

The Future of Public Sector Pension Schemes

The NAPF Submission to the Independent Public Service Pensions Commission
July 2010

Executive Summary

Analysis

- I. The UK is suffering from a crisis in retirement saving, with over half of all pensioners predicted to be reliant on means-tested state benefits by 2050. Reducing public sector pensions could make this crisis worse, increasing pensioner poverty levels and pushing up the costs of state benefits.
- II. The Local Government Pension Scheme (LGPS) is different from the other main schemes as it is funded, with £122 billion of assets at the last valuation. This funding has important benefits, and the LGPS needs to be treated differently to other schemes.
- III. Previous reforms of the main public sector schemes have helped contain costs, but further reform is inevitable. We need an evidence-based assessment of the schemes and of the issues that have been raised about affordability and comparisons with the private sector.
- IV. Snapshot figures of liability are not helpful in measuring affordability. It is more useful to look at long term projections of expenditure on public sector pensions, which actually show costs remaining constant at around 2% of GDP for the next 50 years.
- V. Steps need to be taken to reduce the gap between public and private sector pensions. The primary means of doing this should be increasing the quality of pensions available in the private sector, rather than 'dumbing down' public sector pensions.

Principles for long term reform

- VI. The NAPF has set out seven principles to guide long term reform of public sector pensions, which should be adopted by the Commission. These principles are:
 - Fit for purpose
 - Adequacy
 - Affordability
 - Transparency
 - Shared responsibility and risk
 - Quality and efficiency
 - Mobility

- VII. As a first step, the Commission needs to develop a consensus on how to measure public sector pension liabilities so that all sides can agree what the scale of the problem is and have a meaningful debate on the solutions.
- VIII. Public sector pensions should continue to provide an adequate standard of living in retirement. Current pensions are modest, with the average LGPS pension only £3,000 a year and the Civil Service pension only £5,500 a year.
- IX. There are many options for public sector pension schemes to better share the risks of pension saving between the employer and employee. Moving all the risk onto the employee and shifting to pure DC is not necessary or desirable.

Options for quick reforms

- X. The Commission should be very cautious about increasing employee contributions, as they could cause employees to leave the scheme, reducing savings levels, and removing any financial benefit to the Government. Low-paid workers would be hardest hit and should be excluded from any increase.
- XI. Although politically attractive, capping pensions for high earners would achieve little, but would increase complexity and potentially reduce income coming into the schemes. The alternative would be to a cap pensionable pay in the future, which the Commission should assess as part of its longer term work.
- XII. There is a case for increasing normal pension ages in line with the State Pension age. But it would be preferable to do this at the same time as wider changes to scheme design, rather than as a separate first step.

Introduction

1. The NAPF is the voice of workplace pensions, both in the private and public sector. We represent 1,200 pension schemes, with some 15 million members and assets of £800 billion. A range of large and small public sector pension funds are NAPF members, including 75 of the 99 funds that make up the Local Government Pension Scheme (LGPS). This mixed membership gives us a unique insight into the public sector pensions debate.
2. The NAPF believes that all workers deserve access to good workplace pension provision, regardless of where they work. We recently set out our blueprint for revitalising workplace pensions in *Fit for the Future – The NAPF's vision for pensions*.
3. This paper responds to the Commission's call for evidence ahead of its interim report due in September 2010. In this paper we have analysed some of the

reasons why public sector pensions are under scrutiny, looked at the principles for reform, and as requested by the John Hutton's letter, considered some of the options for short term savings ahead of the Government's spending review.

The response has five sections:

- Background to the debate
- The current shape of public sector pensions
- The case for public sector pensions reform
- Principles for long term reform
- Options for quick reforms

