

The Public Sector Pensions Commission – CIPFA response to the Call for Evidence

July 2010



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30 July 2010

Lord Hutton of Furness
Chairman
Independent Public Service Pensions Commission
Room 1/20
1 Horse Guards Road
London
SW1A 2HQ

Dear Lord Hutton

Call for evidence – Independent Public Service Pensions Commission

Thank you for your letter of 2 July 2010 in which you invited initial evidence and views of the affordability, fairness, impact on mobility and plurality of current public service provision of the current public sector pension schemes and the objectives that should guide public service pension in future.

CIPFA is pleased to offer its comments on these issues which are set out in the attached document and we look forward to working with the Commission further over the coming months as the future of public sector pensions takes shape.

I hope that you find these comments a useful contribution to the work of the Commission. If you have any questions regarding any of the above comments, please contact Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely



Steve Freer
Chief Executive



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Call for evidence – Independent Public Service Pensions Commission

Summary of response

CIPFA welcomes the establishment of a Commission to review the long-term affordability of public service pensions. As a significant element of public spending, sound financial management requires that such costs are subject to careful scrutiny and periodic review.

In order to begin to explore what future pensions provision in the public sector should look like, the first aim of the Commission should be to determine what is fiscally sustainable in the context of public sector pensions. Setting the scope of the funding envelope will then allow for the design of a pensions system that can be contained within the set funding level.

The Office for Budgetary Responsibility (OBR) in its June 2010 report has already highlighted the fact that there is no single widely accepted definition of “fiscal sustainability” and concedes that to avoid being over-simplistic fiscal sustainability needs to take account of several dimensions, such as solvency, economic growth, stability, fairness and robustness. In a pensions context, there is also the added dimension of ensuring that the cost of pension rights accrued today do not fall disproportionately on future generations.

The question of what is affordable therefore can be viewed from a number of different perspectives. Achieving a common understanding of what is deemed affordable is key to setting the objectives for the future of public sector pensions.

CIPFA believes that changes are necessary to ensure that public service pensions remain financially sustainable and affordable in the long-term.

However change should not be restricted to the public services. Pension provision in the private sector has deteriorated markedly in the last fifteen years and this too will have an impact upon the public finances in the years to come. We believe that the single most positive and constructive way of closing the gap between public services and private sector pensions is to reverse the decline in the provision of affordable and sustainable employer-sponsored occupational pensions in the private sector.

Reducing the retirement incomes generated by public service pension schemes to such a level that public sector employees are reliant upon state benefits in retirement simply replaces taxpayer-funded employer contributions to a pension arrangement with taxpayer-funded state benefits.

The structure of public service pensions has not kept pace with demographic and workforce changes and it is those changes - particularly increasing longevity together with the natural maturation of ‘pay-as-you-go’ schemes that are forcing up the cost of pensions across the UK.

Changes are therefore necessary to ensure that these schemes remain able to meet the income needs of public sector workers in retirement, while being affordable for current employees and taxpayers, and avoiding transferring burdens to future generations.

However we are keen to see that change is guided by clear principles and objectives; a sound evidence base; recognition of the differences between the schemes and the sectors they serve, as well as the different financing dynamics of funded and unfunded public sector schemes; and a clear understanding of both the short and long term financial and non-financial effects any changes may bring.

These points are explored further in the sections below.

1 The growing disparity between public service and private sector pension provision

Providing adequate pensions is a long term challenge. Closing pension schemes provides benefits for private sector employers and shareholders today, but transfers the long term costs to employees and potentially future taxpayers as well.

