remains 65; Rule of 85 abolished for all new service with transitional protection	No change from 55	50 with 25 years' service (below 50 with 30 years); 55 (57 or 60 for higher ranks) → 55	55 (from 50 after 25 years' service) → 60
NPA for early leavers	Same as NPA	Same as NPA	Same as NPA	Same as NPA	60 → 65 (all members for future service)	60 → 65	60 → 65
Basic design	Remains final salary	Remains final salary	Final salary → career average	Remains final salary	Remains final salary	Remains final salary	Remains final salary
Accrual rate	80ths → 60ths	80ths → 60ths	60ths → 2.3%	80ths → 60ths	69ths (91ths after 22 years) ¹⁰⁵ → 70ths	60ths (30ths after 20 years) → 70ths	60ths (30ths after 20 years) → 60ths
Additional lump sum?	3 x pension → commutation	3 x pension → commutation	Commutation only	3 x pension → commutation	No change from 3 x pension	Commutation → 4 x pension	Commutation only
Late retirement enhancement?	No → Yes	No → Yes	No → Yes	No → Yes	No	No	No
Draw-down option?	Yes	Yes (all members)	Yes (all members)	Yes	No	No	No
Rate of employee contributions ¹⁰⁶	6% (5%) → 5-8.5% (for all members)	6% → 6.4% (for all members)	No change from 3.5%	6% (5%) → 5.5-7.5%	Remains non-contributory	11% → 9.5%	11% → 8.5%
Cost sharing?	Yes	Yes	Yes	Expected to apply	No	No	No
Eligibility for survivor's pension	Now includes non-legal partners and payable for life (but only for new joiners in the Police and Fire schemes)						
Survivor's pension on death in retirement	Remains a 160ths pension	Remains a 160ths pension	160ths → 3/8ths of member's pension	Remains a 160ths pension	50% → 62.5% of member's pension	Remains 50% of member's pension	Remains 50% of member's pension
Ill-health benefit	1-tier → 2-tier	1-tier → 2-tier	Remains 2-tier	1-tier → 3-tier	1-tier → 2-tier	1-tier → 2-tier	Remains 2-tier
Timescale	1 April 2008	1 January 2007	30 July 2007	1 April 2008	6 April 2005	6 April 2006	6 April 2006

¹⁰³ The scheme for salaried staff is illustrated. Self-employed members, such as GPs and dentists, have a career-average scheme that is not shown.

¹⁰⁴ The Premium section of the Civil Service scheme is illustrated here, since the Classic section has been closed to new members from 2002.

¹⁰⁵ For other ranks. Officers have higher accrual rates.

¹⁰⁶ If a range is shown then employee contributions depend on pay. Figures in brackets denote special provisions for certain categories of workers.

Appendix D: Summary of written evidence received

D.1 The Commission's consultation exercise

The Commission undertook extensive consultation with organisations and individuals with knowledge of and an interest in public sector pensions, attending a number of face-to-face meetings and receiving a considerable quantity of written evidence.

The authors of a number of submissions requested that they remain anonymous. The written submissions of those that were happy to have their advice made public have been uploaded in full on the Commission's website: <http://www.public-sector-pensions-commission.org.uk/evidence/>. In this section, we quote both from submissions that have been uploaded onto our website and from anonymous submissions – in order to preserve anonymity, we do not reference any individual submissions.

The Commission asked for written respondents to give their “*views on public sector pensions as they are today – including such questions as whether they are fair, whether are they sustainable and whether they need to be reformed – and on possible reforms to public sector pensions – including such questions as whether a more sustainable DB pension can be designed, the merits or demerits of DC, and how a consensual way forward can best be found*”.

