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Clearing the pensions fog: Achieving transparency on public sector pension costs

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The cost of providing defined benefit pensions has increased dramatically over the past decade. Private sector employers have taken decisive action to control pension costs. We now need to see equivalent action in the public sector.

Private sector employers have responded to pressure on funding by pumping extra contributions into their final salary pension schemes. They have also taken tough decisions to contain future costs at an affordable level. But the public sector has taken no such decisive steps. Pension liabilities there are continuing to mount without proper recognition of their costs and scale. The CBI estimates that unfunded liabilities now amount to at least £900bn. At a time when government debt is escalating rapidly, there is an urgent need for a realistic assessment of future commitment expected of taxpayers.

Longer life expectancy and additional regulation have increased the cost of defined benefit (db) pension provision at an extraordinary rate over the past ten years. Changes in investment strategy and lower returns have also pushed up the costs of funded db schemes.

The private sector and public sector have responded to these changes in very different ways. In the private sector, where db benefits are paid from pension funds set up under trust law, companies have made huge additional contributions into those funds to meet their costs. Many have also changed the shape of future pension provision to keep costs manageable. In the public sector by contrast, the increasing cost of db provision is not widely recognised. Nor is it taken

into account in setting the overall remuneration packages of public sector workers. The steps taken so far to manage escalating costs in the public sector, while welcome, do not go far enough.

It is taxpayers – businesses and individuals – who will pick up the tab. They are entitled to question why, when the private sector has recognised the need to take steps to ensure affordability, comparable action has not been taken in the public sector.

The widening divide on pension provision also poses a threat to the smooth operation of the labour market. Trade unions have traditionally argued that generous pension benefits help compensate employees for lower rates of pay than the private sector. Whether or not there may once have been some justification for such arguments, this is no longer the case. Research in recent years shows there is no reason to think that pay levels in the public sector are behind those of broadly equivalent employees in the private sector.¹

As the pay gap between public and private sector no longer exists, the difference in pension offerings gives public sector employers an advantage they would be unlikely to have if the cost of public sector benefits were fully understood. Where companies take on public sector employees under

TUPE regulations it frequently costs them far more than public sector employers are charged to provide equivalent benefits. The cost of final salary provision is often not even taken into account when private organisations compete with public sector organisations to deliver public services.

This position is not sustainable. Reform is needed – at some point government must take action. There is a choice, though: either action is taken now and managed fairly over a period of time, or it is delayed and will become even more painful for all sides at a later date.

Having faced up to these issues themselves, CBI members recognise their complexity. As a first step, every effort must be made to establish transparency. To achieve this, the government should follow the same principles for disclosing pension costs as the private sector – in line with UK and international accounting and actuarial standards. This brief outlines the extent of the problem and the case for action. It highlights that at present:

- There is a lack of transparency over the costs and liabilities of public sector pensions
- Steps already taken in the public sector do not go far enough
- The private sector has taken action to ensure affordability – the lessons should be applied to reforming public sector provision.

Public sector provision is largely unfunded

Most public sector pension schemes take the form of unfunded pay-as-you-go schemes. Unfunded schemes are found in the NHS, civil service, school teaching and the uniformed services. In these schemes the government collects contributions from public sector employees and charges their public sector employers a notional contribution intended to cover the cost of the future pension benefits earned each year. That money is then used to pay benefits to current pensioners. The sums involved amount to a substantial proportion of payroll – for example in the civil service the average employer contribution rate is currently 19.4% of salary – but still do not take account of the true costs.

A minority of public sector schemes – such as those covering MPs and local government – are funded and so are more like private sector db schemes. Their position and long-term sustainability is more easily established than for the unfunded pay-as-you-go schemes.

Liabilities and costs of public sector pensions are not transparent

Historically, the government has published the total unfunded public sector pension liability on a regular basis. But the latest figures made available are from March 2006 when the total liability stood at £650bn – already equivalent to almost 50% of GDP.² Many pension specialists believe even this figure was an underestimate, based on unrealistic assumptions.