Background to the debate

4. Public sector pensions are high on the political and media agendas, especially considering the current Government's focus on reducing the UK's structural deficit. Until now, the tone of the debate has been unhelpful. The focus on deficits has been distracting, and has provided little insight into the true nature of the situation. This is why earlier this year the NAPF called for the creation of an Independent Public Sector Pensions Commission. We are pleased to be submitting our comments to this Independent Commission, and to be contributing to what we hope will be a more constructive debate.
5. The challenges facing public sector pensions in the UK are fundamentally the same as those that all private and public pensions in the developed world have been grappling with over the last decade.
 - Increasing longevity is making pensions more and more expensive to provide.
 - Investment returns over the last decade have not met previous expectations, making all funded pension schemes (whether public or private) more expensive.
 - Accounting standards have made all pensions appear more expensive, particularly when gilt yields are low.
 - Employers are facing increased scrutiny of their pension liabilities, either from shareholders in the private sector, or increased political and media scrutiny in the public sector.
 - More recently, the recession has made it harder for employers to be able to afford pension contributions.
6. However, the UK is also suffering from a severe shortage of pension saving, with millions of workers not saving enough for an adequate retirement, and facing poverty in old age. Currently 58% of pensioners need some form of means-tested benefit in retirement, and without reform this is predicted to increase further. The problem of under saving is so severe that the previous Government set up the Turner Commission, which resulted in improvements to the State

Pension and the planned introduction of auto-enrolment into workplace pensions by 2012. These reforms will stop the situation worsening but still leave 53% of pensioners reliant on means-tested benefits by 2050¹.

7. Public sector workers are one of the few groups making any proper retirement savings. Currently, only 45% of workers are saving into a workplace pension scheme, and almost half of these savers are using public sector schemes. So significant reductions in public sector pensions risk making this savings crisis worse, resulting in higher levels of pensioner poverty and higher costs from means-tested benefits and care services.

The current shape of public sector pensions

8. Public sector pensions are often discussed as if they are one homogenous group. In fact, there is a wide variety of different schemes with different rules, benefit structures and costs. The four largest schemes are the Local Government Pension Scheme (LGPS), the NHS Pension Scheme, the Teachers' Pension Scheme and the Civil Service Pension Scheme.

Funded and unfunded

9. Of these schemes, the LGPS is by far the largest with 1.7 million active members in 2009 and 1.1 million deferred members². It is also the only funded public sector pension scheme. It has a positive cash flow with £10.8 billion of income coming from employees, employers and investment returns in 2008/2009. At the last valuation (2007) it was 82% funded, with £122 billion in assets and £149 billion in liabilities. Although the results of the 2010 valuation will probably show that the funding levels in the LGPS have dropped, the scheme will still have a positive cash flow and would, if required, be able to pay out its pensions for many years to come.

10. As a funded scheme the LGPS has a number of advantages over unfunded public sector schemes:

- The scheme's £112 billion of investments is a major benefit to the UK and world economy, with billions invested in UK companies, property, infrastructure and in the UK Government.
- Funded schemes are able to smooth the costs of the scheme over many decades, increasing employer contributions gradually when necessary, whereas unfunded schemes are less flexible. As the Office for Budget Responsibility (OBR) states in its pre-budget forecast: 'the lack of a fund to back liabilities imparts a level of fiscal inflexibility

¹ *Fit for the Future: NAPF's vision for pensions*, 2010, p8.

² Statistical Release: Local Government Pension Scheme Fundss England 2008-09, Communities and Local Government, October 2009.

regarding future shocks to revenue³. For example, a negative GDP growth shock could mean that the cost of paying current pension obligations displaces other expenditure and thereby causes distortions'.

- Funded schemes have to be transparent about their costs, with independent actuarial evaluation and scrutiny through governance committees, whereas unfunded schemes are usually much less transparent.
11. It would be almost impossible to switch large schemes from being unfunded to funded (as it would double costs by paying for today's and tomorrow's pensions at the same time), or from funded to unfunded (as it would mean disinvesting billions from the UK economy). So this key difference will remain, and the reforms proposed by the Commission will need to treat the LGPS differently.

Recent reforms

12. All the main schemes have undergone reforms in recent years to try to curb the costs of the pensions, modernise their benefits and reduce risk for the taxpayer. The main change was to increase the normal retirement age for new members of the NHS, Teachers and Civil Service Schemes from 60 to 65 (the LGPS has always had a normal pension age of 65). However, existing members are continuing to accrue a pension with a normal retirement age of 60. So, unless changes are made, a 30-year old teacher who joined the scheme before 2007 will be able to get her Teachers Pension aged 60 in 2040, but will only be able to get her State Pension in 2048 aged 68.
13. The other key change was to increase formal risk-sharing arrangements in the main schemes. These mean that some of the risks of costs increasing unexpectedly are shared between employers and members – rather than resting solely with employers. For instance, it means that employee contributions will rise if longevity predictions improve further. However, these arrangements do not cover all the risks faced, and so employer contributions could still be increased by unexpected extra costs.
14. The Pensions Policy Institute (PPI) analysis⁴ of these reforms found that they did reduce the costs of these schemes:
- The value of a local government pension remained at 20% of salary after the reform of the scheme.
 - The NHS pension was worth around 22% of salary before the 2008 reforms, and for new members this has now been trimmed to around 19% of salary.

