Independent Public Service Pensions Commission:

Interim Report

7 October 2010

Independent
Public Service
Pensions Commission

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Foreword by Lord Hutton of Furness

As we have all come to appreciate in recent years – whether we work in the private or public sectors – providing good quality pensions is becoming a much more challenging task given the increasing length of time that most people can now look forward to spending in retirement. This is particularly true of defined benefit pensions, where a pension is ultimately determined by the level of a person's earnings, rather than the level of their pension contributions. Defined benefit pensions make up most of the pensions on offer to public service employees and they raise substantial issues of affordability as well as risk sharing. As my interim report makes clear, there have been important attempts made to address the underlying drivers that have seen costs of providing public service pensions increase sharply in recent years. I welcome these reforms as they have helped to strike a better balance between employees and taxpayers in the distribution of pension costs. But as my report also makes clear we must satisfy ourselves that we have fully and openly addressed all of the underlying pressures that are still pushing up the cost of providing public service pensions. To do this properly we need to expose all the real costs of providing the current range of public service pensions as well as understand the real benefits they represent to employees.

The public sector performs functions that are vital to the security of our country, the success of our economy and the health of our society. There is therefore a compelling public policy objective in being able to recruit and retain the best possible people for these crucially important jobs. As many people have rightly pointed out in their evidence to me, we should regard public service pensions as part of an effectively designed overall remuneration system that will allow us to achieve this end. In doing so we need to keep firmly in mind the need for fairness and efficiency in the use of scarce public resources. And whilst it is right that taxpayers finance a proportion of public service pensions, as they are also the recipients of the services that are provided by employees, they are also entitled to expect that their hard earned money is spent wisely and to the best possible effect right across the public sector.

First and foremost, pensions are provided in order to ensure an adequate income when someone stops working which can help them sustain a reasonable standard of living without becoming a burden on the welfare state. If we lose sight of this when we consider the case for reform and end up pushing more people into a reliance on state benefits in retirement, we may well find that overall costs are likely to rise, whatever changes might be made to the design of public service pensions. Simple, sloganistic approaches are not the answer. Any reforms must try and avoid this obvious pitfall.

My interim report therefore attempts to establish a proper baseline from which we can answer the fundamental question – are public service pensions on a fair and sustainable footing that provides the best possible value for money to the taxpayer as well as adequate retirement incomes for public service employees? It is my clear view that the figures in this report make it plain that the status quo is not tenable. I believe we need to adopt a more prudent approach to meeting the cost of public service pensions in order to strike a fairer balance not just between current taxpayers and public service employees but also between current and future generations. In the short term, however, I consider there is also a strong case for looking at some increase in pension contributions for public service employees, to better meet the real costs of providing these pensions, the value of which has risen in recent years with most of these extra costs falling to taxpayers. Ministers should, however, proceed carefully and ensure adequate protection and proper safeguards to protect accrued rights, avoid undue hardship and minimise the risk of any rise in the number of employees who opt out of scheme membership. In particular, I would not recommend introducing contribution rates for the armed forces at this time. This issue should be dealt with in a way that is consistent with any long-term reforms.

In undertaking this review, I have been struck both by the enormous complexity of the subject matter, as well as by the degree of misunderstandings and confusions that surround any debate about it. My report tries to dispel some of these myths. It is mistaken to talk about 'gold-plated' pensions as being the norm across the public sector. In the most part, the pensions that are paid out to public service employees when they retire are fairly modest by any standard, although in part these reflect part-career or part-time working. For some people these modest pensions now look over generous because of the changes that have taken place in the private sector over the last 30 years or so, where pensions have become generally much less valuable than they used to be. Fewer people in the private sector are also contributing to a pension. I hope these negative trends can be reversed and I fully support efforts to do so.

This downward drift in pension provision in the private sector does not however provide sufficient support or justification in my view for the argument that pensions in the public sector must therefore automatically follow the same course. I regard this as a counsel of despair. In making clear I believe there is a case for further reform I have therefore rejected a race to the bottom as the only answer, and hope that reformed public service pensions can be seen as once again providing a benchmark for the private sector to aim towards.