One reason for this is that the government uses different interest rates in different parts of its liability calculation. This is important because the higher the expected interest rate used to discount the cost of benefits, the lower the amount of money needed today to pay for a set level of benefits in future. In other words, the higher the assumed investment returns, the lower the contributions that need to be collected from employees and their employer.

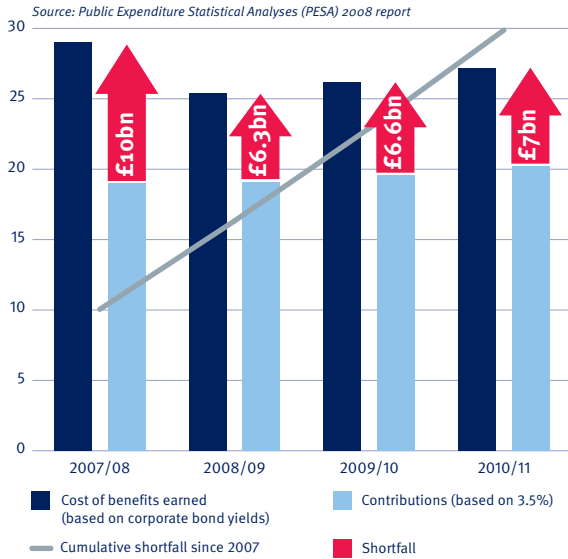
To keep a pay-as-you-go scheme in balance, the contributions required from employers and employees should be equivalent to the calculated cost of paying the benefits each year. But the government chooses a very optimistic interest rate of 3.5% (based on historic economic circumstances) to calculate the contributions required from public sector employers and employees. This has the effect of deflating the level of contributions required.

When, however, it comes to calculating the published cost³ of future benefits, a lower interest rate of 1.8% (based on corporate bond yields) is used. Over time, this means the contributions charged to employers and employees and the calculated cost of pensions diverge.

The government's own figures suggest that the unfunded public sector pension benefits earned in the year 2007/08 were around £29bn (using the interest rate of 1.8%). But it collected only £19bn in contributions (based on the interest rate of 3.5% that has applied for several years) from public sector employers and employees – a shortfall of £10bn. To meet this high real cost, expenditure on public sector pensions overall is forecast to increase from 1.5% of GDP to 2% of GDP by 2027⁴ – an increase of around £7bn a year.

This shortfall is not a one-off event. Instead it is a cumulative process, generating a shortfall in contributions amounting to some £30bn over the four-year period from 2007/08 to 2010/11 according to government estimates. **Exhibit 1** illustrates the build-up.

Exhibit 1 The mounting shortfall in pension contributions (£bn)



Another area of questionable assumption relates to life expectancy. This is important as the longer the period a defined benefit pension is paid for, the higher the cost to the employer of providing it. CBI members transferring staff from the public sector report that the mortality assumptions used by the government are below the standards used in the private sector. In other words, the government is assuming that those in receipt of public sector pensions will typically have a shorter lifespan than pensioners from the private sector. There seems no basis for using this different assumption.

Use of a more realistic discount rate and more realistic mortality assumptions for the calculated cost would increase the **Exhibit 1** shortfall even further.

Liabilities are escalating

So what is the scale of liabilities? A CBI estimate of the liabilities of the unfunded schemes points to total unfunded liabilities of some £915bn by August 2008 – more than 40% higher than the 2006 government figure (**Exhibit 2**).

This figure takes account of the benefits earned by public sector employees since 2006, uses an up-to-date discount rate (based on corporate bonds, as in the private sector) and makes a correction for more realistic mortality rates. It should be emphasised that this is a conservative figure – it accepts

the government’s 2006 figure for unfunded liabilities as a correct starting point and the discount rate effect is lowered by the impact of the credit crunch on AA corporate bond rates. Many commentators calculate the true liability figure to be well over £1 trillion.

There is a growing taxpayer subsidy

In a sense, however, the total liability is unimportant if someone is willing to pay for it – the employee or employer from their own budget. But increasingly, the unfunded pension schemes depend on a large, growing and hidden taxpayer subsidy, with the money coming from central government funds, not the employer. This subsidy is needed to cover the shortfall between the contributions collected from public sector employees and their employers on the one hand and the value of pensions paid on the other.

