Public sector pensions; DC is inevitable

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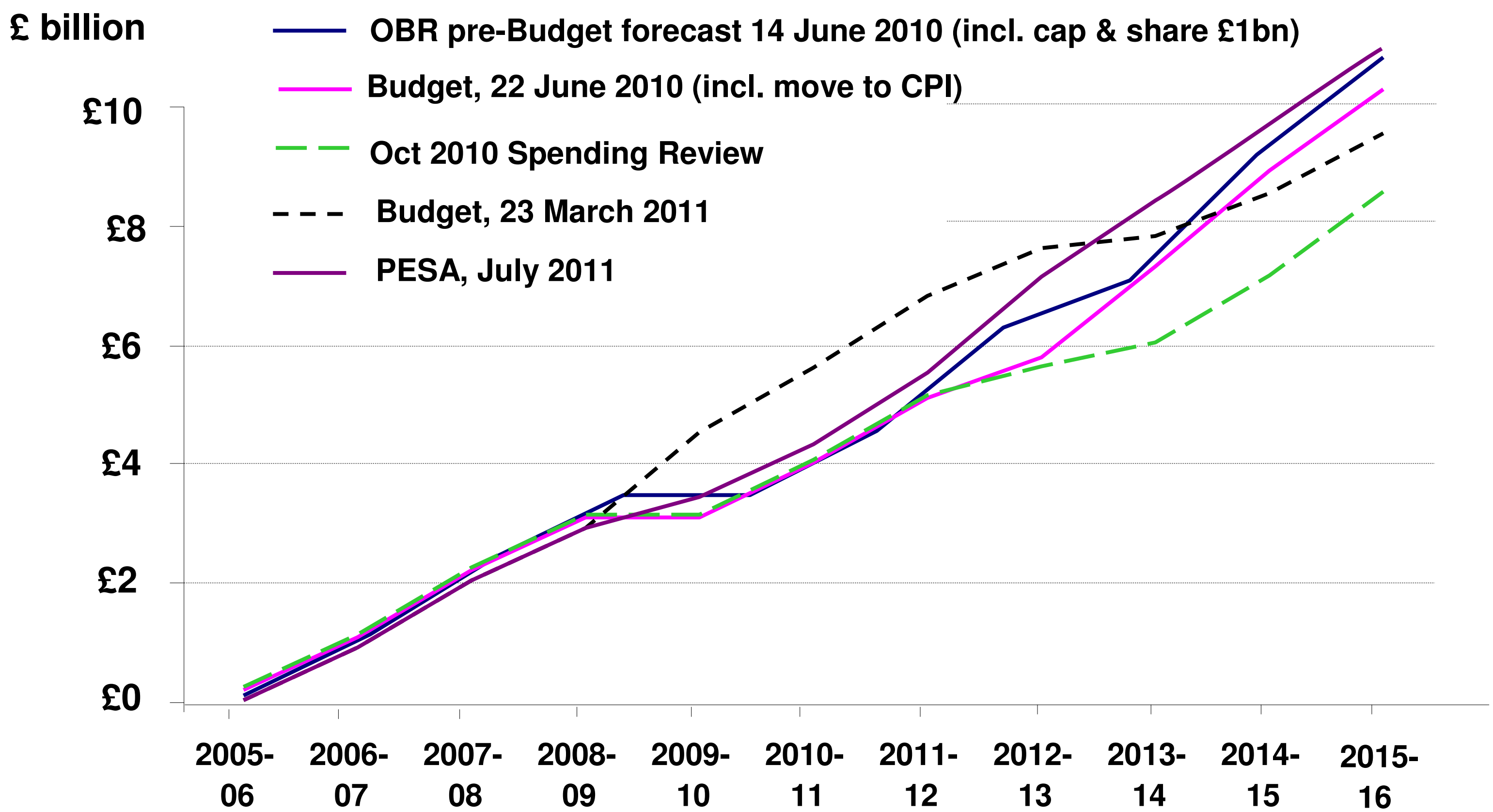
Michael Johnson