- 1.1 Data from the Office of National Statistics reveals that between 1991 and 2008 private sector pension scheme active membership fell from 6.5 million to 3.6 million, a decrease of some 45%¹.
- 1.2 The vast majority of these 3 million active members have been lost from defined benefit schemes – the same ONS data shows that defined contribution (DC) scheme membership has remained relatively stable over this period.
- 1.3 This decline is reflected in the large rise in the number of preserved pensions (already-earned pension benefits now frozen and due to be paid on retirement) as employers have closed their defined benefit pension schemes in response to rising costs. Private sector employers have benefitted significantly from closing their pension schemes or switching employees from defined benefit to defined contribution schemes. Research published last year showed that these savings could amount to as much as £4.5 billion per annum.²
- 1.4 What is less clear however is how those individuals who are no longer participating in occupational pension schemes are now making provision for their retirement, as all major surveys, economic indicators and government research³ suggest that the public in general are saving less, and what this means for the long-term public finances.
- 1.5 Research by the Association of British Insurers (*State Of The Nations Savings – November 2008*) shows that property investment (buy-to-let, speculative investment etc), cash deposits and stock and shares are the most popular investment choices other than pension schemes.
- 1.6 However all of these investment types have suffered during the economic downturn and may not provide the expected returns. Certainly those relying on dividend income, stock market gains or interest on savings will also most certainly be facing a shortfall in light of the recent volatility in the financial markets and an extended period of record low interest rates.
- 1.7 The recent economic downturn is also affecting the way in which those in pension schemes are approaching saving for their retirement. Research in 2008 by the Prudential found that 18% of workers had already cut back on pensions contributions. Another life company, AXA, have also suggested that 1.5 million people are considering suspending their pension contributions altogether in response to the current economic conditions.
- 1.8 Even those in pension schemes may find that they do not provide the level of income expected. The National Association of Pensions Funds (NAPF) 2008 annual pension scheme survey showed that the average defined contribution scheme is producing an annual pension of around £1,000. In the absence of any other income, and even with the basic state pension, this would still leave the recipient entitled to considerable state support as discussed in the next section.

¹ ONS, 2009

² Research by MGM Advantage, June 2009.

³ In an interview in July 2010, Pensions Minister Steve Webb reported that around seven million people are currently not saving enough to meet their retirement aspirations (The Independent, 29 July 2010).

- 1.9 These factors point to an acceleration of the worrying trend for pensions underprovision highlighted by Lord Adair Turner's Pension Commission report in 2005, which concluded that "voluntary private pension provision is not growing: rather it is in serious and probably irreversible decline. Employer's willingness voluntarily to provide pensions is falling...".
- 1.10 In turn, these trends increase the likelihood that additional state finance will be required in the future to support those whose basic state pension and privately generated income in retirement, either from an occupational pension or other sources, falls short of the government's minimum income guarantee for those in retirement. Hence it is important that the Commission consider, alongside affordability issues in public service pensions, how the private sector can be encouraged to increased pension provision in order to avoid further increases in the level of costs transferred to the Government and future taxpayers.

2 Encouraging savings for retirement and longer working lives

Making arrangements during employees' working lives for an adequate income during retirement is essential. If this isn't achieved through a pension scheme or private investments, the costs will fall on the taxpayer.

- 2.1 The average pension in payment in the major public sector pension schemes varies from scheme to scheme. In local government it is around £4,000; in the Civil Service around £6,000; the NHS around £7,000; the Armed Forces around £7,500; and around £9,400 for teachers. The average across all schemes is approximately £6,250⁴.
- 2.2 Even when basic state pension entitlement is added to the modest sums received from public sector pensions, the average public sector pensioner is still in the lowest 20% of retirement incomes across the UK, and is far below the average for those retiring in 2010 of £16,509⁵.
- 2.3 The average public sector pensioner also only sits just above the minimum income standard in retirement as determined by the Joseph Rowntree Foundation⁶.
- 2.4 The following example demonstrates the important role played by public sector pensions in reducing the level of benefits paid to former public sector workers in retirement.
- 2.5 The table below shows income sources for a single male pensioner aged 65 living in rented accommodation costing £100 per week and with an average Council Tax bill. Pensioner A has no occupational pension; Pensioner B receives an amount equivalent to the average gross public sector pension of £6,250 per annum.

⁴ These averages mask a wide distribution of actual pensions in payment which support the assertion that the actual pension received by the majority of public sector employees is relatively low. Research by the West Midlands Pension Fund shows that 72% of its members receive an annual pension of less than £5,000.

⁵ The Prudential "Class of 2010" survey (March 2010) found that 18% of people retiring in 2010 would receive less than £10,000 per annum. It also reported that the average income for those retiring in 2010 would be around £16,500.

⁶ A report by the Joseph Rowntree Foundation – "A Minimum Income Standard for the UK in 2010" – sets out a minimum income standard for a single pensioner as £10,608.