The Commission also provided a set of 10 questions for respondents who wished to answer more specific questions, which are reproduced below:

1. *Do you believe there is a “pensions apartheid” between the public and private sectors, and why? If so, do you think this is economically and socially sustainable?*
2. *Do you think the reforms to public sector pensions that have been enacted over the last four years are sufficient to put them on a financially sustainable footing, and why?*
3. *Do you have any views on whether some groups within the public sector benefit more from public sector pensions than others? Does it matter?*
4. *Are the current “contracted-out” arrangements for public sector pensions fair?*
5. *Do you believe it is reasonable for the taxpayer to continue to support DB in the public sector when the private sector has largely withdrawn from DB provision? If so, why?*
6. *What would be the most radical change to public sector pensions that you would suggest, and why?*
7. *What would be the most practical change to public sector pensions that you would suggest, and why?*
8. *Thinking about the place of public sector pensions within the wider pensions system, what is the best way forward, given the enormous fiscal deficits currently being run, and why?*
9. *Do you see merit in a ceiling on the level of public sector pensions? Would this be better as a limit on pensionable salary or on the pension?*
10. *How can we best find a consensual way to reform public sector pensions, that avoids industrial action, and why?*

D.2 Summary of responses to specific questions

1. Do you believe there is a “pensions apartheid” between the public and private sectors, and why? If so, do you think this is economically and socially sustainable?

Most responses disagreed with the term “apartheid” to describe the disparities between public and private sector pension provision. One response was typical:

“Pensions apartheid is a politically loaded term that makes the challenge of engaging in a discussion as to any potential reform more rather than less problematic.”

There was also widespread agreement, however, that a genuine disparity between public and private sector pensions does exist. One respondent said:

“If looked at from the perspective of preserving a standard of living, then an ‘apartheid’ exists and it should be addressed, because that is not on offer to the average Private Sector worker. If looked at from the safety net perspective, then Public Sector pensions are too high for just a ‘safety net’ – so, again, the ‘apartheid’ exists. In any case, ‘safety net’ provision should surely be made through the state Pension, to all (to whatever degree is deemed affordable), rather than solely and differentially to Public Sector workers.”

There was further concern that the disparity was not economically or socially sustainable. For example:

“Workers in the private sector without such gold-plated pensions are going to have to pay the taxes necessary to make good the promises to public sector workers. I’m not sure this is either economically or socially sustainable.”

One respondent argued that the issue of social sustainability was not primary, and that:

“The major question we should seek to be understanding is what the impact on the economy will be of the large future obligations created by Public Sector pension schemes, and therefore, whether the nation can afford them... With the example of Greece starkly before us at this time, it is important to bring home to all that the future cost of Public Sector pensions is financially unsustainable in the longer term, being of an order of magnitude that is likely to singlehandedly, if continued, bring about a long term collapse of the UK economy.”

2. Do you think the reforms to public sector pensions that have been enacted over the last four years are sufficient to put them on a financially sustainable footing, and why?

Almost all respondents believed that the recent reforms to public sector pensions were minimal, and wholly inadequate to address the issue. One respondent said:

“I know of no reforms worthy of the name.”

Most respondents therefore argued that it was not really possible to assess the financial sustainability of the reforms. One respondent argued:

“As I understand it, rising longevity, indexation of benefits, the past and likely future demography of the membership, and (importantly) the pricing of the discount rate, means that working members are effectively ‘sold’ a benefit below market price (or rather the Government ‘borrows’ from active members at a higher than market real interest rate). As such, there is nothing financially sustainable or unsustainable about the public sector occupational schemes per se, but

rather the question arises as to whether borrowing off-balance sheet at a far higher than market rate of interest is sustainable politically and financially for a government when the sums involved are as large as they are, for the benefit of a small sub-section of the general population.”

3. Do you have any views on whether some groups within the public sector benefit more from public sector pensions than others? Does it matter?

Not all respondents had opinions on this issue. Among those that did there was general agreement that higher-paid public sector employees benefitted to a greater extent than the lower-paid. One respondent argued:

“CIPFA and others should look at the funding arrangements of final salary benefits for higher-paid members, whose own contributions and average employer contributions are effectively being cross-subsidised by other members and, ultimately, by council taxpayers and other taxpayers.”