Research Fellow, Centre for Policy Studies

Centre for Policy Studies

www.cps.org.uk

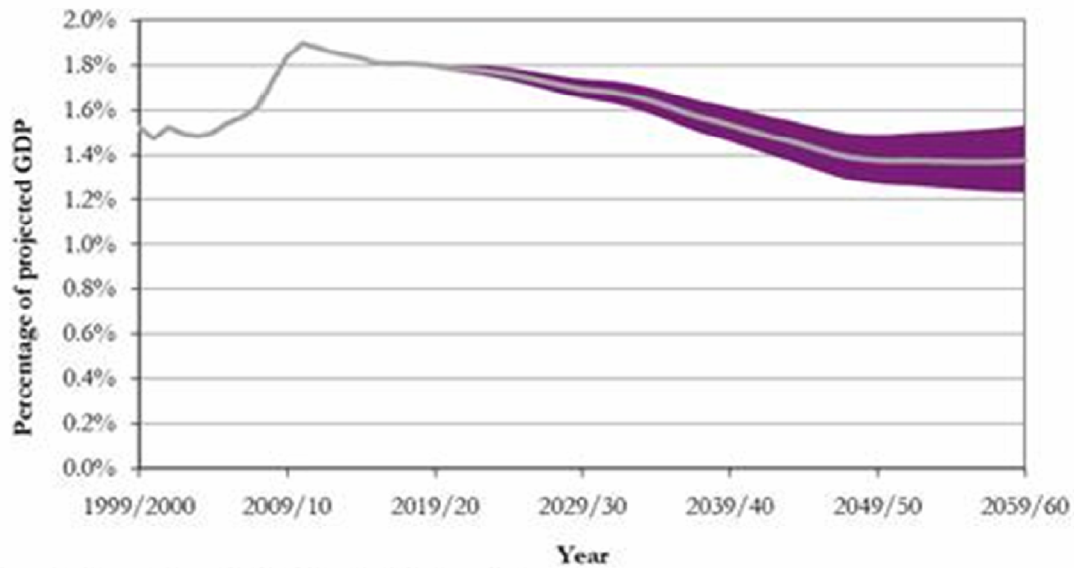
Cashflow; mind the gap (unfunded schemes)



Introduction of additional employee contributions:	*2012-13*	*£0.2bn*
	2013-14	*£1.3bn*
	2014-15	*£1.8bn*
	2015-16	*£1.8bn*

Modelling risk *par excellence*

Chart 1.B: Projected benefit payments as a percentage of GDP – sensitivity analysis



Source: GAD projections for IPSPC and IPSPC analysis.

Note: The fan chart shows how the projections would be affected by altering assumptions about productivity growth, public service workforce growth and life expectancy (see Annex C of the interim report).

Assumptions	Hutton	What if?
Workforce	0.25%	-0.25%
Productivity	2%	1%
Real earnings	2%	0%

Fairness; Madoff economics

- 85% unfunded (PAYG)
- Funded schemes……are underfunded
  - Shortfall of £95bn on liabilities of £210bn

More pensioners and / or shrinking workforce + Lack of financial discipline = Unsustainable framework

⇓

Generational injustice and fiscal calamity

Fairness; the official data

Pensions	**Median**	**Mean**	
LGPS (funded)	-	£4,000	(>50% part time, c75% women)
Main unfunded schemes	-	£6,500	
All public sector	£5,600	-	
Private + public sector	£3,900	-	

	Private	**Public**	
Average gross weekly pay	£581	£605	+4%
Total reward	£614	£692	+13%

= gross pay
+ employer pension contributions ← *Unrelated to real cost of meeting pension promises*

Use contributions as proxy for pension value:

Average private occup. DC 12%

To match equiv. public sector earner's pension: 37%

3 times better

Quick wins needed

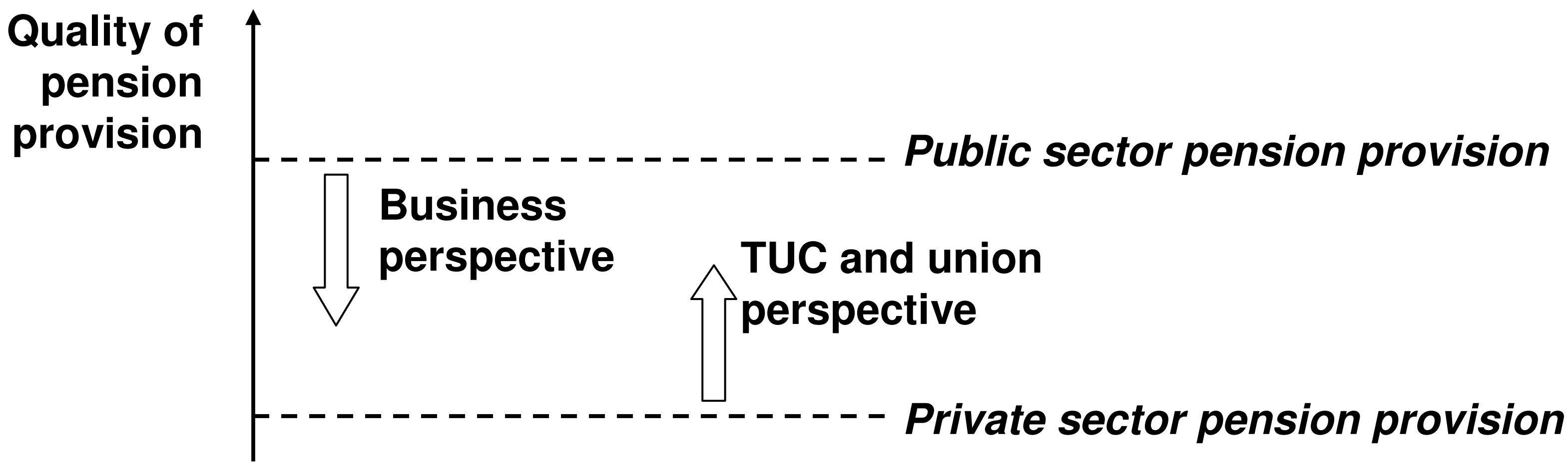
- Hutton: significant long-term savings
- But quick wins needed; little scope
- Contributions (unfunded schemes)

		2010-11*		2015-16 post-Hutton			
Employees		£5.4		21%		£7.2	22%
	(+£1.8bn)		79%	£25.8		78% from taxpayers	
Employer		£16.0					
Gap (Treasury)		£4.5					
Pensions in payment	£25.9		£33.0				

- Public sector employee contributions need to double (at least)

* HMT: Public Expenditure Statistical Analyses (PESA), July 2011

The media war



- Funded and unfunded; interchangeable language
- The word “average”
- “Something being taken away”?
  - Not for all: lower paid better off with CARE DB
- A new 80:20 rule……..societal schism?

Proposals; three steps

Now; prepare the ground

- Raise the State Pension above G'tee Credit
- Means-tested benefits; virtuous circle +£8.6bn p.a. (max)
- End S2P and contracting out +£3.9bn p.a.
- End higher rate tax relief +£6.9bn p.a.