Table 1: Pensioner income comparison

Income Source	Pensioner		Benefit saving B compared to A
	A	B	
Occupational Pension (after tax)	-	£5,884	
Basic State Pension	£5,078	£5,078	-
Pension Credit	£1,817	-	£1,817
Housing Benefit	£5,200	£3,272	£1,928
Council Tax Benefit	£724	£131	£593
Winter Fuel Payment	£250	£250	-
<i>Total income</i> ⁷	£13,069	£14,615	£4,338

- 2.6 The effect of the occupational pension is to reduce the demand on state benefits by £4,338 per annum.
- 2.7 Put another way, the average public sector pension is worth only 30% above the level of state benefits that would have been received had the employee not made any provision for retirement. This 30% is roughly equivalent to the share of pension generated by the employees own contributions (based on a ratio of 2:1 employer to employee funding).
- 2.8 Table 1 shows that the average public sector pension is sufficient to ensure that many public sector pensioners place only modest demands upon state funds to support their incomes in retirement, such pension credit, housing and council tax benefits etc. Without their occupational pension arrangements, the average public sector worker would be wholly reliant upon direct state funding to support them in retirement. The Commission must therefore consider this 'trade-off' between pension provision and benefits carefully when assessing the affordability of future arrangements.

3 Public service employer recruitment and retention needs

Commission recommendations on public service pensions must balance affordability and the needs of workers in retirement with the continuing ability of public sector employers to recruit and retain staff in key public service roles.

- 3.1 The public service pension schemes which fall within the scope of the Commission's review cover a wide range of different arrangements which provide pensions to vastly different roles within public sector employment. This diversity is reflected in the cost of providing pensions in these sectors. There is a clear divide between the cost of pensions in the uniformed services (police, fire armed forces) and the other public sector schemes which arises as a consequence of a pensions benefits structure which is designed to reflect a shorter active career (Annex A).
- 3.2 There is therefore an argument for looking at the affordability of such schemes not in the context of the wider public sector but in the context of the type of high benefit⁸ pension schemes provided in the private sector.

⁷ The table is based upon the Minimum Income Standard calculator (<http://www.minimumincome.org.uk>).

- 3.3 The Pensions Policy Institute have undertaken extensive research on the value of public sector pensions in which they sought to compare public and private sector pensions by assigning a value to pension arrangements expressed as a percentage of pensionable pay. In their 2008 report⁹, they estimated the overall cost averaged out across all the uniformed schemes to be 33% of pensionable pay. A comparable high level benefit pension scheme in the private sector was found to be 32%.
- 3.4 Turning to the non-uniformed services schemes, during the last round of public sector pension scheme reform (which took effect between April 2005 and April 2008), a broad consensus seemingly emerged that an employer contribution of 14%-15% (expressed as a factor of pensionable pay) was a sustainable employer contribution. When average employee contributions are taken into account (6.5% in the NHS scheme; 6.4% for Teachers; 6.1% in Local Government) this brings the total contribution rate to around 20%-21% of pensionable pay. This is broadly in line with the contribution rate found in private sector defined benefit schemes (14.6% employer and 5.1% employee in open schemes; 18.1% employer and 4.8% employee in closed schemes¹⁰) which offer a medium level of benefits.¹¹
- 3.5 In this context an employer funding envelope of 14%-15% of pensionable pay for the non-uniformed services and 23%-24% for Fire, Police and Armed Forces is consistent with the same level of benefits in the private sector.
- 3.6 The impact on recruitment and retention from increasing employee contributions require further investigation. As in any other personal financial decision, there are large groups of public sector employees who are "price-sensitive" to the cost of pension scheme membership. Experience in the Local Government Pension Scheme (LGPS) in particular shows that the low paid, part-time workers and younger employees are often reluctant to join the scheme due to the cost of contributions (and in the case of younger employees, other financial pressures such as student debt, etc).
- 3.7 Consequently scheme membership in the LGPS currently runs to around 80% of employees, despite efforts during the last round of scheme reform to encourage greater take-up amongst the lower-paid by reducing the lowest rate of contribution to 5.5% for employees whose whole time equivalent pay is less than £12,600 per annum.
- 3.8 There is also evidence to suggest that at the upper-end of the pay-scales the cost of membership is also a concern. The proposed changes to tax relief on contributions have prompted many of those affected to reconsider their continued membership – a prospect also widely reported in private sector schemes.
- 3.9 Whilst increases in pension contribution rates and retirement ages clearly offer opportunities to make savings during the Spending Review period, if the reaction

