The Teachers' Superannuation Working Party

TEACHERS' SIDE

Secretary: Andrew Morris
Hamilton House, Mabledon Place, London WC1H 9BD
Tel: 020 7380 4772   Fax: 020 7383 3454

TEACHERS' SIDE RESPONSE TO HM TREASURY CONSULTATION ON THE DISCOUNT RATE USED TO SET UNFUNDED PUBLIC SERVICE PENSION CONSTRIBUTIONS

The Teachers' Side responds to this Treasury consultation on the basis that it is, as outlined in paragraph 1.13, also the formal consultation required under the terms of the Teachers' Pensions Regulations 2010 in respect of the Teachers' Pension Scheme for England and Wales and under the relevant legislation governing the separate schemes for Scotland and Northern Ireland.

The Teachers' Superannuation Working Party is the joint body which has existed, for over 40 years, to negotiate and agree the provisions of the Teachers' Pensions Scheme (England and Wales). The Teachers' Side brings together the teacher organisations with members in that scheme and also those with members in the Schemes for Scotland and Northern Ireland. We represent members in all types of establishments, including State-funded and independent schools, sixth form colleges, further education colleges and the 'new universities'.

We wish to make clear at the outset that this response is made without prejudice to our position with regard to the future of the Teachers' Pension Schemes.

OVERVIEW OF TEACHERS' SIDE POSITION ON THE DISCOUNT RATE

As the following sections set out, we believe that the current discount rate used by the Treasury to estimate the long term costs of public service pensions remains appropriate and supportable.

We reject the arguments put forward by critics of the public sector schemes such as Policy Exchange and the Institute of Directors' so-called Public Sector Pensions Commission. They propose that the Government should use similar assumptions in relation to the notionally-funded public sector schemes as those used by funded defined benefit pension schemes operating principally in the private sector. This reflects either a complete failure to understand the different circumstances of these public sector schemes or a deliberate misrepresentation of the circumstances in order to attack the schemes.

Specifically, we believe that these critics offer no justification for arguing that State-backed pension scheme liabilities should be calculated and funded as if based on index-linked gilts; and no case for departing from the Treasury's SCAPE assumptions and the current 3.5% discount rate used to value those liabilities.

The Treasury consultation document goes some way to refuting these arguments and it is very disappointing, therefore, that the options proposed do not include the status quo.

Fully-funded defined-benefit schemes sponsored by private sector employers require regulation in order to ensure that funds will continue to be available on an ongoing basis to meet the obligations of the scheme to its members. This requires a considerable degree of prudence in valuation assumptions. The circumstances of the notionally-funded pension schemes for public sector employees are very different. In particular, there is a massive difference in the nature and status of the 'covenant' or security of guarantee available from the State compared to any private sector employer.

The cost to the State in providing public sector pensions is not directly dependent on financial markets. The ability to rely on the continuing existence and involvement of the State as sponsor, and its capacity to finance its long-term liabilities, allows assumptions to be made which are both less costly and more realistic. The cost of providing pensions through these schemes is therefore naturally going to be less than for private sector employers' fully-funded defined-benefit schemes.

The use of the 3.5% discount rate in public sector pension scheme valuations is, furthermore, the result of a deliberate policy approach which is not just applied when valuing public sector pensions. It is an approach to valuing liabilities which applies to all long term public spending commitments and which is set out and considered in detail in the Treasury 'Green Book'. That document sets out the Treasury's guidance to all public sector bodies on the appraisal and evaluation of public spending projects such as large-scale long-term projects for construction. It makes clear that there is no need for public bodies to approach this on the same basis as would individuals – in fact that this is positively undesirable. An approach based on market-based comparative investment returns is therefore discouraged. Instead, the Treasury has advocated an approach which seeks to convert such costs to 'net present values' and has specifically recommended a discount rate of 3.5% in doing so.

In calculating long-term pension liabilities, just as in calculating long-term costs of major public spending projects, the Teachers' Side is clear that the nature of the State's involvement and support means that these calculations do not need to reflect the circumstances and pressures of financial markets which have no influence or relevance. We do not see a case for departing from this principle.

It is worth pointing out that most critics of the existing discount rate arrangements also advocate moving away from the current notionally-funded basis for the public service schemes. This basis for the schemes has exempted them from the turmoil in financial markets which have created deficits in defined benefit schemes and slashed the value of members' shares in defined contribution schemes. Continuing use of this basis will assist long term planning for pension provision and for other matters affecting the workforce. Alternative approaches would be very likely to place substantial additional burdens on the taxpayers. It cannot be sensible to consider moving down that road.

The Teachers' Side believes that this review of the discount rate is driven by politics, not economics. The Teachers' Pension Schemes are subject to regular actuarial valuations which determine employer and employee contribution rates. The Government has, however, now decided to seek to increase employee contributions as part of its plan to tackle the structural deficit. Ordinarily, this increase in employee contributions would simply lead to an equal and opposite reduction in the employer contribution rate, other things being equal, following the next valuation and the Government would then lose this new source of income. The due valuation of the Teachers' Pension Scheme (E&W) has now been postponed until at least the

second half of 2011 pending the outcome of this review of the discount rate. A lower discount rate would allow the Government to retain the contribution increase. This suggests to us that the outcome – a reduction in the discount rate and a consequent increase in combined contributions – is pre-determined. The funding of public service pension schemes is a long-term endeavour. It is a separate issue from the short-term funding pressures that face governments, and the two issues should not be linked.