My final report will therefore look at a wider range of radical solutions that might represent a better balance between the need for fairness between taxpayers and scheme members – allowing for increasing longevity – and the need to ensure adequate retirement incomes for those who have devoted some or all of their careers in the service of the wider community. It is for this reason and to ensure that public service pension schemes represent the best possible value for money to the taxpayer, that I have set out a set of general principles that should guide and govern the appraisal of all of the options for longer-term reform. Each of these options will be assessed against these general principles. I consider that the public sector should continue to set a good standard as an employer and this includes a good standard of pension provision that seeks to avoid widespread opt-out of public service employees from these pension schemes. Promoting a responsible approach that encourages employees in the public sector to save for their retirement should be uppermost in our minds.

My interim report has also tried to tell the full story of who benefits most from the current system. Final salary schemes, which are the norm across much of the public sector, primarily reward high earners who progress rapidly through the salary scales. I am concerned that this may no longer provide a robust and fair mechanism for the majority of the public service workforce. I will return to this issue in my final report.

Pensions are long-term commitments and any reform I propose must protect the rights that public service workers have already accrued. The recommendations in my final report will ensure these rights are protected and I am taking advice on how this might best be defined. However I am clear that protecting accrued rights does not extend as far as protecting current terms for future pension accrual.

Finally, I have looked at the issue of how we currently deal with the pensions of those employees who move from the public sector when services are taken over by new providers. It would be unwise to allow the current arrangements to apply an unintended brake on the development of a more mixed economy of providers in the public sector. There is, at present, a danger of this happening. This issue will be dealt with in my final report and will form part of my appraisal of long-term reform options.

My final report will be completed next year. I am extremely grateful to all those who have submitted evidence to my Commission to date and to the panel of experts who are advising me in this work. I intend to conduct the widest possible consultation over the next few months as I now begin to examine options for long-term structural reform. I hope to build the widest possible measure of consensus about the way forward. I realise this will not be easy. But it is my belief that in finalising my recommendations, it will be possible to design a set of solutions that meet and address the principles I have set out in this interim report.

Lord Hutton of Furness

Executive Summary

The importance of public service pensions

Ex.1 Public service pensions provide retirement incomes for millions of people in the UK. In total there are 12 million active, deferred or pensioner members and dependants of public service pension schemes. That is around one in five people in the UK. Each year schemes pay out billions of pounds to their pensioners – in 2008-09 payments were £32bn, about two-thirds of the cost of the basic State Pension.

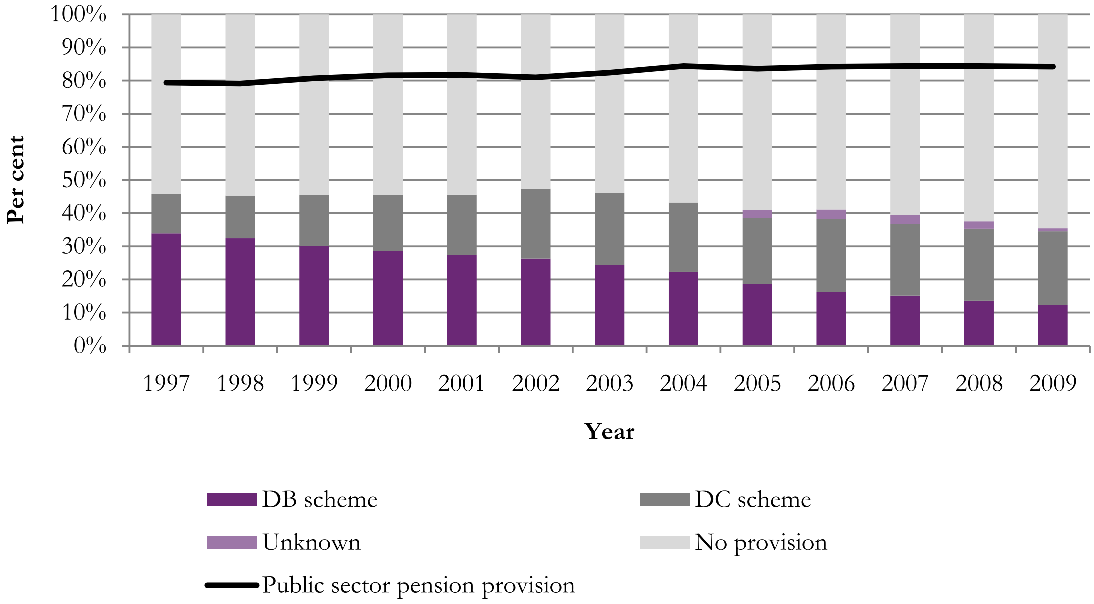
Ex.2 Many of the current public service pension design features, including accrual rates, pension ages and the link to final salary, date back nearly 200 years, despite the enormous upheavals in demography and in the nature of work in our economy. In 1841, someone who reached the age of 60 might expect to live a further 14 years on average, but most people did not live to this age. By the early 1970s, when the schemes were substantially reformed, the life expectancy of a 60 year old had increased to about 18 years and this has now risen to around 28 years. In addition, many more people can now expect to reach 60.