⁸ Based on ONS analysis. "High level benefits" include a normal pension age of 60; accrual rate of over 1/60th; all earnings pensionable pay; non-contributory for employees or under 5%; uncapped RPI indexation; and death in service lump sum of 4 times salary or higher.

⁹ Pensions Policy Institute – An assessment of the Government's reforms to public sector pensions, 2008.

¹⁰ Occupational Pension Schemes Annual Report 2008, ONS.

¹¹ Based on ONS analysis. "Medium level benefits" include a normal pension age of 65; accrual rate of 1/60th; all earnings pensionable pay; member contribution rate of between 5% and 7%; RPI indexation; and death in service lump sum of between 3 and 4 times salary

of employees is such that they chose to leave pension scheme membership, the resulting negative effects could outweigh the additional financial contribution. In the short term, the sizeable contribution from employees which, in pay-as-you-go schemes, is supporting meeting the cost of today's public service pension payments could be reduced, while reductions in pension scheme membership could also have longer term adverse consequences for the public finances, as discussed above.

4 Fair future provision across the public service workforce

There are a wide variety of pension schemes in the public sector. The Commission's recommendations should recognize the vast differences in employment types and career structures in the public sector, from front-line soldiers to back-office workers that these schemes provide benefits for.

- 4.1 Whilst there may be scope for a set of common pension scheme design principles to emerge from this review, the way in which they are implemented should recognise and accommodate the diversity of employment types.
- 4.2 Despite the vast differences in employment types and career structures in the public sector pension scheme provision is currently based on a "one size fits all" approach, defined only by sector of employment (health, teaching, civil service, local government etc). This gives both employers and employees little flexibility in adapting pensions to meet the cost constraints faced by both.
- 4.3 There are therefore potentially some lessons to be learned from the approach taken in the Social Housing Pension Scheme (SHPS)¹².
- 4.4 Prior to 2007 the SHPS offered a 1/60th accrual final salary scheme, with employee contributions determined by age. Since 2007 SHPS has been widened to encompass a number of sections offering variable benefits:

Table 2: Development of SHPS choices

Pre April 2007	From April 2007	From April 2010	From October 2010
1/60 th Final salary	1/60 th Final salary 1/70 th Final salary 1/60 th CARE ¹³	1/60 th Final salary 1/70 th Final salary 1/80 th Final salary 1/60 th CARE 1/80 th CARE	1/60 th Final salary 1/70 th Final salary 1/80 th Final salary 1/60 th CARE 1/80 th CARE Defined Contribution section
Age related employee contributions	Employer-determined employee contributions (subject to minimum 50% employer contribution)	Employer-determined employee contributions (no employer minimum)	Employer-determined employee contributions (no employer minimum)

¹² The Social Housing Pension Scheme (SHPS) SHPS is administered by The Pensions Trust. The scheme is designed for people working in social housing. There are currently around 59,000 members and over 700 employers participating in the scheme.

¹³ CARE – Career Average Revalued Earnings: where pension benefit for each year of membership is related to the pensionable earnings for that year.

4.5 The cost of accruing a pension under each of the options varies allowing employers and employees to choose an option which is affordable to them. The costs from April 2010 were as follows:

Table 3: SHPS costs by benefit type from April 2010

Benefit type	Cost from April 2010 (expressed as percentage of pensionable pay)
1/60 th Final salary	17.8%
1/70 th Final salary	15.4%
1/60 th CARE	14.9%
1/80 th Final salary	13.5%
1/80 th CARE	11.9%
Defined Contribution	Minimum employer: 3% Minimum employee 3% (rising to 5% from 2012 to conform with NEST ¹⁴)

4.6 This “menu” approach, combined with the ability to manage the ratio of employer/ employee contributions, offers employers the opportunity to manage pensions provision in the long-term within a specified funding envelope.