RESPONSE TO TREASURY QUESTIONS IN CONSULTATIVE DOCUMENT

Q1 Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

The Teachers' Side rejects the premise that there should be a *change* in the discount rate or a *lower* discount rate. We note that while the Hutton Commission's interim report recommended a review of the discount rate, it did not conclude that a change is necessary. It stated merely that the current discount rate is "... at the high end of what is appropriate". We believe that, even if this analysis is shared by Government at the conclusion of this consultation, the current rate can and should be retained.

Q2 Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

The five potential objectives referred to are as follows:

- **To provide a fair reflection of costs**
- **To be transparent and simple**

These appear obvious and unexceptionable but are, of course, open to different interpretations by different parties.

- **To reflect future risks to Government income**

Clearly this is an appropriate matter for consideration. As outlined earlier, however, we do not accept that the risks involved in assessing public service pensions costs are in any way comparable to those involved in private sector employers' funded schemes.

- **To provide stability in employer charges**

Again we accept this is a sensible objective. However, given that the relationship between employer and employee contributions is governed also by other considerations such as the cost-sharing agreement reached in 2006 for the TPS, this cannot be in any way an overriding objective.

- **To support plurality of provision of public services**

We do not accept that this is in any way an appropriate objective in determining the discount rate for funding pensions.

The Teachers' Side has had the advantage of considering the TUC response which proposes a further objective:

- **To encourage high quality pensions provision**

We endorse the TUC view that this objective, which is consistent with the statements in the Coalition Government's programme which commit it to seeking to "help reinvigorate occupational pensions" and encourage "high-quality pensions" for all employees, should also be taken into account when setting the discount rate.

Q3 Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

We support Option 4 (based on the Social Time Preference Rate) which represents a continuation of the present Treasury approach to estimating the cost of a wide range of long term public spending liabilities. Indeed, if this approach were to be discontinued for public service pension provision, it would raise questions about the estimated cost of many other spending projects creating much wider and probably unwanted implications for Government. We emphasise, however, that we do not accept that a case has been made for any change in the current rate.

We reject Option 1 (rate consistent with private sector and other funded schemes) and Option 2 (rate based on the yield on index-linked gilts) for the reasons set out above. Advocating these approaches represents a fundamental misunderstanding of the nature and basis of public service pension provision. We regard Option 3 (rate in line with expected GDP growth) as a necessarily narrower approach than Option 4 and therefore less appropriate.

Q4 Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

We are not aware of other approaches and have no further comments on this question.

Q5 Which approach to setting the SCAPE discount rate do you recommend and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

As stated in response to Q3, we endorse the fourth option (Social Time Preference Rate) but on the basis of the current discount rate of 3.5 per cent. We would prefer retention of the RPI-based formulation rather than an alternative related to the CPI.

Q6 Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?

We do not believe that reviews of the discount rate should be pursued on a regular basis.

Teachers' Side
December 2010

Members of the Teachers Side
Association of School & College Leaders
Association of Teachers and Lecturers
Educational Institute of Scotland
Irish National Teachers' Organisation
National Association of Head Teachers
National Association of Schoolmasters Union of Women Teachers
National Society for Education in Art and Design
National Union of Teachers
Scottish Secondary Teachers' Association
Ulster Teachers' Union
Undeb Cenedlaethol Athrawon Cymru

University and College Union
Voice

TUC Submission to HM Treasury Consultation

The discount rate used to set unfunded public service pension contributions

TUC

Executive summary

There are two important points of principle to recognise when deciding upon the appropriate Superannuation Contributions Adjusted for Past Experience (SCAPE) discount rate for unfunded public service schemes.

- First, these schemes are, by definition, unfunded and there is no advantage or logic in treating them as though they are funded; and
- Secondly, the Government, unlike private sector employers or, even more so, private individuals, is in a position to carry risks without incurring the cost of carrying those risks that would arise for such private sector employers or individuals.

We accept most of the objectives for setting the discount rate given in the consultation document, including in particular the need for fairness. However,

- The objectives should include encouraging the provision of high quality pensions, in line with Government policy; and
- We do not consider that "support [for] plurality of provision of public services" is an appropriate objective for setting the discount rate for SCAPE purposes

The first three options set out in the consultation paper do not provide an appropriate basis for setting the discount rate. There is no logic or any advantage to scheme members or the public at large in treating an unfunded public service scheme as though it is a funded private sector arrangement. However, the discount rate used to calculate the contribution rate for a private sector scheme with the strongest possible employer covenant does provide a floor that the social time preference rate (STPR) must logically exceed.

The current approach to setting the discount rate used for SCAPE purposes based on the use of the social time preference rate is correct. We are not aware of any coherent argument as to why HM Treasury should depart from a well established approach to making a current assessment of future expenditure. Nor have any arguments been advanced as to why a given financial commitment should be assessed differently, compared to other commitments of a like amount, solely on the grounds that it relates to a public service pension scheme. Given this conclusion, there is no logical reason why the discount rate should not continue at the current rate of 3.5 per cent, unless and until it is changed more generally.

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Introduction

The TUC represents 58 affiliated trade unions with 6.5 million members, working in a wide range of organisations, sectors and occupations. We welcome the opportunity to respond to the consultation on the discount rate that is used to set unfunded public service pension contributions, i.e. the rate used as a key element of the methodology used for the Superannuation Contributions Adjusted for Past Experience (SCAPE). We hope that HM Treasury, when reaching its conclusions, will take the opportunity this presents to dispel the myths that have arisen about the excessive cost of providing public service pensions and to demonstrate, in particular, that the contribution rates that underlie the ‘cap and share’ arrangements that have been agreed between the government and the public service unions provide a reasonable assessment of the government’s future pension obligations.