Ex.3 In the past the public service pension schemes have provided a lead for employers in the private sector, but more recently there has been significant divergence. The pensions landscape in the private sector has been varied, but over the first two thirds of the last century the number of people in private sector pension schemes grew, almost all of which followed the defined benefit structure of the public sector. Over the last third of the century and the start of this century, the picture has been very different.

Ex.4 The general trend from the 1950s has been one of increasing public service provision – particularly once allowance is made for the inclusion of many nationalised industry scheme members within the public sector figures for the 1950s to the 1980s. This is set against a fall in provision in the private sector, especially in defined benefit provision, which is not fully offset by the increase in defined contribution provision.

Ex.5 The trend is increasing, with a sharp fall in defined benefit provision in the private sector since the late 1990s. Whilst the provision of defined contribution schemes has increased significantly, there are still a growing number of employees with no provision. In fact, around 85 per cent of public sector employees have some form of employer sponsored pension provision compared to around 35 per cent in the private sector.

Chart Ex.1: Private sector employees by type of pension provision



Source: Annual Survey of Hours and Earnings, 2009

Ex.6 This divergence between the public and private sectors is of concern, particularly in the context of mobility between the public and private sectors. However, it does not necessarily follow that public service pension schemes should be modelled in future on what has been happening in the private sector in recent years, especially given the decline in private pension provision and the concern that saving levels in the private sector are not currently optimal. It is important to take into account other issues as we consider future options, including the need to ensure public service pensions provide adequate retirement incomes for retirees.

Ex.7 The key question regarding public service pensions is whether they fit the needs of a modern flexible workforce, whilst being affordable, sustainable, adequate and fair to both taxpayers and employees.

The need for reform

Ex.8 The need to modernise public service pensions has been recognised for some time, in particular the need to deal with increasing costs: between 1999-2000 and 2009-10 the amount of benefits paid from the five largest public service pension schemes increased by 32 per cent.[1] This increase in costs was mainly driven by an increase in the number of pensioners, a result of the expansion of the public service workforce over the last four decades, longer life expectancy and the extension of pension rights for early leavers and women.

1 Based on estimates by the GAD undertaken for the IPSPC. IPSPC analysis of schemes Resource Accounts.

Ex.9 The previous Government recognised these issues and in 1997 started a series of significant reforms. These included:

- limited increases in pension age for groups such as the uniformed services, mostly for new entrants. In the civil service, NHS and teachers schemes existing members were allowed to keep a pension age of 60 if they wished, but new entrants have a pension age of 65 and pension ages lower than 65 will be phased out by 2020 in the Local Government Pension Scheme;

- sharing of risk arising from demographic change in the form of 'cap and share' rules. This spreads the cost of any future unexpected increases in contributions more equitably between employer and employees than previously, up to a cap after which any future increases would be borne by the members. Cap and share at present applies to the four biggest schemes – NHS, teachers, local government and civil service, although it has not yet affected employee contributions in any scheme and the Local Government Pensions Scheme does not yet have a cap set; and

- changed accrual rates for many of the reformed schemes, particularly for new entrants, but all except the civil service are still based on final salary. The change to a career average structure in the civil service scheme was not primarily undertaken as a cost saving measure, but as a response to the changing nature of the workforce.