A second respondent argued that this was an important consideration:

“High-paid public servants benefit significantly more from these schemes than do low-paid public servants (it is not clear what the relative liability of Public Sector pensions is for the low- versus the higher-paid segments). The social desirability of a safety net at a low level of pension is higher than the desirability of preserving high standards of living for highly-paid executives.”

4. Are the current “contracted-out” arrangements for public sector pensions fair?

Respondents had little to say on this question. One argued that it “depends on whether or not the benefits forgone equal the cost saved”. A second argued that the arrangements were not fair, but were not the key issue to address. A third said they were fair:

“But the incentive to generate greater investment returns from the reduced National Insurance contributions is poorly understood and even more poorly implemented.”

5. Do you believe it is reasonable for the taxpayer to continue to support DB in the public sector when the private sector has largely withdrawn from DB provision? If so, why?

Respondents were split on this issue, although the point was made by one respondent that supported DB pensions that they should be priced correctly:

“It is entirely reasonable and sensible for the taxpayer to continue to support DB in the public sector regardless of whether or not the private sector has withdrawn from DB provision. I take objection to the phraseology of this question, which appears heavily loaded and politicized. The only problem with DB provision is one of price... As it stands, deferred income is massively underpriced and hidden off-balance-sheet. This is a scandal. If an employee seeks a stable and defined deferred income they should understand that this comes at a cost of a variable current income as discount rates vary. Their defined benefit can come only from the ‘purchase’ of inflation-linked gilts combined with an approximately priced longevity insurance contract. I have no problem with the state providing this, as long as it is appropriately priced and these prices are market prices so that risk can be transferred away from the state if need be at no taxpayer loss.”

Another respondent took an opposite view:

“Any Defined Benefit scheme is, in an age of extended and ever increasing longevity, immoral. Until each generation of society takes upon itself the responsibility of worrying about its own old

age, the temptation to place insupportable burdens on future generations in order to pay for the old age of the existing generation may be in the short term irresistible, but will not, in the long term, ultimately prove to be (as the burden of annual payments and interest on the national debt becomes too great) supportable.”

6. What would be the most radical change to public sector pensions that you would suggest, and why?

A number of different suggestions were made, including:

- “Immediately increase the retirement age. This would be the least costly way of bringing the system back into balance.”*
- “For future service they must switch immediately to a Defined Contribution scheme, whilst past service benefits must feature a (capped) price inflation link, before retirement as well as after.”*
- “The conventional use of asset allocation as the main driver of returns, the employment of so-called active, but in practice closet index-tracking, investment managers needs to be overhauled and replaced with investment based on their fundamentals, structured to meet the cash requirements for pensions and other benefits.”*
- “The fully-funding of public sector occupational pension schemes with inflation-linked bonds would bring a number of benefits, including... Increasing accountability for public sector scheme management; potentially reducing the cost of provision of public-sector pensions, and bringing the UK into line with OECD best-practice.”*
- “The proper (and, probably, only realistic) solution is, essentially, to cease all future accrual of benefits in Defined Benefit schemes for the Public Sector, and to find every way possible to mitigate the cost of existing Public Sector Defined Benefit obligations.”*

7. What would be the most practical change to public sector pensions that you would suggest, and why?

Most respondents believed that their responses to question 6 also answered this question. One respondent put forward further suggestions:

“It is noticeable that in Ireland, there have been ‘headline’ cuts of up to 15-20 per cent in Public Sector pay as a response to the financial crisis. Latvia, for example, has taken similar steps. Accomplishing something of this sort in the UK would result in significantly lower existing pension obligations, as well as bringing Public Sector pay more appropriately into line with Private Sector pay. As an alternative, or in combination with that, moving to average rather than final salary, or finding ways legally to impose caps, would lower retirement obligations. (I am unsure of the permissibility or legality and therefore the feasibility of any of these, however.)”