The following section of the TUC’s submission sets out our views on the general principles that should apply to the determination of the cost of public service pensions, stressing, in particular, that they should reflect the specific nature of unfunded future commitments. The subsequent sections respond, in turn, to the questions that are raised in the consultation document. The final section summarises our key conclusions.

General principles

We are pleased that the government has accepted the recommendation of the Independent Public Services Pensions Commission (IPSPC) to reject a funded, individual account, defined contribution (DC) model for public service pension provision (The Independent Public Services Pension Commission, 2010). The corollary of this recommendation is that there will continue to be defined benefit public service schemes and those that are unfunded are likely to remain so. Hence, given the SCAPE methodology, this will require a discount rate to value future financial commitments. However, we do not accept the Hutton review’s suggestion or the implication in the consultation document that there may be a need to change the current discount rate of 3.5 per cent.

This SCAPE approach obviously requires a method for assessing the commitments that are undertaken in respect of the rights to future pensions that are being accrued by the current workforce. The consultation document refers to the issue in paragraph 1.2, where it mentions “... it is important to understand the value today of future payments ...”. We have some concern about the use of the term “value” in this context, as the term is widely perceived as having a subjective element, raising, as it does, the question of value to whom? However, it is clear, in the context of the consultation document, that what is meant is the value, or rather the cost, to society as a whole rather than, for example, the cost to an individual employee of securing such benefits or to a notional private sector employer.

The problem is that the assessment of the cost of such pension commitments using the SCAPE methodology depends on various assumptions about which there is an inevitable degree of uncertainty. It is worth noting that the IPSPC indicated in its original consultation document that it would seek to arrive at a consensus on the

current cost of the pensions that are being accrued. While this objective was understandable, it is apparent that it was not achievable and this has led to the Commission's recommendation that HM Treasury should undertake the current review. The fundamental difficulty of the task, as suggested by the TUC in our submission to the IPSPC, is that estimating these liabilities is not just a matter of forecasting what will happen in the future; it is also a question of political judgement.

Given this inherent difficulty, there are two important points of principle that should be recognised when deciding upon the appropriate SCAPE discount rate for unfunded public service schemes.

- First, these schemes are, by definition, unfunded and there is no advantage or logic in treating them as though they are funded; and
- Secondly, the Government, unlike private sector employers or, even more so, private individuals, is in a position to carry risks without incurring the cost of carrying those risks that would arise for such private sector employers or individuals.

Difference between funded and unfunded schemes in setting SCAPE

The distinction between funded and unfunded schemes is crucially important. Many commentators confound the two and make the fundamental error of concluding that given the rules that apply to funded schemes, the same rules should apply to unfunded schemes. It is even implied on occasion that unfunded pensions are an inferior substitute for funded pensions. However this argument is supported by neither logic nor the interests of members and taxpayers. They are different types of entity and it is entirely rational that they should be treated differently when considering what they cost to provide. We urge the Government to make it clear that funded and unfunded pension schemes are different and it should, therefore, be no surprise that different considerations apply to the way they operate and the choices that are made.

Difference between private and public sector schemes in setting SCAPE

The second difference is that public service pension schemes are provided by an employer with an inherently strong covenant. This is crucially important because it means that it is less expensive to provide pensions where the employer has a strong covenant and, hence, can take a longer term view, without sacrificing the interests of scheme members. It must be assumed, barring an economic catastrophe, that public service pensions will be paid and it would therefore be a waste of public resources to pay for the level of protection that, by contrast, is required for private sector schemes. This saving is in addition to the savings from the lower level of management costs that come from the large scale that is typical of public service schemes. Hence unfunded public service schemes are inherently less expensive to provide than comparable private sector funded schemes and it simply makes no sense for the former to be treated as though they cost the same to provide as the latter.

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Response to questions in consultation document

Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

The TUC is concerned at the clear implication in Chapter 1 of the consultation document that the review is likely to conclude that the SCAPE discount rate should in future be lower than the current rate of 3.5 per cent. While it is not unreasonable to give some consideration to the impact of a lower discount rate, we emphasise that the interim report of the IPSPC does not justify such an assumption. Thus, the report does not say the discount rate is too high but rather that it is "... at the high end of what is appropriate". This does not preclude the possibility that, given the results of the review, the current rate will continue to be found to be the "appropriate" rate. We are concerned, therefore, at the statement in paragraph 1.29 of the consultation "... that organisations that currently participate in the public service pension schemes have access to public service pension schemes at a lower contribution rate than would otherwise be the case." While it might be claimed that this is simply a matter of logic, the way it is phrased in the context of the consultation document carries the implication that the Government believes that this is a situation that should be rectified.

We are also concerned that the Government is overlooking an important aspect of the change in the SCAPE discount rate in paragraph 1.33, which refers to the impact of any change on employees. The key section states that "... the split in respect of how much of these contributions are paid by employers and how much are paid by employees is a question of pension scheme design that is beyond the scope of this consultation." The problem is that the discount rate has a direct effect on the overall figure for the cost of future benefits and this is bound to impact on the perception of what constitutes a fair or affordable share of the cost to be met by the members. Thus, while we agree that benefit design should be outside the scope of this consultation, since they are matters for collective bargaining, the Government must recognise that the outcome of the consultation will still constrain the scope for such bargaining.