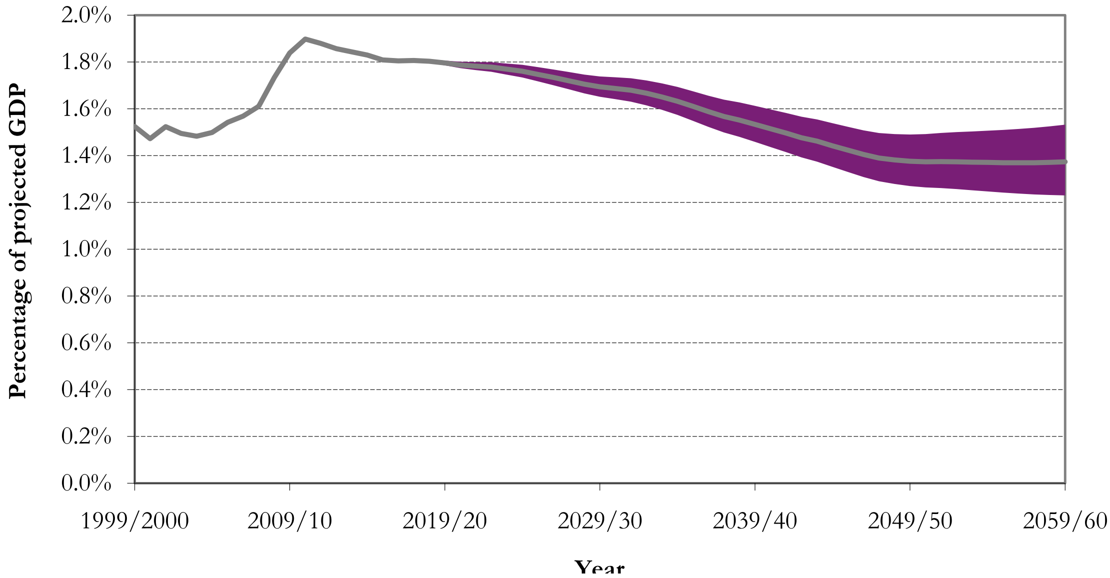
Ex.10 More recently the current Government changed the measure of annual price movements, so that from April 2011 onwards pensions uprating will move from the Retail Price Index (RPI) to the Consumer Price Index (CPI).

Ex.11 This change in the indexation measure may have reduced the value of benefits to scheme members by around 15 per cent on average. When this change is combined with other reforms to date across the major schemes the value to current members of reformed schemes with CPI indexation is, on average, around 25 per cent less than the pre-reform schemes with RPI indexation.

Ex.12 All these past reforms, the current pay freeze and planned workforce reductions will reduce the future cost of pensions. The gross cost of paying unfunded public service pensions is expected to fall from 1.9 per cent of GDP in 2010-11 to 1.4 per cent of GDP by 2060 as the central projection of Chart 1.B shows.

Ex.13 However, these measures will take many decades to fully affect the costs of pensions in payment, which are heavily influenced by existing pensioners, the vast majority of whom are still in pre-reform schemes. The Commission estimates that gross expenditure on unfunded public service pensions will remain close to current levels as a proportion of GDP over the next decade.

