Affordability of public sector pensions

Submission by Prospect to the Public Accounts Committee call for evidence.

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Introduction

1. Prospect is an independent trade union representing over 150,000 professional, managerial, technical and scientific staff across the private and public sectors.

2. Tens of thousands of Prospect members are members of a public sector pension scheme.

3. This submission reflects the strong views of Prospect members that they have accepted detrimental changes to their pension over the past 15 years to ensure that the schemes were sustainable for the long term. Members believe that there should now be a period of stability and that the government must stand by its commitment to not make any further changes to public sector pensions for 25 years.

4. This submission is intended to be a constructive attempt to deal with the issues being raised. As always, Prospect officials are available to discuss our response in more detail.

Background

5. The main public service pension schemes were reformed in 2015, to ensure greater fairness between lower and higher earners, future sustainability, and affordability.

6. The then Chief Secretary to the Treasury Danny Alexander said "Yes, we are asking public service workers to contribute more. Yes, we are asking them to work longer, along with the rest of society, but we are offering the chance of a significantly better pension at the end of it for many low and middle income earners. It will be a fairer pension, so that low income workers stop subsidising pensions for the highest earners. It will be a sustainable deal that will endure for at least 25 years, and an affordable deal that will ensure that taxpayers are asked to make a sensible contribution, but will keep costs sustainable and under proper control."[1]

7. In the HM Treasury paper Public Service Pensions: good pensions that last, the government outlined its proposals for reformed public sector pension schemes and stated that this solution would "last a generation" and that these reforms offered "certainty and fairness to both the public service workers and other taxpayers."[2]

8. HM Treasury in their consultation response for remedying age discrimination in public sector pensions reaffirmed this position by saying: "It is a long-standing practice that the overall reward package for public servants includes a generous pensions element. The main public service pension schemes were reformed in 2015, to ensure greater fairness between lower and higher earners, future sustainability and affordability." It goes on to say "The government remains committed to providing generous pension arrangements for public service workers. This provision must be sustainable and affordable. The 2015 schemes that were introduced following the recommendations of the Independent Public Service Pensions Commission (the reformed schemes) offer generous pension provision, improve affordability and sustainability, and are fairer to lower and middle earners" and, "The government remains of the view that these schemes – of which most public servants are already members – offer generous pension provision and address the objectives of affordability and sustainability."[3]

[1] Public Sector Pensions, Hansard, 2 November 2011
[2] HM Treasury - Public Service Pensions: good pensions that last, November 2011
[3] HM Treasury - Public service pension schemes: changes to the transitional arrangements to the 2015 schemes. Government response to consultation, February 2021

9. The reforms that were introduced in 2015 were designed and implemented for the long term. Members have repeatedly been told that the increased contributions which they needed to pay and the significant reforms to their pension benefits, were necessary to make the pension schemes sustainable for the long term. The reforms were a result of intense negotiations between the government and trade unions and the end result was a set of proposals that Union members could accept and that the Government were satisfied with as they achieved their goal of making public sector pensions more affordable and sustainable for the long term.

10. Prospect members in the civil service voted by 4-1 to accept the deal negotiated between unions and the government on the shape of their pension scheme from 2015 and as the quote from HM Treasury demonstrates, the government believe the public sector pension schemes are affordable and sustainable.

Measuring the cost of public sector pensions

11. There are different ways of measuring the cost of public sector pensions. The Independent Public Service Pensions Commission's preferred measure was the level of benefit payments as a percentage of GDP as this can "give a good sense of the share of national income that has to be devoted to public service pensions expenditure." We support this measure as the only proper method of judging the cost as this is essentially a cash measure.

12. Figures for measuring the cost that involve discounting are inappropriate for a public sector pension schemes that are unfunded.

13. When using discounting, liability calculations fluctuate significantly because of changes in one assumption, the discount rate, which is used in valuations for funded pension schemes that rely on investment returns to pay out future benefits. Unfunded pensions schemes are different and there is no reason why they should be considered as a notionally funded scheme or affordability assessed as if they are funded.