It is also unfortunate that the consultation document does not make clear how any change in the SCAPE discount rate will be dealt with under the 'cap and share' agreements already in place. On the one hand these agreements are intended to ensure that employees do not bear the brunt of increasing costs through changes to financial assumptions. On the other hand, however, the consultation states that departmental budgets will not come under any additional pressure from any change in discount rates and that there will be no material impact on the annual cost to the taxpayer of unfunded pension schemes.

This appears to leave scheme members as the sole remaining party to take on the burden of extra costs. Whilst there is no such statement in the consultation document one could infer that scheme members will pay for costs arising from any change in discount rate. Scheme members are already being faced with the prospect of increased contributions, as announced in the Spending Review 2010;

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a reduction in benefits, through the change in indexation announced in the Emergency Budget 2010, and the uncertainty of the outcome of the Independent Public Sector Pensions Commission's findings. The TUC is therefore concerned at the possibility that any change to the discount rate could further reduce the value of pension schemes to public service employees.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

Paragraph 3.2 identifies five potential objectives for the SCAPE discount rate. We comment on each of these in turn below and then outline an additional and important objective that also needs to be taken into account, namely the public policy objective of encouraging "high quality pensions" for all employees.

- **To provide a fair reflection of costs:** While the consultation document suggests that there are tensions between the objectives and it is unlikely that any one approach will satisfy them all, the TUC considers that a fair reflection of the cost of prospective benefits is an absolute requirement that must underlie any decision on the SCAPE discount rate. How such fairness should be achieved is discussed in answer to subsequent questions.
- **To reflect future risks to Government income:** The risks faced by a Government in funding future liabilities is a factor that should be taken into account in setting the SCAPE discount rate. However, the risk that the Government will be unable to meet its commitment is relatively low, given its ability to levy taxation. Further, the minimal risk which is faced is in no way specific to future pension liabilities. To use the appropriate technical term, future risks are "fungible", where fungibility is the property of a good or a commodity whose individual units are capable of mutual substitution. In other words, the risk that at some point in the future the government would be unable to discharge its commitments would be shared equally by all those commitments.
- **To support plurality of provision of public services:** The TUC rejects the suggestion that the need to support plurality of provision of public services should be an objective for setting the SCAPE discount rate. The proper process is to set the discount rate first, given the appropriate objectives of fairness and practicality. Only then should any impact on plurality of provision – and any appropriate measures to compensate - be considered. This is not the place for a full discussion of whether and how such plurality might be encouraged. However, it would be wrong and against the public interest to saddle all public service providers with artificially high costs, merely to bring the costs borne by those providers into line with the higher costs that, everything else being equal, have to be met by private sector providers.

We have fundamental doubts about the whole approach to the plurality of provision of public services. However, to the extent that this is an objective of public policy, the aim should be to find ways of extending the advantages in terms of costs that are possessed by the public service, particularly its ability to carry risks, to the private sector. Pensions are an obvious example of where the public service has a significant advantage in terms of its costs. To the extent that this tends to put public sector providers in a better position than those in the private sector, the discrepancy should be removed by extending the inherent advantages of public service pension provision, rather than placing artificial and inherently costly constraints on pension provision in the public sector.

- **To be transparent and simple:** We agree that the SCAPE discount rate should to be set on a basis that is both transparent and simple, subject of course to the over-riding need for fairness. It is worth emphasising, therefore, that the existing system, as set out in HM Treasury, Green Book, Appraisal and Evaluation in Central Government (HM Treasury, 2006)[1] is both transparent and simple and we would be opposed to any changes that would add complexity.
- **To provide stability in employer charges:** Stability of cost is not only a desirable objective for straightforward practical reasons, but also because it must be a better reflection of the underlying relationship. This is discussed further in answer to Question 6.

In addition to the objectives listed above the TUC urges that the following objective should also be taken into account.

- **To encourage high quality pensions:** We believe that there is an additional objective that the Government should take into account when setting the SCAPE discount rate, which is to encourage or facilitate a sustainable and affordable future for public service pensions that provides both adequacy and fairness. This objective is in line with the coalition government's stated intention, in the May 2010 Coalition Agreement, to "help reinvigorate occupational pensions" and to encourage "high-quality pensions" for all employees. A crucial part of this policy is to achieve the highest possible level of participation in public service pension schemes and there is no doubt that this will be made more difficult to achieve, the lower the level at which the SCAPE discount rate is set.

[1] http://www.hm-treasury.gov.uk/d/green_book_complete.pdf

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Question 3: Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

The TUC's comments on the four options that were identified by the Commission and repeated in the consultation document are as follows.

Option 1. A rate consistent with private sector and other funded schemes:

We emphasise that unfunded public service schemes are inherently less expensive to finance than funded private schemes and that there is therefore no logic, nor is there any advantage to members or taxpayers, in treating the former as if they are the same as the latter. As the consultation document explains in paragraph 2.3 "For funded pension schemes in the private sector the discount rate used to set contribution rates ... is generally set with reference to the return expected from the assets held by the pension scheme, adjusted to allow for the employer's financial strength and long term commitment to the scheme (this is known as the employer's covenant)". The obvious difficulty in applying such an approach to unfunded public service schemes is that they do not hold any assets, so it is therefore not possible to know what return should be expected.