4.7 SHPS has come from a similar position to where many public sector pension schemes find themselves today. Adopting a similar flexible approach may offer a potential solution to the affordability issues facing the public sector.

5 Risk sharing between the taxpayer and employee

We are all living longer. To minimize the financial burden facing future generations of a shrinking taxpayer base, changes to public service pension schemes are essential. Public service employees will have to work longer, retire later and contribute more towards providing for their retirement alongside everyone else.

5.1 In 2008-09, UK public sector employees contributed over £6 billion into the unfunded public sector pensions arrangements across the UK. These contributions were used to defray the £25.7 billion cost of paying today’s public sector pensioners – around 24% of the total cost (Annex B). By the time we reach 2015-16, this will have risen to approximately £7.6 billion (based on Office of Budget Responsibility (OBR) forecasts of unfunded public sector pension schemes contributions income).

¹⁴ NEST (National Employment Savings Trust) is a new low cost pension scheme available to employers to meet new legal duties to provide pensions to the workforce that start to be introduced from October 2012. NEST is designed specifically to meet the needs of low-to-moderate earners and their employers. It will operate as a trust-based occupational pension scheme run by the trustee body, NEST Corporation.

5.2 In its 2010 Budget report¹⁵, the OBR forecast that the direct funding from the Treasury necessary to meet the gap between pension scheme contributions and expenditure would rise from £4 billion in 2010-11 to £10.3 billion by 2015-16:

Table 4: Extract from OBR Budget 2010: the economy and public finances – supplementary material

	£billions							
	Outturn		Estimate	Forecast				
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Net Public Service Pensions	3.1	3.1	4.0	5.1	5.8	7.3	8.9	10.3
<i>of which:</i>								
Gross Expenditure	22.5	24.3	25.4	26.8	28.3	29.9	31.3	32.9
Pensions receipts	- 19.4	- 21.2	- 21.3	- 21.6	- 21.5	- 21.5	- 21.4	- 21.6
Cap and Share	-	-	-	-	- 1.0	- 1.0	- 1.0	- 1.0

5.3 Expenditure is forecast to rise through inflation, past real terms increase in earnings, longevity improvements and an increasing number of pensioners. However not all of the increase in the funding gap (from £4 billion to £10.3 billion) is due to increasing expenditure.

5.4 The assumption of low growth in pension receipts is consistent with the government's planned two-year public sector pay freeze and planned reductions in the public sector workforce.

5.5 This latter element accounts for £2.8 billion (or 44%) of the increase in the gap between expenditure and contributions by 2015-16, of which £670 million (or 11%) is in respect of employee contributions (Table 5 below).

¹⁵ Budget 2010: The economy & public finances – supplementary material (Office for Budgetary Responsibility – June 2010) - http://budgetresponsibility.independent.gov.uk/d/junebudget_supplementary_material.pdf

Table 5: Breakdown of pensions receipts

	Ebillions							
	Outturn 2008- 09	Estimate 2009-10	2010- 11	2011- 12	Forecast		2014- 15	2015- 16
					2012- 13	2013- 14		
Gross Expenditure	22.5	24.3	25.4	26.8	28.3	29.9	31.3	32.9
Pensions receipts ¹⁶	19.4	21.2	21.69	21.86	22.04	22.72	23.42	24.15
Cap and Share	-	-	-	-	1.0	1.0	1.0	1.0
<i>Forecast reduction in scheme membership</i>	-	-	0.1%	1.3%	2.9%	6.1%	9.9%	12.2%
<i>Impact of reduction in scheme membership:</i>								
Employer contributions	-	-	0.02	0.21	0.47	1.01	1.69	2.15
Employee contributions	-	-	0.01	0.08	0.14	0.31	0.53	0.67
Net Public Service Pensions funding ¹⁷	3.1	3.1	3.7	5.2	5.9	7.5	9.1	10.6