³ Pre-Budget Forecast, Office for Budget Responsibility, June 2010, p61.

⁴ *An assessment of the Government's reforms to public sector pensions*, PPI, October 2008

- The 2007 reform of the teachers' scheme reduced the average value of a pension from 22% to 19% of salary for new members.
- For a new joiner the Civil Service pension is now worth 21% of salary – compared to 28% of salary before 2007.

The case for further public sector pensions reform

15. The NAPF has long recognised that further reform to public sector pension schemes is inevitable. All pension schemes need to adapt to meet the challenges set out earlier, such as increasing longevity. However, much of the debate about public sector pensions has been unhelpful, with commentators competing to find the most sensational snapshot figures for pension liabilities, rather than looking at the long term costs and benefits of pension provision. Reforms should be evidence-based and address the real challenges facing UK pensions, and we hope this is the approach the Commission will take.
16. Calls for reform have focused on two key issues – the affordability of public sector pensions, and their fairness in comparison to private sector pensions. These issues are analysed below.

Affordability

17. The argument that public sector pension schemes are unaffordable hinges upon the figures used to measure the liabilities faced by the taxpayer. However, there are disagreements on how to measure this. Looking only at the unfunded schemes, the Government Actuaries Department has estimated that the total liability is £770 billion (at 31 March 2008); whilst other organisations have said it is over £1 trillion (£1,000 billion). The main reason for the difference between these figures is the discount rates used, and particularly the choice of gilt or bond rate used to calculate it.
18. However, none of these figures are particularly helpful as they are snapshot figures, whilst pension liabilities stretch over many decades and are not realised all at once. The NAPF does not believe measuring pension liabilities in this way is helpful in the private sector or the public sector, where we can be sure that the employer can stand behind long-term commitments.
19. The NAPF believes it is more useful to look at the projected expenditure as a proportion of GDP. The Office of Budget Responsibility (OBR) in its June 2010 Pre-Budget Forecast recognised that current projections show the costs of public sector pensions remaining static at around 2% of GDP for the next 50 years⁵. Given the large increases in the number of pensioners projected over the next 50

⁵ Pre-Budget Forecast, Office for Budget Responsibility, June 2010, p61.

years, this figure seems to show that public sector pension costs have been successfully constrained in the long term.

20. However, despite these projections showing costs remaining roughly constant, some genuine concerns about affordability remain. The areas of principal concern are the transparency, risk and short term affordability:

- Transparency: Without independent and robust governance for the unfunded pension schemes, there will always be questions about whether scheme liabilities are being properly measured.
- Risk: Even if the liabilities are being independently measured, there is always a risk with defined benefit pensions that projections turn out to be incorrect and that liabilities become much higher than expected. This is the experience of many private sector employers, who have sought to reduce risk as a result.
- Short term affordability: As the OBR notes in its report, with unfunded schemes there can still be a short term issue of affordability when there is a 'GDP shock' – as with the current crisis in public finances.

21. This suggest that the reforms should be focused on measures to improve transparency and governance of the unfunded schemes, reduce the risk of long term liabilities increasing unexpectedly, and make the schemes flexible enough to deal with short-term affordability problems.

Comparisons with the private sector

22. Commentators argue that public sector pensions are unfairly out of step with private sector pensions. Pensions have always been relatively generous in the public sector, often because it is easier for the public sector to provide pensions. For instance, the public sector has economies of scale and is better able to guarantee the risks of DB provision. According to the Institute for Fiscal Studies (IFS), different work patterns between the public and private sector also play an important part in the higher value of public sector pensions⁶.

23. For many decades this disparity was accepted. However, in recent years the balance between the public and private sector pensions has been upset by the rapid decline in Defined Benefit provision in the private sector. In 1999 86% of DB schemes (who were members of the NAPF) were open to new members. By 2009 this figure had fallen to just 23%. Figures from the Office of National Statistics (ONS) show that during that period the numbers of active members of DB schemes has roughly halved from around 5 million to 2.6 million⁷. The DC schemes that have replaced DB schemes generally have lower contributions and are less

⁶ *The Pension Advantage of Public Sector Workers*, IFS, December 2009.