Of course it would be possible to derive the discount rate by assuming a hypothetical fund with hypothetical investments but this does not avoid the difficulty of having to make the underlying decision. Instead it presents the need to make a choice in a different form. There is really no difference between making an arbitrary decision about what discount rate to use for SCAPE purposes and making an arbitrary decision about how a hypothetical public service pension fund would or should be invested. Either way, the TUC believes that the members of unfunded public service schemes deserve a more reasoned and soundly based approach.

Setting the floor

Nevertheless, the discount rate used for private sector and other funded schemes is of interest because it sets a floor on the rate that it would be logical to use for SCAPE purposes. This is because it makes no sense to suggest that it costs the Government more to provide pensions for its employees in unfunded public service schemes than it would cost in a funded scheme with comparable benefits and a strong employer covenant. What this means is that the SCAPE discount rate cannot logically be less than the discount rate that is used in practice for the purpose of calculating the contributions that are payable to funded schemes where there is a strong employer covenant. If it were the case then the government could reduce the cost of the pensions it provides by switching to a funded basis, then it must be assumed that it would do so.

In this context it needs to be emphasised that the consultation document makes a significant error in describing how the discount rate is set when calculating contribution rates for funded pension schemes. What it fails to recognise is the

crucial distinction within the Pensions Act 2004 that established the present funding regime, between the discount rate used to calculate accrued pension liabilities for regulatory purposes, known as the technical provisions, and that used to calculate the contribution rates required to pay for future benefits. These two rates do not have to be the same and for SCAPE purposes the distinction is crucial. The difference is that the rate used to calculate the technical provisions has to include a margin for prudence, whereas there is no such requirement for the rate used to calculate contribution rates for private sector schemes. In common usage the latter only has to be a "best estimate", which means that it does not have to include a margin for prudence.

For most employers with a balance of cost scheme the difference between a prudent and a best estimate is not that significant, as it only affects the timing of what they have to contribute to cover the cost of benefits, i.e. any extra they pay because contribution rates are calculated on a prudent basis produces a surplus in the scheme that, all else being equal, will be offset against what they have to pay in future. But in a shared cost arrangement it does make a difference to members, since they come and go and it cannot be assumed that they will still be around to benefit from any excessive prudence in the past. This is relevant because most of the unfunded public service schemes have 'cap and share' arrangements and are therefore, in effect, on a shared cost basis. This means, if members of such schemes are to be treated fairly, that the discount rate that sets a floor on that used for SCAPE purposes must meet the following two requirements. First, it should be the rate that is used for the purpose of producing a best estimate of the contributions required, rather than a prudent estimate. Secondly, it should be the rate that is used for a funded scheme with the strongest employer covenant. It should not be assumed that this is the same as the rate used to calculate a scheme's technical provisions.

Scheme practice on discount rates

Given the TUC's view that the discount rate that is used by private sector and other funded schemes to calculate the ongoing cost of benefits is relevant for this purpose, i.e. setting a floor on the rate used for SCAPE purposes, this raises the question of what rates are actually used by those schemes with the strongest employer covenant. Unfortunately information about the discount rates used by individual schemes is not readily available. However, the Pensions Regulator (tPR) produces a survey of relevant information in its publication Recovery Plans, Assumptions and triggers (The Pensions Regulator, 2010) and, as part of the survey, it looks at the discount rates used by private sector funded schemes. This shows that the weighted average of the real discount rates used in the most recent tranche of recovery plans, i.e. those with an effective valuation date 22 September 2008 and 21 September 2009, was 2.35 per cent. This figure is what tPR describe as the single effective discount rate (SEDR), which allows for those schemes that have adopted the practice of using different discount rates before and after retirement.

However, it would not be correct to assume that 2.35 per cent is the rate that it would be appropriate to use as the floor, since it is averaged across all schemes, rather than being the rate that is appropriate for schemes with the strongest

employer covenant. It is also apparent that for the sake of simplicity many schemes use the same discount rate as that used to calculate their technical provisions, even though it includes a margin for prudence. For both these reasons it can be taken that the floor for the SCAPE discount rate will be significantly higher than 2.35 per cent. We suggest that a reasonable estimate of the appropriate increase can be obtained from the figures in the tPR report that show the range of assumptions that have been made about the SEDR. These show that the scheme at the 5th percentile of the distribution, which it is reasonable to assume provides a proxy for those schemes that have an employer with the strongest covenant, used a discount rate that is 0.86 per cent greater than the overall average. This suggests that the floor to the discount rate for SCAPE purposes that is set by the practice of funded private sector schemes is around 3.21 per cent. We would expect the SCAPE discount rate to be higher than this figure, as explained below.

Option 2. A rate based on the yield on index-linked gilts;

We do not believe there is any logic in basing the SCAPE discount rate on the yield on index-linked gilts. This is a version of Option 1 but with the restriction that the comparable private sector scheme is invested in gilts. However, it is worth emphasising in this context that there is a basic misunderstanding about how to assess the cost of two different things:

- The cost to the State of providing a pension with a given level of security; and
- What it would cost the individual to secure a pension with that level of security on his or her own account.

As explained above, it is the former which is relevant when setting the discount rate for SCAPE purposes, rather than the latter. The cost of providing a guaranteed level of benefit through a personal pension would be substantial and, for the purpose of estimating that cost, the rate of return on gilts might be relevant. However, in the context of the current review, we are not looking at what it would cost individuals acting on their own; what we need to know is the cost that is incurred by the State. Put simply, the latter will be significantly less costly than the former, in terms of the obligation that is incurred. Consequently, the cost of providing a pension through a state sponsored pension scheme (whether funded or unfunded) is bound to be less than the cost of providing the same amount of pension through any private sector arrangement that is invested in gilts.