- 5.6 Employee contributions are set to be enhanced further as a consequence of the “cap and share” arrangements that are already in place in several of the largest public sector pension schemes.
- 5.7 Under these agreements, future cost increases (driven by improving longevity) will be shared between employers and employees in the NHS, Teachers, Local Government and Civil Service schemes and are due to take effect from April 2012. The Office of Budget Responsibility (OBR) has budgeted for a subsequent reduction in state funding for public sector pensions of £1 billion per annum as a greater proportion of the aggregate cost will fall on employees, taking the forecast contribution from employees in the unfunded schemes to an estimated £8.6 billion per annum by 2015-16.
- 5.8 Given the pressures which are driving up the cost of defined benefit pension schemes, maintaining scheme contributions at a level that remains affordable both to the public purse and to the employees presents a significant challenge. The example of the private sector comparator set out earlier is predicated on the level of employer contribution remaining stable whilst employee contributions will rise alongside increased contributions. However we have also found that employee attitudes to pension scheme participation are driven by the costs of membership.

¹⁶ Here pension receipts are shown growing in line with the OBR General Government average earnings growth forecast (OBR - 30 June 2010). The reduction in contributions due to workforce reductions are shown below.

¹⁷ The Net Public Service Pension funding figures vary marginally from the official OBR figures due to modelling differences.

- 5.9 The OBR forecasts place a great deal of emphasis on the employee contribution remaining intact throughout the course of this Parliament to avoid the contributions/expenditure gap widening further and therefore placing greater strain on the public finances. This is also the reason why many commentators have suggested that this contribution should be exploited further by raising employee contributions (above and beyond those assumed under the 'cap and share' arrangements), as this would seem to provide an immediate solution to reducing public expenditure.
- 5.10 Our research shows that increasing the employee contribution rate by 1% across all contributory schemes could raise up to £1.3 billion per annum (based on 2008-09 contributions) to further reduce the funding gap and increases in pension employee contribution rates and retirement ages clearly offer opportunities to make savings during the Spending Review period.
- 5.11 Conversely, it would take less than 15% of current pension members to decide that an extra 1% pension contribution (implemented at the same time as a pay freeze) was unaffordable, to cause total employee contributions yield to fall instead of rise.
- 5.12 If pension scheme membership were to reduce significantly, and beyond that already assumed in the OBR forecasts, the sizeable contribution from employees which at present is supporting the cost of today's public service pension payments could be reduced, while reductions in pension scheme membership could also have longer term adverse consequences for the public finances, as discussed above.
- 5.13 An increase in contribution rates would also not have a direct impact on the public finances where there is a separately funded pension fund, as in the case of the Local Government Pension Scheme (LGPS).
- 5.14 The LGPS is a defined benefit (DB) scheme funded with assets of over £100bn invested widely in global markets and it has a strong positive cashflow projected for the next 20 years. As a funded scheme, it is a significant source of long-term capital for the private sector and also benefits from a third income stream, returns on investment (which in 2008-09 generated £2.9 billion), that help to reduce the cost of employer contributions.
- 5.15 Were the LGPS fully-funded at this point then it would be reasonable to assume that an increase in employee contributions would allow the employer to reduce their contributions accordingly, thus reducing the cost to the taxpayer. However with funding levels estimated to be down on the 84% achieved at the last valuation in 2007¹⁸, (a recent Audit Commission paper¹⁹ has estimated a funding level of 75% as at 31 March 2010), scheme actuaries may be reluctant to recommend reductions in employer contributions.
- 5.16 The spending review period is a relatively short period of time within which to see material financial benefits from effecting change to policies on pensions provision which deal with time spans of up to 80 years. Changes to the benefit accrual rates, such as those set out in the example above when applied to future service, in order to protect accrued rights (in line with the Government's undertaking), are only likely to generate modest savings during the spending review period. Over the longer-term, the savings from such a change could be more significant, as would measures such as increasing the normal pension age in the

¹⁸ See http://www.cipfa.org.uk/panels/pensions/download/2007_LGPS_Valuation_Survey_Results.pdf

¹⁹ Audit Commission - Local Government Pensions in England – an information paper, July 2010

public sector pensions schemes in line with state retirement age (or a measure more aligned to useful service capacity in the uniformed services) since it would mean that that employee and employer contributions were paid for a longer period and also that pensions were in payment for a shorter period than would otherwise be the case.