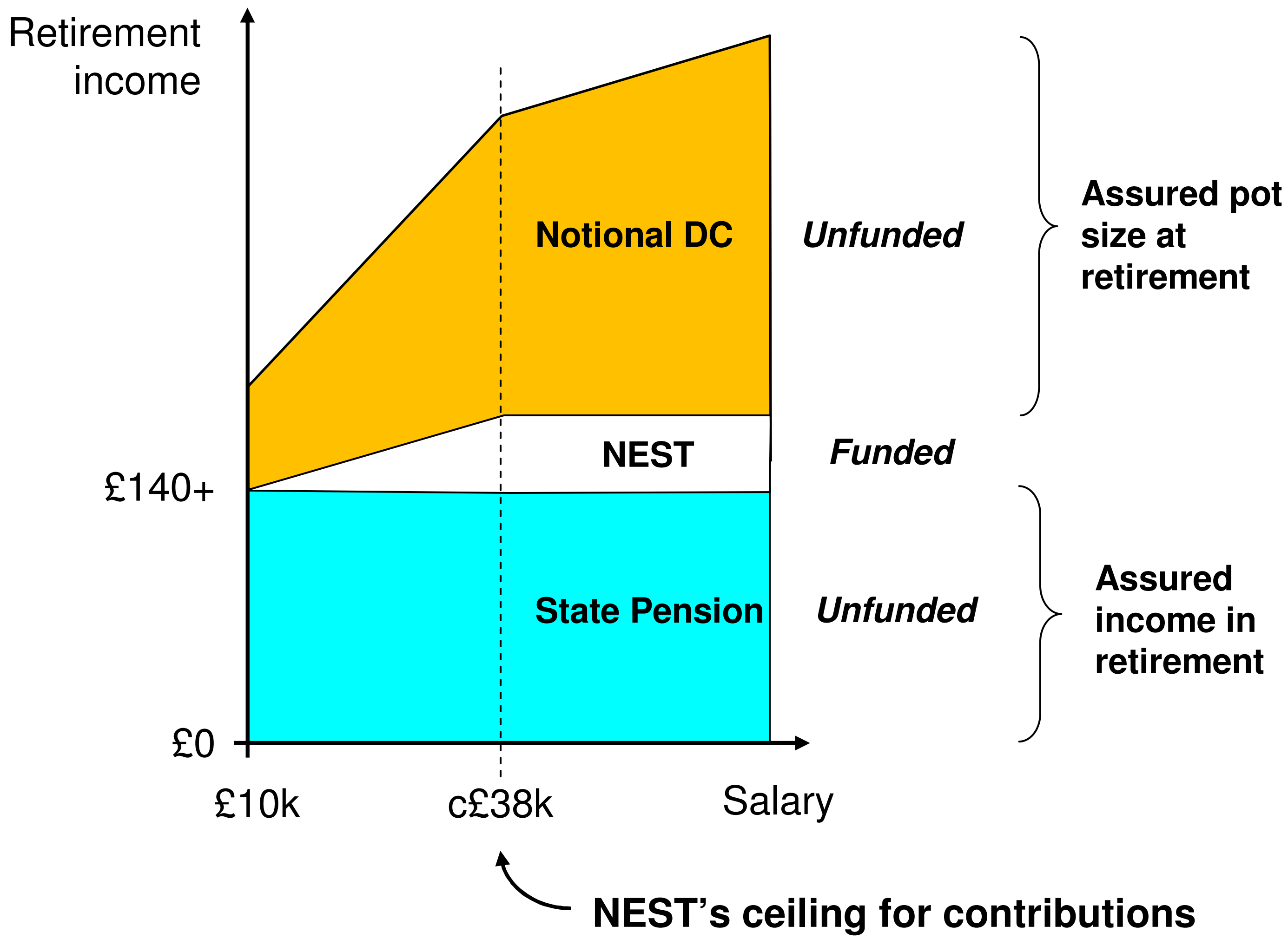
+ 2 years

- Compulsory NEST participation + CARE DB

+ 10 years

- Notional DC to replace CARE DB (NEST on-going)

Overview in 2021



NEST: compulsory public sector participation

- The pay twice problem
  - Use *additional* employee contributions

- Starts the (slow) transition to funded DC
  - Audit Commission: funded better than unfunded

- Funds flow to underpin NEST
  - Economies of scale to reduce NEST unit costs and charges

- Golden opportunity to catalyse a savings culture

Notional DC

- Unfunded; individual's notional account details contributions
    - Cashflow to HMT

- "Deemed" return on account balance, e.g. gilts or GDP growth

- At retirement
    - Pot size "defined"
    - Account converted into an annuity "at market"
    - Scheme members assume interest rate and longevity risks

- Variant: gilts seeding?
    - Enhanced transparency; **<u>no</u>** increase in the state's liability

Implementation; self-sufficiency is the key

- Signal move to DC ten years in advance
  - Foremost an exercise in effective communication

- Thereafter, employers must be pensions self-sufficient
  - HMT door shut (ref. cashflow gap)
  - Taxpayers' contribution capped at 65% of pensions in payment

- Employers to have complete discretion as to how to achieve self-sufficiency
  - Parameterisation at individual scheme level

Conclusion

- Even if Lord Hutton's reforms were implemented in full…….

  ……a second round of reform will be needed

- The vision: pensions equality across sectors
  - Hutton: tacitly signalling pvt. sector will be 2nd class from hereon

- Concentrate all of state's limited capacity for longevity risk into improved State Pension