As the State can provide a strong covenant at no cost, it will be less expensive to provide a given pension through a State sponsored scheme than it would be for a private sector employer or, even more so, for an individual. What this means as far as unfunded government sponsored pension schemes are concerned, is that treating them as though they were invested in index-linked gilts makes no sense. It does not increase the security of members by being subject to the constraint of having to invest in physical assets, so there is no reason why it should be treated as though it is. Significant savings can be achieved by providing benefits collectively, particularly in the public sector, and it would be wrong for members to be charged for costs that are not actually being incurred.

In any event it cannot be assumed, even if public service schemes were to be invested in gilts, that the necessary bonds would be available on the same terms as they are available in the absence of such a practice. Gilt yields are market driven and, hence, are significantly influenced by the supply and demand of these instruments in investment markets. In addition, they are subject to significant variation as a result of government policy or developments in other areas of the investment market. As a result it would be inappropriate for current yields to be used, even in the absence of the other arguments set out above.

Option 3. A rate in line with expected GDP growth

The expected rate of GDP growth does not have a role in the derivation of the SCAPE discount rate, other than as one element in the approach based on the concept of the social time preference rate that is discussed below. In other words, while the expected rate of GDP growth is relevant, account should also be taken of the other elements that make up the social time preference rate, including an allowance for society's preference for expenditure to be incurred in the future rather than today, referred to as "pure time preference" and catastrophic risk. However, it should be noted that the way in which the social time preference rate is calculated makes it implausible that it would be any lower than the expected rate of GDP growth.

Option 4. A Social Time Preference Rate that makes allowances for the particular context of pension provision.

The TUC supports a social time preference rate (STPR) approach to setting the SCAPE discount rate, along the lines set out in HM Treasury's own Green Paper on appraisal in central government (HM Treasury, 2006). The main advantage of the STPR approach is that it is an accurate reflection of what is going on, i.e. it is the right approach to use where a financial decision has to be taken by the government at a point in time that is removed from when the decision is given effect. Much of the criticism of unfunded public service pensions arises from a failure to understand the nature of unfunded pension liabilities in the public sector and how, more generally, political judgments should be made on issues of public policy that depend on income or expenditure that arises at some time in the future.

Such "inter-generational" judgments are difficult but they have to be made and, when they are made, they need to be made on a consistent basis. To this end the Treasury has laid down the policy it wishes to see adopted when making such judgements in its publication the Green Book. The TUC understands that the Treasury still follows the process set out in the Green Book when assessing future expenditure and that the underlying approach is not in question. It is, for example, still used for the closely analogous task of assessing the cost of changes in both State and private sector pensions in the various impact assessments accompanying the current Pensions Bill. We cannot see any logical reasons why it can be appropriate to use a discount rate of 3.5 per cent in some areas of pension policy and not in others.

The question arises, therefore, as to why a different form of assessment should be made in respect of future public service pension payments and public service

pension payments alone. We understand that the Treasury is responding to comments made by the IPSPC but it is clear that these comments are more in the form of questions, rather than a reasoned critique of the Green Book.

The Green Book's approach to the STPR

The Green Book explains the STPR approach in its introduction, as follows:

1.1 "The Treasury has, for many years, provided guidance to other public sector bodies on how proposals should be appraised, before significant funds are committed – and how past and present activities should be evaluated. This new edition incorporates revised guidance, to encourage a more thorough, long-term and analytically robust approach to appraisal and evaluation. It is relevant to all appraisals and evaluations"

The argument that is presented in the Green Book is relatively straight forward, with the report itself stating that it is not "rocket science". The full explanation can be found in the *Green Book* itself and it is unnecessary for it to be repeated at length in this submission. However, the key section reads as follows:

"5.49 For individuals, time preference can be measured by the real interest rate on money lent or borrowed. Amongst other investments, people invest at fixed, low risk rates, hoping to receive more in the future (net of tax) to compensate for the deferral of consumption now. These real rates of return give some indication of their individual pure time preference rate. Society as a whole, also prefers to receive goods and services sooner rather than later, and to defer costs to future generations. This is known as 'social time preference'; the 'social time preference rate' (STPR) is the rate at which society values the present compared to the future.

In essence, the *Green Book* makes it clear that when policy decisions have to be made now that involve income or expenditure in the future, there is a proper distinction to be made between the discount rate that it would be appropriate for individuals to use and the discount rate that should be used for society as a whole. Put simply, there are things that society as a whole can do that are just not open to individuals. One of the key differences is that individuals are subject to the exigencies of investment markets, while society as a whole is not. As a result the STPR does not go up and down with movements in markets, but is set for the long-term.

A useful explanation of this point was provided by the Government Actuary, Mr. Chris Daykin, in evidence to the Treasure Select Committee on 1 November 2006, as follows:

Mr Daykin: *"I think the concept is all part of the Treasury financing of public sector liabilities, so whether it is a true value or not depends on your understanding of what the cost to Government of providing pensions would be. The concept ... is that the cost to Government of providing pensions is not directly dependent in any way on the market; it is to do with the Government's ability to raise taxes in the future and to finance its long-term liabilities. So from one point of view, from Government liabilities, it should just be looked at as a cash flow issue as to what the call on the budget and on borrowing will be in the*

future—what the percentage of GDP will be that is allocated to paying for these liabilities. From another perspective the valuation process is intended to place a discipline on the employers and employees of public sector pension schemes, and the mechanism that we have does that without making it unduly volatile. It does ensure that the costs are brought home to the employers and employees at the time, whilst not subjecting those changes to the volatility of using market interest rates."