⁷ Occupational Pension Scheme Annual Report 2009, ONS, October 2009

generous. Despite the efforts to reform public sector schemes, this decline in private sector pensions has left pensions in the public sector final salary schemes looking out of step with those available elsewhere.

24. It is difficult to make the case for taxpayers to fund public sector pensions that are much more generous than those available in the private sector, and clearly steps need to be taken to reduce the gap. However, we do not believe that the public sector should get into a Dutch auction with the private sector, competing to provide the least generous pensions. What most people want to see is good workplace pensions available to all employees. The primary means of doing this should be increasing the quality of pensions available in the private sector, rather than reducing the quality of pensions in the public sector. The NAPF has set out action that can be taken to boost workplace pensions in the private sector in *Fit for the Future: NAPF's vision for pensions*.

Principles for long term reform

25. The issues of affordability and fairness in public sector pensions are important, but they are not the only issues to consider. Earlier this year, the NAPF set out the seven principles which we feel should guide reform of public sector pensions (see box on next page). These have been well received, and closely resemble many of the points in the Commission's Terms of Reference. In its interim report the Commission needs to set out the key principles that will guide its plans for reforms and we believe these seven principles should be adopted by the Commission.

Fit For Purpose:

26. Public sector pensions should play an integral part of pay and reward and support the recruitment and retention of staff needed to deliver vital public services. Workplace pensions in both the private and public sectors should be viewed as a valuable part of the employment package. This means that public sector managers need a strong role in designing pension benefits that will help them attract and retain the workforce they need to deliver public services.

Adequacy:

27. Public sector pensions should not be 'dumbed down' but must continue to provide adequate standards of living in retirement. The average pension in payment from the LGPS is currently only £3,000 a year⁸, and in the Civil Service Pension Scheme the average is £5,500 a year⁹. Many public sector workers are low paid, and there are more women and part-time workers. Reducing pensions

⁸ Local Government Pensions in England, Audit Commission, July 2010.

⁹ *Public Sector Pensions*, GMB, January 2010.

for low to moderately paid workers in the public sector would only increase the numbers of people heading for poverty in retirement and would increase the amount of people who will be dependent on means tested benefits in the future.

28. The main problem with the current UK pension system is the lack of pension saving, not too much pension saving. The NAPF strongly believes that reform of public sector pensions must be set in the context of wider Government objectives to encourage saving levels, cut pensioner poverty, and to provide security and dignity in retirement.

The NAPF's seven principles for public sector pension reform

1. **Fit for purpose:** public sector pensions should be an integral part of pay and reward and support the recruitment and retention of staff needed to deliver vital public services.
2. **Adequacy:** public sector pensions should not be 'dumbed down' but must continue to provide a good standard of living in retirement.
3. **Affordability:** public sector pensions must be affordable in the long term. The schemes should be designed to meet changing circumstances and ensure intergenerational equity.
4. **Transparency:** the costs of public sector pensions must be clear and transparent.
5. **Shared responsibility and risk:** the employer and employee should share the burden of contributions and the risks of costs increasing.
6. **Quality and efficiency:** public sector schemes should demonstrate efficient and high-quality administration and governance.
7. **Mobility:** public sector pensions should not put up barriers between the public and private sector workforces, which might make the UK workforce and economy less flexible.

Affordability

29. Public sector pensions must be affordable in the long term. The schemes should be designed to meet changing circumstances and ensure intergenerational equity. As discussed earlier, the key issues appear to be reducing the risk that liabilities and costs are higher than expected, and managing the short term costs

during the current public sector spending squeeze. The issue of short term savings will be looked at in the following chapter.