8. Thinking about the place of public sector pensions within the wider pensions system, what is the best way forward, given the enormous fiscal deficits currently being run, and why?

Several respondents referred to their answers to the previous questions. One argued the current fiscal deficits were not relevant:

“Equating a pensions deficit with a fiscal deficit is apples-and-pears. Pensions deficits should be seen in the context of a long-term understanding of pensions cash flows, inflows from contributions, investment yields and planned investment realizations, and outflows in benefits and overhead and other running costs.”

Another respondent argued that a reformed DB should remain in the public sector:

“First, the public sector has historically provided a role model for the design of private sector pensions. Keeping defined benefit pensions in the public sector could therefore provide a useful benchmark against which new private sector pension arrangements could be compared, and possibly even lead to the reintroduction of some form of DB or hybrid scheme in which the employer doesn’t bear all the risk. Second, if the Government did replace DB with DC in the public sector and the DC outcome was poor, it is only going to have to make up any shortfall in the form of means-tested benefits. Means-testing of benefits just takes away all the incentives for citizens to voluntarily save for their retirement. So we need to have a DB system that is sustainable and equitable in the public sector. This means considering things such as career average and conditional indexation on top of raising the retirement age.”

A third respondent said:

“Unless Public Sector Defined Benefit Schemes (for accrual of future as opposed to existing obligations) are wound up quickly, a future financial catastrophe for the whole of the UK is in my opinion... pretty much inevitable.”

9. Do you see merit in a ceiling on the level of public sector pensions? Would this be better as a limit on pensionable salary or on the pension?

Some respondents were unsure if capping would be sufficient to solve the affordability issue. Others argued that it would be better to look at public sector remuneration more generally. A further respondent said:

“I think a career average DB pension system would go a long way to dealing with this. One could also put a cap on employer contributions, with the employee going for DC AVCs if they wanted to enhance their pension.”

10. How can we best find a consensual way to reform public sector pensions, that avoids industrial action, and why?

One respondent argued that industrial action was unavoidable:

“Forget consensus; it is not possible. Industrial action is best avoided by changing the laws which condone it, for example the law that precludes companies from hiring temporary workers during stoppages. If that doesn’t work, make industrial action illegal in the public sector, via a clear employment contract.”

Most, however, were more optimistic, suggesting that their responses to questions 6 and 7 could provide a way forward. One argued, in addition:

“I think the best starting point is having full transparency of the costs of public sector pensions with an independent agency providing estimates of the costs. This could then be compared against the costs in a range of private sector schemes... Transparency and comparability are the essential prerequisites to any consensual reform.”

Another respondent argued that reform would be a long process:

“I think everyone understands that the rise to the existing high level of Public Sector pension liabilities was the result of a long and involved process. Getting these obligations down to a level

that the country can afford is likely to be an equally difficult process, requiring a number of different (and very difficult) actions, rather than any one ‘magic bullet’.”

D.3 Summary of general responses

There were also a number of general responses to the Commission’s call for evidence. One respondent argued that investment policies for the funded schemes needed to be looked at again:

“Allowing for the strength of the underlying employer covenant of the public sector should in turn allow for a genuine longer term basis of investing, which takes account of each of the cash flow profiles of contributions, investment income and benefit payments. Instead, I see all too often the conventional tendency to expect strategic asset allocation to be the largest determinant of returns, instead of developing and implementing investment strategy based on fundamental drivers of returns such as yields, expected growth in yields and buy/hold/sell disciplines based on relative valuation.”

A second respondent argued that fundamental reform to both funded and unfunded public sector pensions was needed:

“The present arrangements for public sector pensions are not sustainable. It is unlikely that the deficits on funded schemes are going to be eliminated by an increase in investment values, and it would be unreasonable to expect taxpayers to make up the shortfall. Actuarial projections for the Local Government Pension Scheme suggest employer contributions in the region of 30 per cent of salaries for the next twenty years will be required to restore full funding, and that is on the assumption that a significant real investment return will be achieved over the period.

