NAPF Response
HM Treasury Consultation on the discount rate
used to set unfunded public service pension contributions

1 About the NAPF

The National Association of Pension Funds (NAPF) is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector. We are grateful for the opportunity to respond to HM Treasury's consultation.

2 Summary

The focus of our response is on the four options set out in Chapter 3 of the consultation paper. We do not attempt to answer the individual questions posed in the consultation paper. Instead we set out general principles for assessing the four options. We conclude that the use of a discount rate based on the yield on index-linked gilts would be incorrect as it would lead to an excessively volatile contribution rate. This does not reflect the economic reality of the public sector's pensions liability, which – like that for the private sector – changes only slowly over time in line with scheme demographics. Nor would it be seen as in any way credible by contributors, thus undermining the Government's intention that contribution rates should provide an indication of the value of the public service pensions to its employees. The contribution rate should be stable (implying a stable discount rate) but the discount rate should be reviewed (say, every five years) to ensure that it continues to be realistic.

3 NAPF response

3.1 *General principles*

There is no discount rate that will provide an incontrovertible measure of the value of future pension benefits. Instead the Government should adopt a pragmatic approach to measuring future pensions that reflects both the value of the benefit and the cost of providing it. Value to the recipient is a difficult concept, but it is clearly linked to the cost of providing it; unless properly costed, benefits – of all kinds – tend to be either over- or undervalued both by those providing them and by those receiving them. Decisions about public service pensions need to be based on a realistic assessment of their cost, especially as unfunded public sector pensions represent a claim on future tax revenues. To be credible, contributions need to be relatively stable from one year to the next. This also reflects the economic reality of an obligation that changes only gradually over time in line with the scheme's demographics.

Finally there needs to be some consistency in the valuation of public and private sector pensions obligations for the proper functioning of the labour market.

3.2 ***The four options***

3.2.1 The consultation paper proposes four options:

- a discount rate consistent with private sector and other funded schemes [Option (a)];
- a discount rate based on the yield on index-linked gilts [Option (b)];
- a discount rate in line with expected GDP growth [Option (c)]; and
- a Social Time Preference Rate [Option (d)].

3.2.2 The use of a discount rate based on the yield on index-linked gilts [Option (b)] would be incorrect as it would lead to an excessively volatile contribution rate, depending upon the stance of monetary policy. This does not reflect the economic reality of the public sector's pensions liability, which – like that for the private sector – changes only slowly over time in line with scheme demographics. Nor would it be seen as credible by contributors, thus undermining the Government's intention that contribution rates should provide an indication of the value of the public service pensions to its employees.

3.2.3 We recognise the arguments in favour of Option (c) and Option (d). The former (a discount rate in line with expected GDP growth) provides a measure of the cost of unfunded public service pensions, the latter (a Social Time Preference Rate) a measure of its value. Calculation of the latter appears somewhat arbitrary and would give a result that we feel is too high compared with discount rates used in private and other funded schemes.

3.3 ***A stable discount rate subject to periodic review***

The credibility of the contribution rate – and its acceptability – to contributors depends on it not changing greatly from one year to the next. This also reflects the economic reality of an obligation that changes only slowly over time in line with scheme demographics. The discount rate should therefore be kept stable but be reviewed from time to time (possibly every five years) to ensure that it continues to be realistic.