- Key risks; communication and implementation

- Politics……is the art of the possible (Hutton)
  - Cross-party support is key

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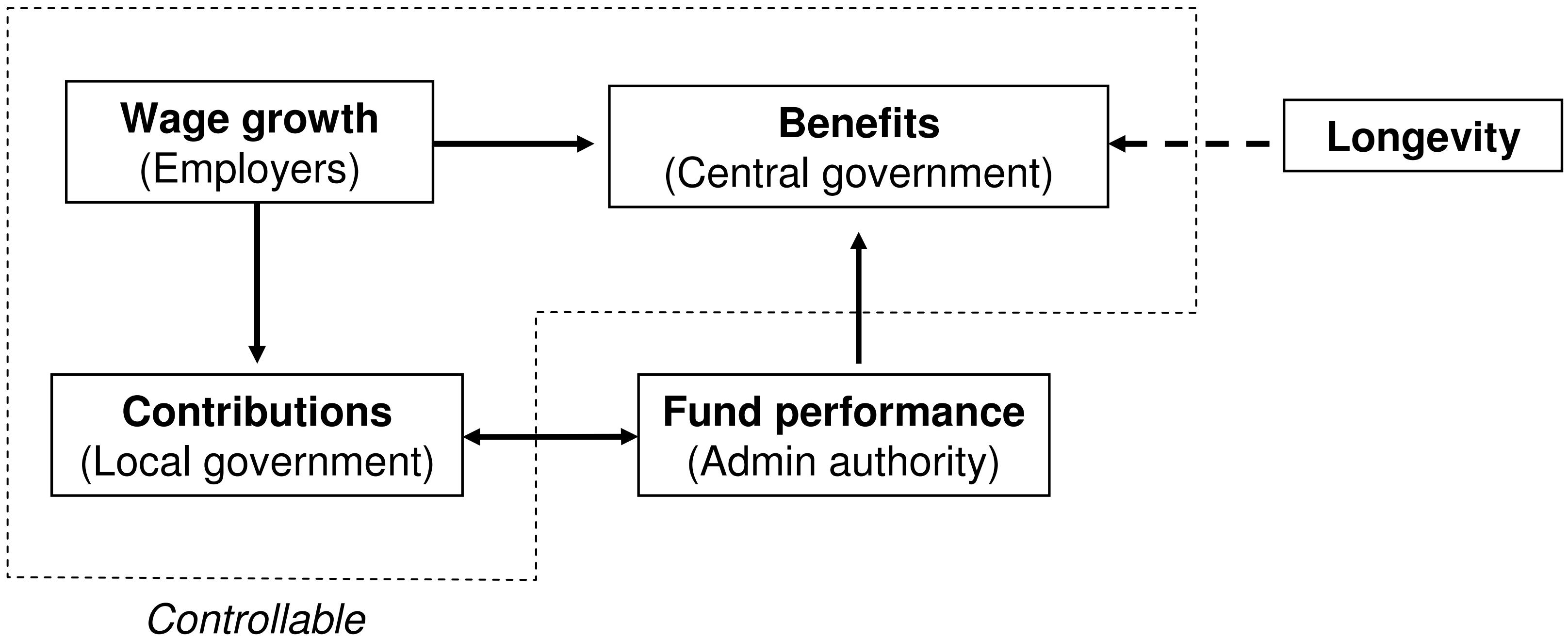
Governance; a tripartite tragedy?



- Single trust-based Board required for each scheme, incl. employers, government (local / central) and admin authority

Lord Hutton; a *framework*

- DB - CARE
  - Pensions indexation: CPI*
  - Active: average earnings (but CPI if deferred?)

Retention vs. mobility

- NPA linked to SPA for *future* accruals
  - Periodic NPA review

- Accrual rates, indexation methods, employee contribution……?

- Risk sharing: fixed cost ceiling
  - If negotiations fail…..automatic default……to what?

* Pre-Hutton, along with 3% contributions rise (scheme average)

Lord Hutton; assessment

- **Adequacy**
  - Ref. Turner's replacement rates — Unclear

- **Affordability**
  - CARE — Slow
  - NRA from 60 to SPA (for future accruals) — Slow
  - Risk sharing; fixed cost ceiling? — Vague

- **Fairness**
  - Internal: redistributive — Yes?
  - External: a new 80:20 rule? — No

Lord Hutton; assessment, cont.

- **Simplicity** Yes
- **Supporting productivity** Unclear
  - No private sector access
  - Fair Deal consultation
- **Transparency / clarity** Some
  - Pension Boards, benefit statements, indep. oversight of governance, OBR reports ref, fiscal impact, more published data

Lord Hutton: summary

- Lacks specificity; more Q’s than A’s
  - Egg-shell politics; pragmatism to the fore?
    - But what else could he have done?
- Parameterisation; a negotiations nightmare?
- Ducked fairness issue; internal focus only
- Private sector provision: second class from hereon… societal schism
- Revisit in 5 years?

Macro-economic perspective

- Moving east
- Context of negative real interest rates why
- Competitive pressure
- Svgs accum to decum
- Savings ratio
- Need to catalyse a savings culture