- 5.17 A good example of the effect such changes could have can be seen from the work done by the Pensions Policy Institute review²⁰ of the last crop of public sector pension scheme changes.
- 5.18 In the Principal Civil Service Pension scheme, increasing the normal pension age from 60 to 65 and moving from final salary to career average have together contributed to reducing the effective employee benefit rate (and thus the cost to the employer) from 28% to 21% of pensionable pay, a 25% reduction. Similarly the changes to the Firefighters Pension Scheme (summarised at Annex A) have reduced the effective employee benefit rate from 35% to 24%.

6 Implementation and transitional arrangements

Closing defined benefit pension schemes in the public sector isn't a 'quick fix' for the current crisis in the public finances. In a defined contribution scheme today's contributions must be invested instead of being used to pay for today's pensions, so costs to the taxpayer will rise before they fall.

- 6.1 The size of the unfunded liabilities in public sector pensions (our estimate based on published accounts puts the figure at £670 billion as at 31 March 2009) has prompted some commentators to recommend an immediate move to end defined benefit arrangements for public sector employees in favour of lower-cost defined contribution schemes, as has happened in large parts of the UK private sector²¹.
- 6.2 Whilst this has the attraction of reducing and capping employer contributions for future pensions provision, it should be borne in mind that such a move would not reduce the liabilities already accumulated, if accrued rights are to be protected. It would also impact adversely on the contribution that today's public sector employees make towards meeting the cost of today's public sector pensioners.
- 6.3 In unfunded "pay-as-you-go" public sector pensions arrangements, the cost of paying the pensions of existing public service pensioners are met by a combination of the contributions made by public sector employers, direct funding from the Treasury and the contributions made by employees.
- 6.4 As noted earlier, employees contributed approximately £6 billion in the 2008-09 financial year toward the cost paying today's pensioners, rising to £8.6 billion by 2015-16. Replacing the existing schemes with defined contribution arrangements would mean that contributions ceased to be available to defray the cost of today's pensions bill, as future contributions by employees would be invested to provide future benefits, rather than used to pay today's pensioners.

²⁰ Pensions Policy Institute – An assessment of the Government's reforms to public sector pensions, 2008

²¹ This is not limited to the UK. In Australia for example, public and private sector employees choose to invest in competing independent pension funds between with the proviso that a certain minimum pension level is provided. Saving is compulsory and there is no opt-out option. Every employer is required to contribute a minimum level though the employer can contribute more to attract staff competitively or where employee and employer can agree to trade current salary for higher pension levels.

- 6.5 To counter this, some have suggested a “notional” defined contribution arrangement, whereby the contributions, rather than being invested, would attract a notional rate of return underwritten by the government. Under this approach the contributions would therefore remain available to be used to meet existing pensions costs.
- 6.6 However this is predicated on the assumption that public sector employees will continue to participate in a scheme (or any form of pension saving) once it has changed to a defined contribution basis. If we look to the reaction of employees in the private sector to the closure of defined benefit schemes (outlined previously in section 1), there is no reason to assume that current high level of pension scheme participation will be maintained. This could again jeopardise the sizeable contribution from employees which at present is supporting meeting the cost of today’s public service pension payments.

7 Potential scheme management efficiency measures

A small but not insignificant element of the cost of public sector pensions is the cost associated with scheme administration.

- 7.1 In the public sector the approach to administration varies from scheme to scheme but generally falls into two categories: centralised (such as the NHS and Teachers) and decentralised (local government and Civil Service). This creates significant differences in the costs of administration as shown in Table 6.

Table 6: Comparative scheme administration costs

Scheme type	Cost per member	Notes
Private sector large scheme (10,000+):		
In-house administration	£47	Based on Capita Hartshead Scheme Administration Survey 2010
Out-sourced administration	£41	Based on Capita Hartshead Scheme Administration Survey 2010
Local Government Scheme (average)	£29	Based on Communities and Local Government data for 2008-09 and excludes investment management fees
Teachers Pension Scheme	£7	Based on DCSF/Teachers Pension Scheme data 2008-09

- 7.2 Centralisation, through amalgamation or shared services, therefore offers the potential for significant economies of scale and subsequent lower costs.
- 7.3 In some parts of the UK, such opportunities are already being investigated, seeking to realise the savings that can be made from exploiting economies of scale. The Pathfinder project in Scotland is one such initiative, where LGPS administering authorities are looking at ways of streamlining administration across the 10 pension funds in an effort to reduce costs.