14. In the last year, there have been significant fluctuations in financial markets which have impacted the value of an individual's defined contribution (DC) pension pot and put increasing pressure on private sector defined benefit (DB) schemes and their funding levels. For defined benefit schemes, part of the issue arises from a reduction in investment returns as these are relied upon to pay benefits.

15. The other problem is employer covenant which plays a large role in scheme funding as it permits or restricts the amount of risk that a scheme can take with investments and the length of the time horizon over which funding the scheme can be viewed. A poor employer covenant ordinarily leads to a lower discount rate as less risk can be taken which leads to higher contribution rates being required. For private sector DB schemes, employer covenant is a key consideration as there is a real risk of employer insolvency and so in order to protect members benefits and prevent schemes from entering the pension protection fund, there has been a focus from the Pensions Regulator for schemes to take less risk and for more money to be paid into pension schemes to increase funding.

16. The issue of employer covenant simply does not apply to the unfunded public sector pension schemes as there is no risk of employer insolvency and similarly, the concerns that private sector DB schemes have regarding investment returns do not apply. Unfunded public sector schemes have not been hit by recent market turbulence which allows the government to take a long-term view when considering the funding of public sector pensions.

17. The result of this is that the government is better positioned than private sector companies to offer good secure pensions. This is partly because the state provides the

strongest of covenant at no cost whereas employers in the private sector employer naturally have a weaker covenant. It is therefore less expensive for the government to provide good DB pensions than it is for a private sector employer.

18. Unfunded public sector pension schemes should not therefore be treated as though a physical fund exits which is invested and upon which members rely on for the payment of their pension. A significant amount of the criticism of unfunded public sector pension schemes and questions on its affordability arise from a lack of understanding on this point.

19. Measuring the cost as a proportion of GDP provides a solid impression of the share of national income that must be devoted to public service pensions expenditure.

20. HM Treasury agree with this method and assesses the affordability and sustainability of public service pensions using projected pension scheme expenditure over the next 50 years as a percentage of GDP. This projection includes annual pension payments and lump sum payments.

21. In its impact assessment for the Public Service Pensions Bill 2012-13, the Government estimated that the cost of providing public sector pensions to the Exchequer would fall as a percentage of GDP from 2 per cent of GDP in 2015-16 to 1.3 per cent in 2060-61.

22. The most recent projections from the Office for Budget Responsibility were published in 2018 and largely agree with the previous assessment and state that the cost of providing public sector pensions is expected to fall over the long-term from 2.0% of GDP in 2019-20, to around 1.5% of GDP from 2064-65.

23. These projections reaffirm our position that the reforms to public sector pension schemes are working as intended and the government believe that costs will decrease over time.

24. The National Audit Office (NAO) have recently published a report[4] of public sector pensions and this finds that government's reforms to public service pensions have helped contain the rise in future costs to the taxpayer.

Impact on members

25. One of the findings of the NAO report was that because of the 2011-2015 reforms, employees are contributing substantially more to their pensions, c£2,700 on average in 2019-20, or 8.5% of the average salary. This is a 33% increase in real terms from 2009-2010.

26. The report also stated that during the period 2009-10 to 2019-20, average pay decreased in real terms (against CPI) by 12%, reflecting that total pay has not kept pace with inflation. (This decrease would be even larger against the RPI measure of price inflation).

27. Sacrifices and compromises have been made by public sector workers to maintain a good pension scheme that can provide a decent income in retirement, this should not be forgotten.

28. The Office for National Statistics (ONS) analyse public and private sector earnings and the latest release of this analysis[5] states that without inclusion of pensions, public sector pay is significantly below the private sector. For more skilled workers in knowledge-intensive sectors, remuneration is higher in the private sector even if pensions are included. Any further changes to public sector pensions would be counterproductive as this would damage public service recruitment, retention and performance. The damage of

[4] National Audit Office - Public Service Pensions, March 2021
[5] ONS - Public and private sector earnings: 2019

any detrimental changes to public sector pensions is further exacerbated by the further pay restraint that is now being proposed for the public sector, with a freeze on pay awards for most public sector workers in 2021-22.