Exhibit 3 (page 4) illustrates the scale of the subsidy. The left hand column shows the expected benefits – or ‘replacement ratio’ by comparison to their salary in working life – for a male member of the post-reform civil service scheme. He is on the UK median salary of around £24,000 and is retiring from the civil service after 30 years of pensionable service (based on the career average revalued earnings (CARE) benefits for new entrants with a retirement age of 65). Our calculations show this employee would expect to receive a pension equal to 60% of salary.

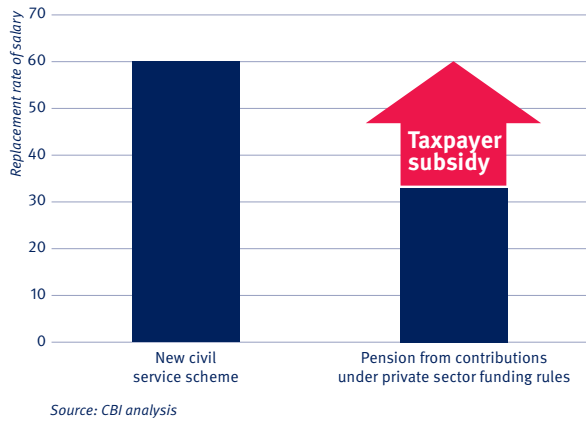
The second column shows the expected replacement ratio we calculate would be achieved, based on the employer and employee contributions actually paid into the scheme for the same member, if the private sector funding rules

Exhibit 2 Total unfunded liability

	£bn	Source
31 March 2006	650	Government estimate
To 31 August 2008		
Cost of benefits accrued	60	PESA 2008
Interest on liability	80	PESA 2008
Benefits paid out to pensioners	(45)	PESA 2008
Updated discount rate	80	CBI estimate
Move to realistic mortality	90	CBI estimate
Total 31 August 2008	915	CBI estimate

Source: Public Expenditure Statistical Analyses (PESA) 2008, HM Treasury

Exhibit 3 The level of taxpayer subsidy (%) new civil service scheme, example employee



applied. It shows the contributions would be expected to provide a much lower pension than the civil service pension scheme in practice provides. The arrow shows the expected level of pension subsidy that taxpayers will have to pay to make up the shortfall.

Even funded public sector schemes are revealing increasing deficits

Where public sector schemes are funded – for example in local government – the true cost of benefits provided is subject to more realistic reporting and accounting, although such schemes do not have to submit their funding plans to the Pensions Regulator for scrutiny as in the private sector and much longer recovery periods to make up deficits are permitted.

The latest figures show a total deficit in the local government plans of £4.7bn – a worrying prospect for council tax payers.

Local government pensions already account for £1 in every £5 of council tax paid. The liability for local taxpayers will keep on rising unless action is taken to tackle the growing burden of public sector pensions.

There is a direct impact on private sector employers

So far this brief has focused on the impact of public sector pension provision on businesses and individuals as taxpayers. But the impact extends into the operation of the labour market.

The form of benefits in the public sector and their poor costing have significant effects where staff are transferred into or out of the public sector under TUPE regulations.