International practice on the STPR

There is an extensive literature on the subject of the STPR, with many learned academic papers, including those that are referenced in the *Green Book*. A more recent survey of both theory and practice is provided by a Working Paper from the Asian Development Bank (ADB) (Zhuang, Liang, Lin, & de Guzman, 2007). The literature makes it clear that the UK Government is not alone in using both the approach in general and a discount rate in the region of 3.5 per cent. For example, while the ADB survey reports that "There are significant variations in public discount rate policies practised around the world" it shows that developed countries like the UK use rates between 3 per cent and 7 per cent (Zhuang, Liang, Lin, & de Guzman, 2007). It is also possible to point to commentators who consider that a rate of 3.5 per cent is too low with one suggestion that it should be 5.5 per cent (Kula, 2006).

The general view, therefore, is that the technique is valid and it appears that the use of 3.5 per cent is not unreasonable. In any event, we feel it would not have been adopted by the Treasury if it was not regarded as legitimate. We also understand that the *Green Book* approach remains the basis for this sort of policy making and is not currently the subject of a specific review.

The STPR and pension liabilities

The TUC is therefore concerned at HM Treasury's failure to provide an adequate explanation in the consultation paper of the STPR approach and, in particular, at the implication that the current approach fails, in the words of paragraph 2.13, to make allowance "... for the particular context of pension provision". We see no attempt has been made to explain let alone justify such a distinction. As we explain in the introduction to our submission, the Government's future financial obligations are fungible, i.e. that there is no difference now between an obligation to pay a given pension and any other obligation of an equivalent amount, such as the cost of disposing of nuclear waste. In other words, the current cost will be the same for future pension provision as that for any other future financial commitments of the same amount.

The Interim Report of the IPSPC confused the issue where it claimed that it was debatable if the concept of catastrophe risk can be applied to public service pensions in the same way as it is used to value public investment projects. This displays a misunderstanding of the nature of the risk that it is appropriate to take into account when assessing the STPR. From the supporting literature, for example the report from OXERA (OXERA, 2002), it is clear that what is relevant here is not the risks inherent in the individual project but rather the systemic risks that face society as a whole. In practical terms, it must be assumed that society

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will seek to meet all its future financial obligations and that it will only fail to do so because of some catastrophic failure that will impact on all its obligations in the same way. It is for this reason that an allowance for risk is included in the calculation of the STPR. However, there is nothing in the literature or in the *Green Book* to suggest that the risk that is allowed for in calculating the STPR varies by the nature of the future liabilities.

We are therefore concerned that the suggestion that the liability to pay unfunded public service pensions is in some way different to other liabilities has been advanced simply to prepare the way to discriminate against public service workers. It is therefore incumbent on the Treasury, in responding to the consultation, to explain the precise nature of the difference, as no evidence-base for changing the discount rate for unfunded schemes is set out in the consultation document.

There is an important corollary that flows from the use of the STPR. Because the use of the STPR is not restricted to the assessment of the cost of public service pensions, any suggestion that it is an invalid approach to making decisions about policies with an impact on future expenditures or income - or even that the assumption of 3.5per cent is wrong - would have profound implications for decisions on a wide range of Government policies and programmes. At a time when public expenditure is under severe pressure it would clearly be perverse to change the process set out in the *Green Book* in a way that would result in a significant increase in the cost not just of public service pensions but also public services more generally.

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

The TUC is not aware of any other approaches to setting the discount rate used for SCAPE purposes.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

It will be clear from our response to Question 3 that our preferred approach to setting the SCAPE discount rate is the STPR along the lines outlined in HM Treasury's own *Green Book*. On this basis the TUC supports the continued use of the current discount rate for SCAPE purposes of 3.5 per cent over expected RPI increases. We appreciate that account will need to be taken of the shift to CPI increases and revaluation, to the extent that they apply in future, but any such adjustment should be cost-neutral. At this stage, however, there is probably

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insufficient data to produce a CPI based figure for the real discount rate for STPR purposes.

A STPR discount rate of 3.5 per cent is in line with the arguments made above that it should be greater than both the rate of discount used by private sector funded schemes where the employer has the strongest covenant and the expected rate of growth in GDP.

We note that the IPSPC raised some questions about some elements that make up the current rate of the STPR. However, as mentioned above, the Commission's relatively brief comments do not appear to be based on any sort of deep analysis of how the STPR should be calculated. For example, the Commission does not appear to understand the nature of the catastrophic risk that is taken into account. The arguments set out in the Green Book therefore provide a much more convincing approach to the calculation of the STPR.

The TUC is aware that the *Green Book* suggests that some circumstances, where a proposal depends materially upon the discounting effects in the very long term, there is a view that a lower discount rate for the longer term (beyond 30 years) should be used. In the event, the original decision by HM Treasury to adopt a SCAPE discount rate of 3.5 per cent did not reflect this practice. It is not clear from any of the published documents why this decision was taken and it would be helpful if HM Treasury were able to cast some light on why it was decided not to use a lower rate in the longer term. In the absence of any such explanation it must be assumed that the decision was made for good reason, such as the sheer complexity of implementing a discount rate that varies over time.