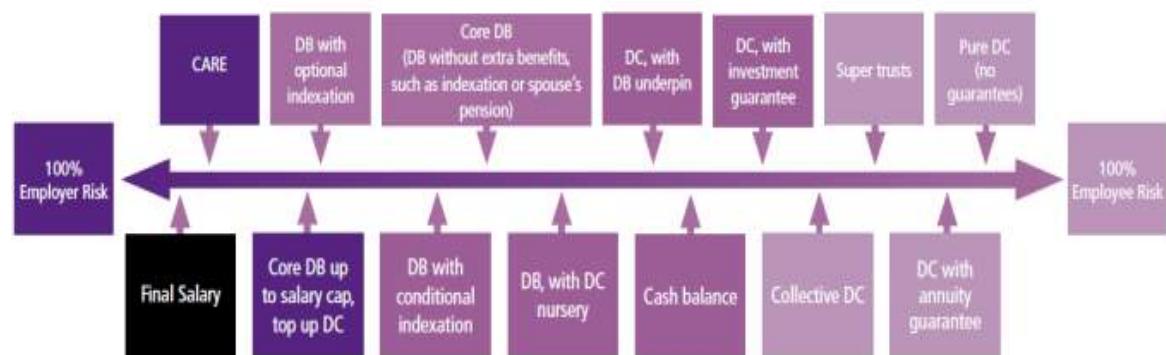
Transparency

30. The cost of public sector pensions must be clear and transparent. As a first step the Commission needs to develop a consensus on how to measure public sector pension liabilities so that all sides can agree what the scale of the problem is and have a meaningful debate on the solutions. The current debate on public sector pensions is highly polarised, and a lack of an agreed measure has prevented a constructive debate on public sector pensions emerging. The interim report of Turner Commission report on pension saving was successful in setting out the evidence and shaping the debate and played a crucial role in developing a consensus on pension reform. The Public Sector Commission should model its interim paper on this.

Shared responsibility and risk

31. The previous public sector pension reforms have already introduced some aspects of cost sharing, but more could be done to share the risks and responsibilities of pensions, to further protect the taxpayer. The main risk associated with public sector pension schemes is longevity, but other variables such as inflation and salary escalation also have a big impact.

32. The diagram below sets out a spectrum of risk-sharing options. In the UK we tend to have a quite polarised pension landscape with most schemes either final salary with 100% employer risk, or pure Defined Contribution, with 100% employee risk. However, there is a whole range of possible scheme design that could share the burden of risks between the risks of costs increasing in the future between the employer and employee. There is clearly no need for public sector schemes to dramatically move towards DC, when there are so many options in-between.



Quality and efficiency

33. The public sector schemes should demonstrate efficient and high quality administration and governance. As large schemes they should try to set standards for good governance and administration. The more complex the design of the pension scheme the harder it is administer and so there is a need to find the right balance between adding in elements of choice, flexibility or risk-sharing and maintaining simplicity. One key way to ensure simplicity (and fairness) is to ensure reforms apply to all members (existing and new) so that different classes of scheme membership are not created.
34. It has been suggested that public sector pensions could be made more sustainable by consolidating and reducing the costs of the administration. In particular, it has been suggested that LGPS funds could be merged to reduce costs and improve investment returns. Options for making the LGPS and other schemes more efficient and effective should be explored further. However, in its very recent report on the LGPS, the Audit Commission found limited evidence that larger funds were better than smaller funds. Administrative costs in the public sector schemes are not high, and the NAPF is not convinced the affordability of the schemes could be affected by changes to the structure or administration.

Mobility:

35. Public sector pensions should not put up barriers between public and private sector workforces, which might make the UK workforce and economy less flexible. Pension differences should not stop workers from moving easily between public and private sector jobs. Reducing the gap between private and public sector pensions would help reduce this risk, but new flexibilities might also be needed for public sector schemes. The Commission should research this issue further. Workforce flexibility might also be improved by public sector schemes converging around similar designs.

Options for quick reforms

36. The Terms of Reference makes it clear that the Commission needs to find short term savings in its interim report ahead of the Government's spending review. As accrued rights are protected and most pension costs and liabilities are very long term, public sector pensions are unlikely to be a rich source of short term savings for the Government. Whilst we recognise that all forms of expenditure must be under scrutiny because of the current budget deficit, forcing short term savings from pensions could be very damaging.
37. In unfunded schemes, such as the NHS and Teachers schemes, the scope for immediate savings is very limited because the immediate costs largely reflect

accrued rights and are unaffected by changing the long term liabilities. In a funded scheme such as the LGPS, changes that reduce long-term liabilities can also reduce shorter term costs. For instance, it is estimated that the move from indexing the LGPS to CPI rather than RPI has reduced liabilities by around 10%, which will lead to lower employer contributions in the short and long term than would otherwise be necessary. In most parts of the UK the LGPS valuation is currently taking place – so any changes can quickly be realised. However, workers in all schemes should be treated fairly and equitably, regardless of whether their scheme is funded or unfunded.

