A note on Public Sector Pension Reform

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A week or so ago the Cabinet Office minister, Francis Maude, told us that public sector pensions were unaffordable. Then, someone pointed out that Lord Hutton's report showed the cost coming down steadily over the next 40 years from a peak of 1.9% of GDP to about 1.4%. This is largely because of the reforms already negotiated by the Labour government.

So, the Economic Secretary to the Treasury, Justine Greening, switched to "untenable". This is a fairly meaningless word without further explanation – which she did not give. It is also a word not used at all in Lord Hutton's report!

We then moved on to "unfair", interpreted by government ministers to mean "unfair to the taxpayer employed in the private sector", because they do not have such good pensions, but are required to pay for good pensions in the public sector, but this is not the unfairness on which the Hutton report dwells.

<u>Alleged Unfairness of Public Sector pensions</u>

In any case, the reason why private sector employees do not have such good pensions is that their employers began withdrawing decent pension schemes many years ago. They were able to do this, mainly because their employees were not highly unionised. Where there were unions, because the employers protected the rights of existing employees, the union's members, and reduced the entitlement only of new employees, it was difficult for unions to oppose the changes as vigorously as they would have liked. It takes a very altruistic union member to go on strike for the benefit of people not yet employed!

The employers' rationale was that they could not afford their final salary pension schemes, because of the stock market crash and the increasing longevity of pensioners. However, most of them had had a "holiday" from pension contributions for many years only a few years before. They did this because their pension scheme actuaries told them that they already had more than enough money in their pension funds to meet the liabilities of the schemes. We now know that the actuaries were disastrously wrong, but at the time they were regarded as having an almost magical ability to predict the future.

Incidentally, it was against this background that Gordon Brown, as Labour Chancellor, altered the taxation of dividends. The purpose of this was to encourage re-investment by companies. Because the received wisdom was that pension funds already had too much money, he did not make an exception for them. This was later characterised as a "raid on pension funds", but at the time there was very little comment, because everyone believed that the funds were in a very healthy state.

So, in spite of their long contribution holiday, when the problem of the longevity of pensioners was noticed and since the stock market crash during the Tory administration, companies around the country have been closing their final salary schemes rather than making up the deficit. If they offered an alternative, it was usually a "defined contribution" scheme, of which more later.

Final salary schemes favour high-flyers

However, as already stated, unfairness to taxpayers was not something on which Lord Hutton's report concentrates. He concentrates on the inherent unfairness of final salary schemes, which favour high-flyers with salaries which reach a high level at the end of their careers over those who work steadily at lower level throughout their careers. The lower paid get less for their contributions (and for the employer's contribution), even in schemes with tiered contributions.

It is from this aberration in final salary schemes that the press stories of "gold-plated" public sector pensions arise. A very few highly paid civil servants and local government chief executives end up with high pensions, but the median civil service pension is £5,023 p.a. and for health workers it is £4,087 p.a.

Hutton proposes continuing with defined benefits

Lord Hutton favours the continuation of a defined benefit scheme. He recommends a scheme based on career-average revalued earnings (CARE), revalued by the average earnings index. This obviates the problem of disadvantaging the lower paid. Average earnings schemes have been characterised by the press as cheaper alternatives, but this is not necessarily so. It depends how you set the benefits and the contributions. Lord Hutton leaves this for the government to negotiate.

Average earnings schemes are also more suited to a flexible job market. Final salary schemes were designed when workers tended to remain with a single employer for all their working lives. Average earnings schemes have got a bad name because, where private sector employers have adopted this model, they have tended to set them up with lower employer contributions and thus poorer average benefits.

All the risks transferred to the employee

However, few private companies have changed to CARE schemes. As Lord Hutton's report shows, in the last 13 years, they have got rid of most defined benefit schemes and substituted defined contribution schemes for them, usually with much lower company contributions.

Such schemes put all the risk of changes, e.g. in investment returns, general salary levels, inflation and longevity, on the employee, completely reversing the previous situation. Unsurprisingly, the coverage of company pension schemes has fallen from 45% to 35% in the same period, with employees seeing this as a very poor deal.

Under defined benefit schemes all the risk is with the employer. Arguably, this is not fair either, perhaps especially in the private sector where smaller employers have no influence on the state of the economy at all.