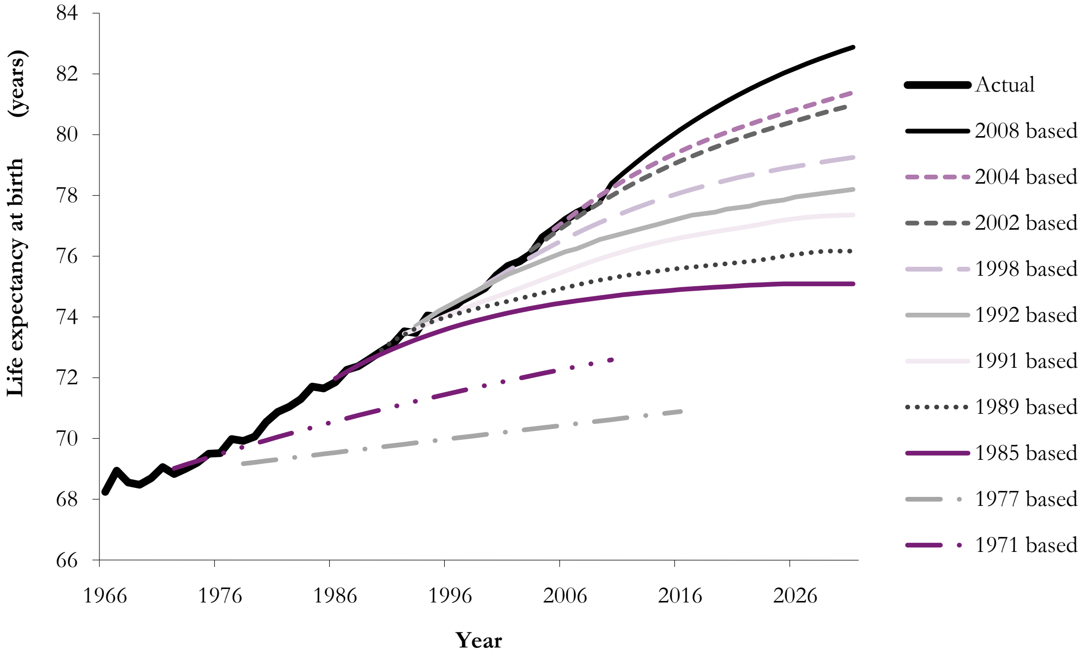
Chart Ex.2: Projected pension payments as a percentage of GDP – sensitivity analysis



Source: GAD analysis for the IPSPC

Ex.14 As Chart 1.B also shows, these costs are inherently uncertain and sensitive to assumptions on life expectancy, size of workforce, earnings growth and the implementation of planned reforms. How long pensioners will live has been systematically underestimated in the past, as Chart 1.C below shows. These issues could impact on the sustainability of these schemes in the future.

Chart Ex.3: Actual and projected period life expectancy at birth for UK males

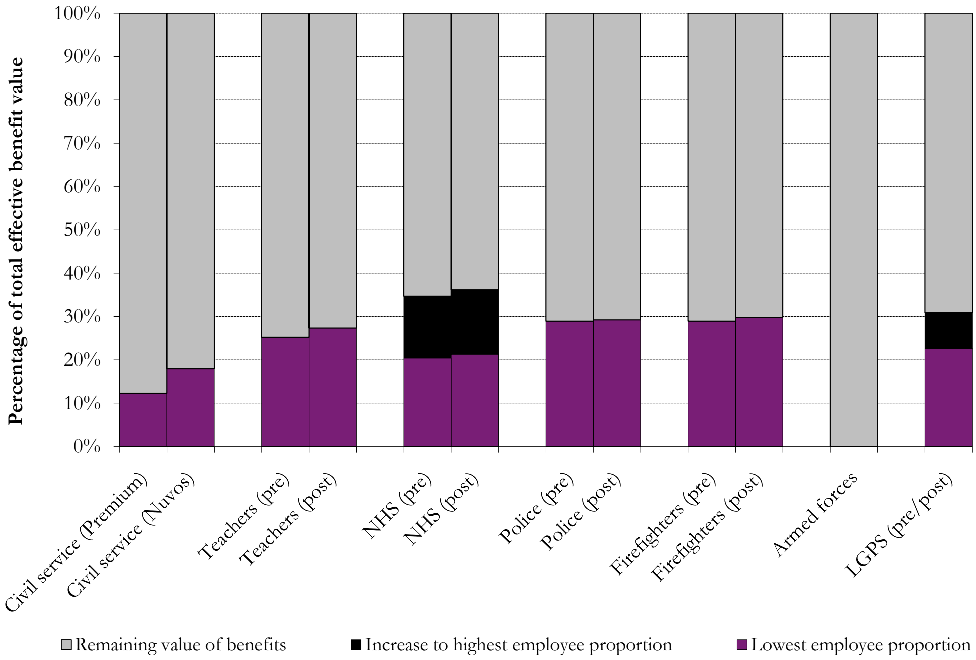


Source IPSPC analysis drawing on C Shaw 2007 and ONS 2008 population projections.

