PPI Seminar: *The Future of the Public Sector Pensions*

The Pensions Policy Institute (PPI) held a seminar on 23 November 2010 to launch its latest report ***The Future of the Public Sector Pensions.*** This research was funded by the Nuffield Foundation and its main goal was to:

- Identify the policy objectives that any Government considering further reforms to the public sector pensions might aim to address
- Identify a set of possible further reforms for the public sector pension schemes that the Government could consider
- Analyse a set of possible reforms against the identified policy objectives and identify what the implications of such reforms might be for public sector employees, and for the overall affordability and sustainability of the schemes.

Neither the PPI, nor the Nuffield Foundation is either calling for, or arguing against, further reforms of the public sector pensions. The research is intended as a contribution to the ongoing public policy debate about the future of the public sector pension schemes.

This research follows a previous discussion paper published in October 2008 that analysed the impact of reforms on public sector pension schemes undertaken by the previous Labour Government between 2005 and 2008 and a more recent discussion paper published in March 2010, which were also funded by the Nuffield Foundation. The seminar was chaired by Sharon Witherspoon, Nuffield Foundation Deputy Director, and it was attended by over 40 people representing a range of interests across the pensions and the public sector.

Niki Cleal, PPI Director, outlined the main findings from the report. This included:

- There are four main policy options that a future Government could consider. A first option could be to continue with the current public sector pension schemes as reformed by the Labour Government between 2005 and 2008. A second reform option could be to apply reforms within the structure of the current final salary schemes such as increasing the normal pensionable age, increasing member contributions or increasing the accrual rate. A third option could be to introduce reforms that involve a greater sharing of risk between employees and employers, such as career average or hybrid schemes. Finally, a fourth option could involve a move to defined contribution arrangements, which could be funded, as those commonly found in private sector pensions, or notional as implemented in the first public tier in Sweden since 1998.

- It was noted that the combined impact of the previous Labour Government's reforms and the Coalition Government's recent announcement to index pensions to the Consumer Price Index instead of the Retail Price Index has already reduced the potential value of a public sector pension to a typical public sector worker by around 25%. As a result, the cost to the Government and the taxpayer of the current public sector schemes is now projected to fall from 1.2% of GDP in 2010 to 1% of GDP by 2050.

- All of the reform options that the PPI modelled would further reduce the generosity of the current schemes. Only the current final salary schemes allow median earners to reach the benchmark replacement rate set by the Pensions Commission. However, final salary schemes benefit high-flyers and long-stayers vis-à-vis average earners and early leavers, which could be argued to be unfair. This is also the most costly option of the reforms modelled, although it should be noted that even under this option the cost of continuing to provide public sector schemes in their current form is projected to fall from 1.2% of GDP in 2010 to 1% of GDP by 2050.

- Among the reforms modelled within the structure of the current final salary schemes, a reduction of the accrual rate from 1/60th to 1/80ths reduces benefit adequacy to the greatest extent, leading to a replacement rate for median earners of 52% which is 8 percentage points below the Pension Commission's benchmark of 60% of average earnings. Under this option, costs are projected to fall to around 0.9% of GDP by 2050. However, this option does not address fairness as pension benefits are still based on final salary levels.

- Career average and hybrid schemes reduce costs in the long term and they also address fairness because pensions are tied to average and not to final salary levels. They also lower the risk to the employers of having to pay a high final salary pension while receiving contributions from lower salaries. The career average option modelled in the research reduced the benefit adequacy to 55% for a median earner, 5% points below the Pensions Commission's benchmark and also reduced the costs to the Government to 0.9% of GDP by 2050.

- A move to funded DC would be costly in the short term as the Government would have to pay current pensions without using the contributions of current public sector employees, which would have to be invested. The notional DC option modelled with a combined contribution rate of 15% reduces costs significantly to 0.7% of GDP by 2050 and addresses fairness. However, adequacy is substantially affected with median earners achieving a replacement rate that is 43% - 17 percentage points below the Pensions Commissions' benchmark.

- None of the reform options are likely to address all of the Government's policy objectives to the same extent and any future reforms should take into account the trade-offs involved in assessing the different reform options.

Lord Hutton of Furness (Chair of the Independent Public Sector Commission) acknowledged the great interest that this topic generates and welcomed the PPI report as a useful contribution to the debate. He also observed that it is important that any future reforms should be simple and implementable. In this sense, he pointed out that final salary schemes can be easy to communicate and to understand. However, he acknowledged that they also subsidise high-flyers and long-stayers and that in the Commission's interim report he had concluded that a continuation of the current final salary schemes is not tenable. On the implementability issue, he remarked that identifying the issues to address is relatively straightforward but understanding the different trade-offs involved is actually more difficult. He pointed out that the Commission is currently analysing reforms that share risks between public sector employers and scheme members. He concluded by highlighting that ensuring benefit adequacy and understanding who is better placed to bear the cost of future reforms, whether employers or employees, are key aspects that the Commission will consider as it takes forward the next phase of its review.