Sharing the risks

Hutton recommends some sharing of the risk in public sector schemes. Longevity would be dealt with by linking normal retirement age to the state pension age, so that effectively employees bear this risk during the early part of their service, but not afterwards. Surges in salary levels are dealt with by using career average pay, but since this is revalued by the general earnings index, the risk, in effect, is shared.

Investment and inflation risks are borne by the Government, with one proviso. The Labour government had negotiated a "cap and share" system (let us leave aside how that works) as a way of sharing the risk of inflated pensions. The Hutton report recommends a simpler method, which provides a ceiling on the proportion of pensionable pay that the government will contribute. If reached, this would trigger a fresh negotiation. If this is set high enough, it would mean that the risk was left mainly with the government. If not, it potentially puts much of the risk on the employee.

Where this is set is left for the government to negotiate. Since the government has more control over inflation than the employee, it should, in my view, be set quite high.

<u>The Change to the Consumer Prices Index</u>

In payment, Hutton recommends that pensions be inflated on the basis of the prices index. He does not specify whether this should be the retail or the consumer prices index.

The government has already unilaterally lowered public sector pensions (and state pensions) in payment by switching from the Retail Prices Index to the Consumer Prices Index. The most recent increase was 3.1% instead of 4.7% because of this. The CPI differs in two main ways from the RPI. It does not include housing costs, but also it is calculated differently, so that it will normally produce a lower figure than the RPI, even if housing costs are showing no increase. (The technical explanation is that it averages the prices of goods by the geometric mean rather than the arithmetical mean.)

<u>The Government's surcharge on contributions</u>

The government have also unilaterally imposed a 3% surcharge on employee contributions to public sector pension schemes. This is not really a part of the Hutton recommendations. His committee were asked specifically in their terms of reference to say how savings could be made in the short term and their response was that the best way to do this was to increase employee contributions. The interim report states that "there is a rationale for increasing member contributions (as a short-term option)": hardly a ringing endorsement of the idea!

<u>Two other unfairnesses</u>

The report refers to two other unfairnesses. One is that, where changes are applied only to new entrants, employees working side-by-side may be earning different pensions. This has happened in many – probably most – private sector schemes. It also happened as a result of the Labour government changes to the retirement age for new entrants.

The report recommends that existing employees as well as new employees should be moved to the new system. This must have been one of the main factors in the minds of those who went on strike. However, accrued rights would be preserved: to give them their due, the government did put this in the terms of reference as a requirement.

So, the recommendation is that service up to the change-over should be based on final salary and subsequent service on the CARE model. However, final salary does not mean salary at the time of retirement, but salary at the time of change-over. Although revalued by the average earnings index, this will not normally be as good as using the real final salary. No doubt, the unions will wish to challenge this.

The other unfairness, often alleged by ministers, is that public servants used to be paid less than private sector employees, but had good pensions to make up for this. It is a measure of the success of the Labour government that the pay of public servants, especially teachers and nurses, has been increased to a much better level. Last year, on average, public sector pay was 8% ahead. However, their pay is now frozen, so that private sector workers, with an average 3% increase this year, are beginning to catch up.

Also, of course, some private sector workers used to have comparable, or even better, pensions, but many of these schemes, as we have already seen, have been withdrawn over the last few years. It would not make sense to remove adequate pensions from public sector workers just because they have been withdrawn from private sector workers.

The Hutton report says little about this "unfairness" other than that salary review bodies should specifically take pensions into account as part of remuneration. It would be disappointing if they had not been doing this already.

<u>Adequate pensions</u>

State pensions are low in the UK compared with other European countries. This has been balanced in the past by the fact that a good proportion of retired people had a decent occupational pension. The loss of decent pensions in the private sector is building up a considerable problem for the future. If public sector pensions are also reduced to the new private sector level, then a great many people will be poor in retirement and an increasing number will require state help, either through means-tested benefits or a large hike in state pensions.

Lord Hutton's report, however, recommends that public sector pensions, along with the state pension, should provide an "adequate income". The measure for adequacy recommended is the table of "replacement rates" set out by Lord Turner's Pensions Commission. This is perhaps the most important recommendation in the report and it is worth spelling out the levels recommended:

Income	Benchmark Replacement rate (in retirement) (%)
<£9500	80
to £17499	70
to £24999	67
to £49999	60
£50000 and above	50

<u>Conclusion</u>

Everything depends on the negotiations, but in my view here is a very good basis for a very good pension scheme.

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