38. This section considers the merits of three potential quick reforms:

- Increasing employee contributions
- Limiting pensions for high earners
- Increasing the normal pension age

Employee contributions

39. The most obvious measure is an immediate increase in employee contributions, which could bring in money from the public sector schemes approximately 5 million active members. However, there is a real risk that increasing employee contributions could encourage employees to leave the scheme, which would have the opposite effect of reducing short term income. This is especially the case during a public sector pay freeze, when any contribution increase will cut pay. The Chartered Institute of Public Finance & Accountancy (CIPFA) has estimated¹⁰ that the revenue increase from a 1% increase in employee contributions would be wiped out by a fall in scheme membership of 15%. The Republic of Ireland introduced a public sector pensions levy in 2009, but as membership of a pension is compulsory, the levy was compulsory across the workforce, and so there are limited parallels to the UK.

40. Low paid public sector workers would be hardest hit by any increase in employee contributions, and would be most likely to leave the scheme as a result. Therefore, workers on lower incomes should be excluded from any increase. The LGPS and the NHS Scheme already have graduated employee contributions depending on salary level. Another option might be to allow scheme members to choose not to increase contributions, and to accrue benefits at a lower level instead, so that those who feel they can't afford an increase don't leave the scheme completely. However, this would create a two tier system that would be administratively complex and potentially confusing for the employee.

41. Overall, the NAPF is concerned that any hike in employee contributions during a period of pay freeze risks decreasing savings levels and disengaging workers from

¹⁰ The Public Sector Pensions Commission – CIPFA response to the Call for Evidence, CIPFA, July 2010.

pensions. We would, therefore, urge the Commission to be very cautious about increasing employee contributions.

Limiting pensions for high earners

42. It has been suggested that another quick fix might be to limit the pensions of high earners in the public sector, such as through a cap on pension benefits of around £50,000. Whilst this would be politically attractive, it would achieve very little as there are so few pensions of this size. A cap on benefits would be difficult to administer, could affect accrued rights, and would probably cause high earners to leave the scheme altogether, which would have the immediate effect of reducing contributions going into the schemes. The NAPF does not believe such a cap would be practical or beneficial.
43. A cap on pensionable pay would be a fairer and more practical alternative, as it would be easier to implement going forward and would not force higher earners to leave the scheme entirely, and so keep them contributing. However, it would still not have a large affect on the long term liabilities (presuming it was limited to the high paid) and would have the immediate effect of reducing contributions from those who earn over the cap. This is an option that could be considered for the long term as part of a package of reforms, but makes little sense as a short term fix. The Commission would need to assess whether the best option is to cut out high earners or just increase their contributions through graduated employee contributions.

Increasing pension age

44. As the Government has moved quickly to speed up the increase in State Pension age, it has been suggested that there could also be a quick move to increase normal pension ages in the public sector schemes. Obviously, there is a case for increasing normal pension ages in line with the State Pension age. However, it would not be possible for public sector schemes to treat men and women differently and women's State Pension age is unlikely to reach 66 before 2022. Also, the change could not affect accrued rights, so would have limited affect on someone approaching retirement, who has already accrued most of their pension at the old pension age. Therefore, an increase in pension age would have very little short term impact on the cost of unfunded schemes, but could reduce the costs of the LGPS in the short term.
45. However, fiddling with the pension age ahead of a more fundamental reform of scheme benefits risks complicating the administration with different rules applying to different short periods of accrual. Therefore it makes sense for the Commission to look at pension ages at the same time as longer term scheme reform in the final rather than interim report. Longer lead-in times also make it easier for employees to plan their retirement.

Conclusion

46. The Commission gives us the opportunity to have a constructive debate about the future of public sector pension schemes. The UK is suffering from a crisis in retirement saving and the NAPF believes that all workers should have access to decent workplace pensions. Clearly some reform of public sectors schemes is necessary to respond to the challenges that face all pensions, such as increasing longevity and affordability. However, we must resist the temptation to dumb down public sector pensions to a level where they no longer provide an adequate level, or push low-paid public sector workers out of savings with damaging short term changes to the schemes.

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