Ex.15 The expected proportion of adult life spent in retirement has increased as people live longer. A male pensioner in the NHS scheme who retired at 60 today is expected to spend 41 per cent of their adult life in retirement compared to 28 per cent if they retired in 1955. This means the value of a public service pension in 2003-04 is expected to be around a third higher than it would have been if assumptions about life expectancy were the same as those in 1955.

Ex.16 The increase in longevity also means that these pensions are now likely to be paid out for longer, increasing the overall costs. These extra costs, despite recent reforms, have not been equally split between employer and employees. Although the way costs are divided varies from scheme to scheme, the significant majority is met by the employer and by extension the taxpayer, as the Chart 1.D shows. This is not unique to public service pension schemes, but when many of the public service pension schemes were introduced employers and employees paid similar levels of contributions to the scheme – now employers pay around twice what employees contribute in most of the schemes and sometimes more.

Chart Ex.4: Employee contributions as a proportion of the overall cost of accrual (pre and post reform)



Source: IPSPC and PPI

Note: Figures based on effective employee benefit rates described in Box 5.B.

Ex.17 In addition, there is also uncertainty over whether the total contributions paid reflect the costs of the benefits received. The current discount rate used to set the level of total contributions in schemes was set in the late 1990s. Initial work by the Commission suggests that the current discount rate is at the high end of what is appropriate. The Commission is asking the Government to review this rate, ideally so that the findings can inform the final report.

Ex.18 In assessing fairness the Commission also found that the reliance on final salary in the majority of public service pension schemes tends to favour those who receive rapid promotion and those who stay in public service for their whole career. The promotion effect alone could mean that high flyers can receive almost twice as much in pension payments per pound of employee contributions than do low flyers.[2]

Ex.19 In addition, there is an issue of fairness between different pension schemes. This is particularly true between pre and post reform schemes given the protections given to most existing members when the schemes were reformed.

Ex.20 Public service pensions need to be considered in the context of the total benefits package for employees. There is no evidence that pay is lower for public service workers to

2 'Should Defined Benefit Pension Schemes be Career Average or Final Salary', Sutcliffe, C., ICMA Centre Discussion Papers in Finance, DP 2007-6, 2007.

reflect higher levels of pension provision. Consequently current pension schemes do not appear to offer best value for money.

Ex.21 Evidence to the Commission has also made it clear that current pension structures, combined with the requirement to provide comparable pensions ('Fair Deal'), are a barrier to non-public service providers, potentially reducing the efficiencies and innovation in public service delivery that could be achieved.

Ex.22 It has been suggested that extending access to public service pension schemes for non public service employees could be a solution to this problem. But it is not clear that this provides a solution either for the Government, which has to accept additional liabilities and long-term risk, or for some external organisations, which, depending on the scheme they are entering, may be required to pay a premium or indemnity for entry, take part in deficit recovery plans, or pay large exit charges.

Ex.23 When examining transparency it was clear that the debate around public service pensions has been hampered by a lack of consensus on what are the key facts and figures and a lack of transparency of the relevant data. This report seeks to provide as comprehensive a picture as possible in order to supply the basis for well-informed debate. In the final report the Commission will consider ways in which transparency and scrutiny can be improved.

Ex.24 The Commission has also come to the conclusion that it remains reasonable to continue to operate arrangements without actual funds as the basic financing model, given the risks, lack of obvious economic benefit and transition costs of moving to a fully funded model. Equally, there is no reason to de-fund existing funded schemes.