- 7.4 The costs of investment management in the LGPS are the subject of particular focus. In 2008 – 2009, these fees amounted to £245 million, which is in addition to the £114 million in administrative costs used as the basis for calculating the cost per member figure given in Table 6.
- 7.5 Concerns have been expressed that merging local authority funds would weaken local democratic accountability. However there remains scope to extend these initiatives further in England and Wales in such a way that does not compromise the principle of local democracy, particularly when it comes to setting investment strategy and investment policies. One approach would be to centralise the procurement of investment managers for a range of pension funds according to the requirements of their particular investment allocations, thereby increasing the size of portfolios under management and thus reducing cost, perhaps through the use of national framework agreements.

Annex A

Uniformed services pension schemes – pre and post scheme changes

	Armed Forces (pre April 2005)	Police (pre April 2006)	Fire (pre April 2006)
Normal Pension Age	55	50 (with 25 years service); under 50 with 30 years service	55 (from 50 after 25 years' service)
Scheme design	Final salary	Final salary	Final salary
Accrual rate	69ths	60ths (30ths after 20 years service)	60ths (30ths after 20 years service)
Lump sum	3 times pension	Commutation option	Commutation option
Current Employee Contribution rate	Non-contributory	11%	11%
Current Employer Contribution rate	35.3% (officers) 19.4% (ORs)	24.2%	21.3%
Survivors pension	62.5% of member's pension	50% of members pension	50% of members pension

	Armed Forces (post April 2005)	Police (new scheme post April 2006)	Fire (new scheme post April 2006)
Normal Pension Age	55	55	60
Scheme design	Final salary	Final salary	Final salary
Accrual rate	70ths	70ths	60ths
Lump sum	3 times pension	4 times pension	Commutation option
Employee Contribution rate	Non-contributory	9.5%	8.5%
Employer Contribution rate	35.3% (officers) 19.4% (ORs)	24.2%	11%
Survivors pension	62.5% of member's pension	50% of members pension	50% of members pension

Unfunded Public sector pensions – taxpayer and non-taxpayer funding 2008-09

Scheme	Total Expenditure (£ billions) 2008-09	Income - net direct contribution to public service pensions (£billions) 2008-09	Income - employer contributions (£ billions) 2008-09	Total taxpayer funding (£ billions) 2008-09	Non-governmental income (£ billions) 2008-09
Armed Forces Pension Scheme	3.410	1.900	1.510	3.410	0.000
Principal Civil Service Pension Scheme (PCSPS)	4.070	0.910	2.800	3.710	0.360
NHS Pension Scheme (England and Wales)	5.450	-2.110	5.010	2.900	2.550
Teachers Pension Scheme (England and Wales)	6.360	1.740	3.150	4.890	1.470
Police Pensions	2.342	0.616	1.165	1.781	0.561
Fire Pension Scheme	1.264	0.000	0.947	0.947	0.317
NHS Pension Scheme (Scotland)	0.643	-0.241	0.561	0.319	0.324
Teachers Pension Scheme (Scotland)	0.702	0.085	0.322	0.407	0.295
NHS Pension Scheme (Northern Ireland)	0.232	-0.104	0.235	0.131	0.102
Teachers Pension Scheme (Northern Ireland)	0.285	0.100	0.126	0.226	0.059
PCSPS (Northern Ireland)	0.203	0.048	0.137	0.185	0.018
UK Atomic Energy Authority Pension Scheme	0.197	0.117	0.053	0.170	0.027
Police Service of Northern Ireland	0.175	0.063	0.083	0.145	0.030
Research Councils Pension Scheme	0.143	0.079	0.055	0.135	0.009
Judicial Pension Scheme	0.073	-0.013	0.081	0.069	0.005
DFID Overseas Superannuation Scheme	0.107	0.107	0.000	0.107	0.000
Total	25.657	3.297	16.235	19.532	6.125

Source: CIPFA, 2010. Note: Numbers may vary slightly from official reports due to the inclusion of some schemes not included in the OBR analysis, particularly Police and Fire.