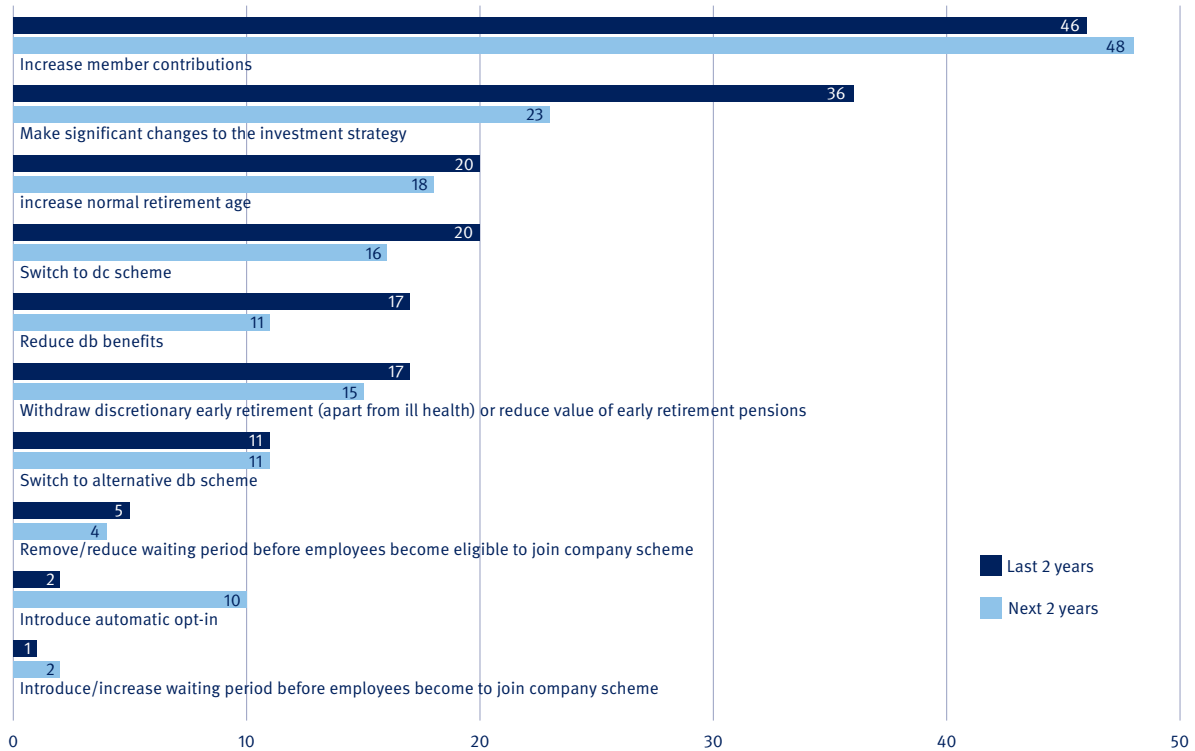
Public sector NHS employers make a set employer contribution in respect of pensions for their employees, with no risk of further requests for contributions if that amount does not turn out to be enough – perhaps due to increasing life expectancy. A private sector employer is in a very different position. If a company takes on employees from an NHS employer transferred under the TUPE regulations, it faces far higher costs. In order to comply with TUPE, the firm first needs to set up an approved pension scheme to offer these benefits. As the scheme is outside the public sector it would have to be funded by separate assets and subject to transparent and prudent private sector regulations. Companies in this situation have found themselves required to contribute roughly double what the public sector is charged to fund equivalent pension provision. They are also exposed to subsequent increases in contributions and an uncapped liability if, for example, investments do not perform well or life expectancy rates improve further. This unfair distortion of employment costs threatens competitive neutrality in public service markets.

Reform steps taken do not go far enough

Some reforms have already taken place in the public sector in reaction to increasing costs. In a previous CBI report⁵ we noted moves to increase the retirement age for future employees and that a cap has been placed on employer contributions close to their current levels in many public sector schemes. Any future increase in cost, for example due to increasing life expectancy, is to be shared between employee and employer. This is welcome news, and is expected to generate net savings of £13bn in total over the next 50 years.⁶ Yet this saving is relatively insignificant compared with the costs of the pensions building up at around £25bn each year. It also deals only with that part of the scheme cost charged directly to employee or employer – no measures have yet been taken to control the overall cost.

The big test of reforms to date, however, is whether they can deliver even the relatively small savings they promise. At least one scheme – the school teachers' scheme – is likely to breach the contribution cap soon, but no mechanism has yet been established to deliver the cost-sharing.