29. The NAO report highlights that public sector pensions are generally quite inflexible. Prospect has pressed for increased flexibility within the Civil Service Pension Scheme and this has always been refused. HM Treasury are intransigent on this point without fully explaining their logic. Given that this would provide flexibility to members, reduce liabilities and encourage retention, it is an odd position to take as it would be of benefit to members and taxpayers.

30. One of the recommendations from the NAO report is that HM Treasury and the Cabinet Office work with employers to understand how public service pensions can help them recruit and retain the staff they need as there is some evidence to suggest that those in lower age and income groups are more likely to opt out as they view contributions as unaffordable.

31. The position in public sector pensions has not changed since the 2015 reforms. The scheme design is the same, and if anything, scheme members should have benefited from improved benefits or a reduction in the contribution level for the last two years due to the cost cap floor being breached.

32. A significant proportion of our membership are members of the Civil Service Pension Scheme. The initial results from the 2016 valuation of the scheme showed that due to pay increases being lower than expected and a tail off of longevity improvement, the cost of providing benefits had fallen to an extent that the cost sharing mechanism floor had been breached and member benefits should therefore increase and/or contribution levels decreased.

33. The government decided to pause this valuation process due to the ongoing legal action regarding age discrimination in the public sector pension schemes. We acknowledge that there will be a cost arising from the age discrimination judgement regarding the transitional protections put in place at the time of the reforms in 2015. In our view the government should shoulder the burden of this cost as it was a part of their reform package that was deemed unlawful, pension scheme members should not be punished for this.

Pension provision in the UK

34. The level of pensions payable to members of the public sector schemes are far from extravagant and the narrative that public sector pensions are too generous or “gold-plated” is tired and far from truthful. The average pension payable across the four largest unfunded public sector pension schemes is around £10,000 per annum. Even if the members were entitled to the full rate of the new state pension, which is unlikely due to contracting out, this would give public service pensioners on average a total income of less than £20,000 per annum. This cannot be described as excessive and is of a level that will hopefully just about provide members with a comfortable retirement, which should be the goal for all pensioners in the UK.

35. As a trade union with members in the public and private sector, we are deeply concerned about the level of pension saving for those in the private sector. Although pension participation has improved drastically due to automatic enrolment, the level of contributions that are being paid into a pension scheme is far too low. As part of our research on the gender pension gap, we found that only 12% of employees were paying pension contributions of 6% or more and less than 8% were in receipt of an employer contribution of 12% or more. There are several suggestions and studies that have

investigated the level of contributions required to provide a member with an adequate retirement income and these vary but are often between 15% and 20%.

36. As our research has shown, not enough people are contributing at this level and are going to be in a position in retirement where they do not have sufficient income to enjoy a comfortable retirement. We are currently in a situation where there are significantly more people in private sector occupational pension schemes (11.0 million) compared to the public sector (6.3 million). Within the private sector, only 1.1 million workers are in a defined benefit scheme with 9.9m contributing to a defined contribution arrangement[6].

37. For private sector DC schemes, the average total contribution rate was just over 5% of pensionable earnings, split between members (2.7%) and employers (2.4%)[7]. This is a very poor level of pension saving and will not be sufficient to provide people with an adequate pension in retirement. Of these members, significant numbers may well have deferred benefits in defined benefit schemes and therefore have sufficient pension income in total. However, for those that do not and for young people especially, more needs to be done to ensure that they are saving enough for their retirement.

38. The focus of government in terms of policy objectives, should be to level-up the pension provision for private sector employees, not to level down those of public sector workers to an inferior level.

Conclusion

39. The changes made in 2015 were predicted to save c£430 billion over 50 years and the projections in terms of cost as a percentage of GDP agree that cost savings will be achieved.

40. The reforms resulted in employees paying higher pension contributions and for most members, the result will be an inferior pension. Savings from changes to unfunded public sector pension schemes take decades to be visible as it is only when retiring members have significant amounts of service in the reformed schemes that the cost saving will be realised. It is simply far too soon since the reforms were made to be assessing the affordability of public sector pensions.

[6] ONS Occupational Pension Schemes Survey, UK: 2018
[7] ONS Occupational Pension Schemes Survey, UK: 2018