The principles of public service pension provision

Ex.25 This is therefore an appropriate time to take overall stock of the situation and begin to address the underlying issues of scheme design and management of costs into the future. The Commission has identified a set of principles against which long-term options for reform should be judged. These are:

- *affordability and sustainability* – what level of pension cost is affordable is a political decision for the Government within the context of a range of priorities. But it is not an issue that can just be looked at in the short-term. In assessing affordability and sustainability we have identified a range of relevant cost measures to consider and the need for an agreed discount rate. Part of any assessment of cost must include the consequences of any reform on increased take-up of benefits such as pension credit. Critical to sustainability is the sensitivity of future costs to risks, such as changes to longevity and how these risks are managed as well as shared;

- *adequacy and fairness* – public service pensions should provide an adequate level of retirement income for public service workers with a reasonable degree of certainty. To assess reforms against this principle we need an agreed measure of what is adequate and what should be measured against the benchmark. We provide some ideas in this interim report. Adequacy is a measure of fairness, but we are also looking at fairness in the distribution of contributions and benefits between members of the same pension scheme; fairness between different schemes; fairness between generations of taxpayers; and fairness between the taxpayer and the public service employee;

- *supporting productivity* – to support productivity, public service pension scheme design should be consistent with an efficient labour market for employees. This should allow the taxpayer to be confident that public services are being delivered on a value for money basis. In general, scheme design should avoid barriers to the movement of employees between sectors. This needs to be viewed in the context of the whole remuneration package and whether the schemes support the recruitment and retention of the right people in the right jobs in a cost-effective way and deal flexibly with specific job issues. In particular, they should not be an unintended barrier to the outsourcing and mutualisation of public services that could drive greater productivity and efficiency in public services; and

- *transparency and simplicity* – public service pensions should be widely understood, both by the scheme members with regard to their own specific entitlements and possible future benefits; and by taxpayers who have a role in funding the schemes. The key design features and the costs to employers and employees need to be set out clearly and transparently. Assessment of reform needs to consider potential trade-offs together with implementation and transitional issues, including the means for protecting accrued rights and possibilities for more cost-effective administration. It is also important that public service pension schemes, like schemes in the private sector, have a clear legal framework and have effective and accountable governance structures.

Options for change

Short-term options

Ex.26 The issues around fairness, sustainability, promoting productivity and the need for transparency and simplicity mean there is a need to consider long-term structural reform of public service pensions. However, that reform will take time. Increased longevity, the imbalance between employer and employee contributions and the fact that total contributions may be too low if the discount rate is too high suggests there is a case to make short-term changes, pending long-term reform.

Ex.27 The Commission considered a range of options that may provide short-term savings, specifically:

- changing the benefits structure;
- contracting public service pension schemes into the State Second Pension; and
- increasing contribution rates.

Ex.28 Of these, the most effective way to make short-term savings is to increase member contributions and there is also a clear rationale for doing so.

Ex.29 It is a matter for the Government to decide the manner and level of any increases in contributions necessary. However, the Commission feels that any increases should be managed so as to protect the low paid and, if possible, increases in contributions should be staged and need to be considered with a view to preventing a significant increase in opt out rates. The Commission does not recommend introducing contribution rates for the armed forces at this time.

Long-term options

Ex.30 The current public service pensions structure was not designed for modern working patterns and has been unable to respond flexibly to changes in this area and to demographic change over the past few decades. This has led to:

- rising benefits due to increasing longevity;
- unequal treatment of members within the same profession;
- unfair sharing of costs between the employee, the employer and taxpayers; and
- not realising the potential for plurality in the ways public services are provided.

Ex.31 Long-term structural reform is needed, as these issues cannot be dealt with through traditional final salary defined benefit schemes. But neither can they be dealt with appropriately through a funded, individual account, defined contribution model for all employees, which would place a major financing burden on taxpayers, ignore the ability of Government as a large employer to manage certain types of risk and increase uncertainty of post-retirement income for scheme members, which is difficult in particular for the low paid to manage.

Ex.32 In the Commission's final report a range of alternative structures will be considered. This will include a career average alternative to the current final salary defined benefit schemes. Drawing upon international experiences, alternatives such as Sweden's use of notional defined contribution schemes and the Netherlands' collective defined contribution schemes will be examined, as will risk sharing models, such as hybrid schemes that combine elements of defined benefit and defined contribution models. The Commission will also consider elements of scheme design, such as, ensuring normal pension ages are in line with the latest developments in longevity. This will enable the Commission to make a recommendation on a range of options to the Government, which can establish a more appropriate framework for public service pensions going forward.