Exhibit 4 Changes to company db pension arrangements for existing employees (%)



Source: 'A view from the top' – CBI/Watson Wyatt pensions survey 2007⁹

Lessons from the private sector

Private sector employers have taken action to contain the escalating costs of their pension schemes. **Exhibit 4** illustrates the extent and nature of the reforms. The changes have not been easy, but employers have recognised them as essential. To limit the build-up of future liabilities, most final salary schemes have closed to new entrants and some have closed to future accrual. To maintain scheme funding, company contributions to final salary pension schemes for the FTSE 100 companies alone have surged from £3.6bn in total in 2002 to £13.1bn in 2007⁷ to take account of factors that have increased pension costs.

Where db schemes do remain open, private sector firms have taken a number of measures to manage the growing burden. These include increasing employee contributions, redesigning benefits, increasing retirement ages and moving from basing future benefits on final salary to career average revalued earnings. Private sector employers and

their employees have shared the full cost of their pension benefits. They have not looked to the taxpayer to pick up the tab.

For many private sector workers a defined contribution plan – often of high quality, as a recent CBI report⁸ set out – is on offer. This offers certainty of cost for the employer, but also brings new challenges in investment understanding and explanation, which business is facing up to. The reality, therefore, is that around 20 million private sector workers are not members of a final salary pension, yet they are expected to bear a substantial part of the cost of such schemes in the public sector.

Moreover, public sector workers benefit from a range of benefits simply unaffordable in the private sector:

- Retirement at 60 for existing employees compared to a norm of 65 in the private sector

- Indexation of benefits fully in line with inflation compared to a 2.5% cap in the private sector
- The ‘transfer club’ for public sector employees (which maintains the salary link when they move jobs) whereas job moves in the private restart the clock.
- A very generous approach to early retirement on ill-health grounds.
- Bringing indexation into line with private sector practice
- Assessing which provision balances the affordability test with the needs of different groups of workers.

What is not in doubt is that as a matter of urgency, public sector employers and employees should begin to meet the true cost of their benefits, just as the private sector does.

There is also a communication task to be undertaken. Public sector employers might usefully be required to produce a total remuneration statement for their employees to help raise awareness of the true cost and value of their pensions. Those costs should also be properly understood and taken into account when reviewing the remuneration packages of public sector employees.

The way ahead

The CBI recognises the complexity and magnitude of the issues around public sector pension provision. We are not arguing for hasty action that could be disruptive to retirement planning and result in ill thought-out and contentious decisions. But reform is needed and the government must start planning now to ensure long-term affordability.

As a first step, greater transparency is essential. The assumptions used to calculate the published costs and required employer and employee contributions must be open to scrutiny and discussion. They must also be internally consistent. The government should follow the same principles for calculating pension costs as the private sector. There has already been significant debate about the possibility of an independent public sector pensions commission to analyse costs and set assumptions. That might well be a useful approach.

More realistic recognition of the mounting costs and liabilities is key to laying the foundations for reform. Public sector employers must also be charged the full cost of the benefits they provide. There are many options for how reform could take place – it is not simply a choice between final salary provision and defined contribution schemes. Different approaches may well be right for different groups. Options for reform include:

- Increasing pension age to 65 over time in line with practice elsewhere and the state pension scheme
- Increasing employee contributions to reflect the true costs of provision

The process of reform will not be rapid or easy. What is essential is that it should be started now.

Footnotes

- 1 *For what it's worth? Managing public sector reward 2008-11*, Nov 2006, CBI. See also *An assessment of the government's reforms of public sector pensions*, Oct 2008, Pensions Policy Institute
- 2 *An assessment of the government's reforms of public sector pensions*, Oct 2008, Pensions Policy Institute, p24.
- 3 *Guidance on managing the change in discount rates for pension liabilities*, PES (2008) 03, 1 Feb 2008, HM Treasury
- 4 *Long-term public finance report: an analysis of fiscal sustainability*, March 2008, HM Treasury
- 5 *For what it's worth?*
- 6 *The IFS Green Budget*, January 2008, Institute for Fiscal Studies
- 7 *Accounting for pensions*, 2008, Lane Clark & Peacock
- 8 *Saving for tomorrow*, 2008, CBI
- 9 *A view from the top*, pensions survey, 2007, CBI/Watson Wyatt

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