Nigel Stanley (Head of Campaigns and Communications from the Trade Union Congress) provided a public sector employee perspective on the reforms to public sector pension schemes. He emphasised that public sector employees are extremely concerned about the changes that have already been introduced by the Coalition Government, in particular the decision to use CPI rather than RPI for future uprating of pension benefits from next financial year. Taken with the changes negotiated in 2005, this meant that public sector pensions have already been reduced in value by 25 per cent – a figure confirmed in the new PPI research. In addition, he remarked that a three per cent increase in member contributions has been announced in the Spending Review and that some schemes are due for a revaluation – the first under the cap and share arrangements.

He argued that this did not provide a constructive context for discussing issues of fairness within schemes, raised by the Hutton report. Unions, he pointed out, have no disagreement in principle with changes in scheme design such as a move to career average, as long as they are negotiated. In this sense, he highlighted that the change in civil service arrangements has also seen an increase in accrual rates. He pointed out that public service schemes and workforces are not the same, and that it is therefore a mistake to think that there is an ideal structure for all of them. In fact, some schemes' features are for the benefit of employers – such as the retention of key staff.

He argued that while there is a general sense that the gap in pensions between those at the very top and the rest is unfair, this is not at root a pensions problem but a reflection of widening inequalities in pay that started in the private sector but have now moved to parts of the public sector.

He concluded by stating that public sector unions are willing to negotiate but public sector staff already feel that their pensions have been cut back, and this will make careful analysis of the different reform options and the fairness trade-offs involved much harder to achieve.

Mike Taylor (Chief Executive of the London Pension Fund Authority) provided a public sector employer's perspective on the future reforms. He started by supporting Lord Hutton's interim report statement that "future reforms should not entail a race to the bottom." In this sense, he supported a move to a career average because it addresses the fairness issue and it is also comparatively easier to understand than other risk-sharing options such as hybrid schemes. He also argued that hybrid schemes with a DC top up for salaries above £75,000 would not make sense in the context of the fund run by the LPFA, given that 95% of employees earn less than that amount. He also made reference to a recent survey among LFPA employers in which a majority agreed that public pension schemes should be fair, easy to understand and remain as a useful tool for retention and recruitment.

He concluded his presentation by arguing that in the future public sector pension schemes should move to a funded basis, as in the Local Government Pension Scheme (LGPS). He also argued that government accounting should be improved, and he recommended the creation of an independent public sector pension chamber in charge of reviewing adjustments to the schemes according to changes in longevity and other factors.

Questions and Discussion:
The following points were raised during the questions and discussion section. They do not necessarily reflect the views of the PPI or the PPI seminar speakers.

- There was a question related to fairness as to whether reforms in the public sector schemes should provide a benchmark for the private sector. Some discussion followed on whether it was the mission of the public sector to set a standard for pension provision in the private sector. There were mixed views about whether there is likely to be any knock-on consequences for pensions in the private sector from any further reforms in public sector pensions.

- It was suggested that a new type of risk that should be considered in any reform scenario is the risk of not being able to predict the future, such as future changes in inflation or in Government legislation. For example, it was argued that it may be difficult to assume that the calculation of the CPI will remain immutable in the future. Likewise, in forty years' time, there may be many changes of Government and legislation. This is especially important to consider when trying to predict long term scenarios.

- There was some ensuing discussion about the uprating of benefits following the CPI or the RPI. Some participants remarked that housing costs make up to half of the difference between the RPI and the CPI but that there may be developments in the future to incorporate housing costs within the CPI. For example, it was remarked that Eurostat is currently trying to incorporate housing costs to the CPI at the European level.

- On the implementation of risk sharing options, it was highlighted that cost capping and risk sharing measures have been satisfactorily negotiated in the NHS. In this sense, there was some agreement that future negotiations could provide some options to workers. It was argued that, for example, it might be worth considering giving workers the choice of paying more to maintain current benefits.

- It was argued that although some of the public sector unions rejected career average options in the last round of negotiations, this did not necessarily mean that the same would be true of any further reforms: the detail of any further reform proposals would be important in determining the public sector unions' responses.

- It was noted that some pensions offer a 25% tax-free lump sum and that this should be factored in to any comparison of reform options. The PPI models assume that DB scheme members commute 25% of their pension as a tax-free lump sum and that DC scheme members take 25% of their fund value as a tax-free lump sum. This enables consistent comparisons to be made.

- In closing the seminar, the Chair thanked the speakers and participants and encouraged those present to draw on the research in submitting their own views to the Commission.