“The liabilities of unfunded pension schemes are only affordable on the Treasury’s assumption that there will be an indefinite increase in GDP to generate sufficient tax revenues, but there must eventually be a limit on how much growth the world’s finite resources can support. There should not be a pensions apartheid between employees in different parts of the public sector, and therefore I believe there must be an immediate reduction in the future cost of all public sector pensions.

“If DB schemes are to be retained it is essential that retirement ages and the level of employee contributions are kept under constant review, but this will only generate long-term savings. The only affordable arrangement for pensions in both the public and private sectors is DC. This should be implemented for all new and existing public sector employees.”

Another respondent argued that it would be better to look at total remuneration rather than concentrating on the pensions element, and that final salary pensions should be replaced:

“With certain qualifications, it must surely be an error to concentrate on only one element of a compensation package, albeit the second-largest one. The main justification for concentrating on the pension element would seem to relate to the issues of funding, accounting, and transparency, where the right description does indeed appear to be ‘apartheid’. However, there is a second and inevitable form of apartheid between the public and private sectors in total compensation...”

“It is well known that over the past decade each of the two main remuneration elements (salary and pensions) have moved substantially in favour of public sector employees, in parallel with the

number of the latter. This situation is unrecognisable compared to fifty years ago when salary-based occupational schemes in the private sector were growing fast – and catching up on those for civil servants, which I understand had begun more than a century earlier. Since then, the size, membership, and costs of public sector schemes have grown beyond all recognition, like government itself... The same goes for the enormous role of state regulation of occupation pension schemes, at the same time as standards in the public sector have been relaxed...

“On pension scheme design, the old model of “final salary schemes” has not stood the test of time. The problem is not the salary-based element; it is the final salary element – again, as I understand it, appearing first in the Civil Service schemes. In the 1980s, when I was heavily involved as a pension scheme consultant, it was by no means unheard of for directors of a company to ensure that they themselves received decent salary rises towards the end of their careers. I didn’t hear too much about public sector schemes, but it has got to the point where any self-respecting public sector executive would have his eye firmly on this particular ball.”

Another respondent argued for a move towards an ISA-type tax structure:

“Retain defined (final salary) benefits for those in such public sector schemes, but in exchange begin tweaking the benefits these contributors currently enjoy. Besides increasing the employee’s percentage superannuation (as is permissible with most schemes nowadays, I believe), why not remove completely the tax-free status that such employee contributions carry? Moreover, consider taxing the contribution the employer makes on the employee’s behalf as an employee’s benefit in kind? (This is, after all, what the tax system does for other benefits that employees enjoy.) As a quid-pro-quo, remove the tax liability from the pension (but only, say, up to the 40 per cent tax threshold) paid out during retirement. (Tax-wise, this is of course effectively how ISAs work, except that the annual ISA contribution is/will be capped at £10,200)... I suggest that the overall effect might be a (fair) increase in tax revenues.”

Finally, a respondent argued that the governance structures were inadequate:

“My comment relates to governance and oversight of public sector pensions. No matter how much money is taken from the tax payer to put into the public sector pensions bucket the way the many Boards and Panels operate means that decision making is actually abdicated to advisors and the executive teams; thus the bucket holes never get bunged up; they keep haemorrhaging the cash through poor investment decisions and excessive administration costs. Consider that Councillors are on the panels, they are elected for 3 years and their day job could be anything from a taxi driver to a granny to a graduate straight from Uni. Hardly a Governance A-team. To stop the bleeding is the first step and a tough decision needs to be made about local level governance. To fix the affordability question is the next step, and if the average pension is really £4,000 per LGPS pensioner then why are we not putting these low paid public sector employees into NEST? They seem to be the ideal target group.”

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