For these reasons there is no justification to reduce the discount rate, even when averaged over the whole period, to a figure that is around 2 per cent to 3 per cent. Instead, all the arguments support the TUC's conclusion that the discount rate should remain at 3.5 per cent.

Question 6: Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?

There is a limited need to review the discount rate used for SCAPE purposes for both theoretical and practical reasons.

We favour an approach to setting the discount rate used for SCAPE purposes based on an assessment of the STPR for the reasons outlined above. So, from a theoretical perspective, the discount rate is arrived at by considering the fundamental relationships that underlie the UK economy that, because of their very nature, are not subject to change in the short-term. It would be redundant, therefore, to undertake frequent reviews of such relationships. This is not to say that such relationships are not subject to change but this will occur only gradually and over a relatively long time-scale. This suggests that a review is needed only once in a generation, i.e. every twenty to thirty years.

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It is also clear that any changes should take place as infrequently as possible for straight-forward practical reasons. Where "cap and share" arrangements have been agreed between the relevant unions and public sector employers both sides are entitled to expect some stability in the benchmark that underlies the arrangement.

Conclusions

The current approach to setting the discount rate used for SCAPE purposes based on the use of the STPR is correct. We are not aware of any coherent argument as for why HM Treasury should depart from a well established approach to making a current assessment of future expenditure. Nor have any arguments been advanced as for why a given financial commitment should be assessed differently, compared to other commitments of a like amount, solely on the grounds that it relates to a public service pension scheme. Given this conclusion, there is no logical reason why the discount rate should not continue at the current rate of 3.5 per cent, unless and until it is changed for public spending more widely.

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

Alasdair Smith
University of Sussex

3 March 2011

Contact details:

Department of Economics
University of Sussex
Brighton BN1 9RF
alasdair@sussex.ac.uk
077 4009 1106

Disclaimers and acknowledgements

I am a Research Professor of Economics at the University of Sussex, chair of the Armed Forces Pay Review Body and a member of the Senior Salaries Review Body. I alone am responsible for the views expressed in this paper; which does not represent the views of the University of Sussex or of either pay review body. Neither I nor members of my immediate family have a financial interest in any unfunded public service pension scheme – I am a member of the Universities Superannuation Scheme, a funded defined-benefit private pension scheme. I am grateful to Nicholas Barr and Michael Johnson for comments on an earlier version of the note which appears as the Appendix.

Technical note

I have throughout this response referred to real interest rates by reference to the Retail Price Index (RPI). This is simply a matter of convenience since both indexed UK government bonds ('indexed gilts') and the social time preference rate (STPR) used in government investment decisions are linked to the RPI.

Introduction

The most important objective in setting the discount rate for valuation of public service pension contributions should be to value these contributions in a way that reflects the true cost of pension provision so that public expenditure and employment decisions are made in this light. Proper costing is essential to ensuring, for example, that public sector workers pay a fair share of the full costs of their pension provision and are not unfairly well treated compared with members of private sector pension schemes. Proper costing is also essential to making comparisons of total remuneration between workers in public and private sectors. It is particularly important that the true costs of public service pensions are not silently passed on to future generations of taxpayers.

Full costing of unfunded public service pensions does not necessarily imply that pension contributions in the public service should be the same as those in private sector employment; the government has inherent advantages as a provider of pensions. Different employers have different advantages in the marketplace and there are other respects in which private sector employers have inherent, not unfair, advantages.

In an unfunded public pension scheme, employee and employer contributions are effectively lent to the Treasury in exchange for which the Treasury has the obligation to pay pensions when they become due. The question of what rate of return should be attributed to the actual employee contributions and the notional employer contributions is a counterfactual question: what would the Treasury do if it did not have access to the pension contributions? The analysis in this document is based on different possible answers to this question. It turns out that a key issue is how the financial markets perceive government pension debt alongside government bonds.

One guiding principle of the analysis in this response is that because the government has inherent advantages as a pension provider, any proposition which arrives at the conclusion that public sector pensions are more expensive than private sector pensions must either be methodologically wrong or must imply that the public sector pension schemes are inefficiently designed. Specifically, the discount rate used in the valuation of unfunded public service pensions should not be less than the discount rates used in the valuation of funded schemes.

The argument that because public pensions are indexed government obligations they should be valued at the interest rate on indexed government bonds falls foul of this principle. The interest rate on indexed gilts is lower than any of the interest rates used to value funded private pension schemes so using the indexed gilts rate to value public service pensions would have the paradoxical implication of making public service pensions more expensive to provide than private sector pensions. The one peculiar and implausible set of circumstances in which it is appropriate to use the indexed gilts rate to value public service pensions is a set of

circumstances in which it would be easy and advantageous to move public service pensions immediately on to a fully funded basis.

The main conclusion of this response is that the rate of discount applied to public investment, the 'social time preference rate', is the most appropriate rate to use in the valuation of unfunded public pension schemes

Responses to consultation questions

Question 1: Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

I have nothing to add to the analysis in Chapter 1 of the consultation document.

Question 2: Chapter 3 sets out objectives for the Government in setting the SCAPE discount rate. Are there other objectives that should be taken into account?

There are no additional objectives which I would add to the list in Chapter 3. However, I do not believe that all the objectives in Chapter 3 have equal weight.

The most important objective is that the rate should be a *fair reflection of the opportunity cost* of financing unfunded public pensions, and a *fair reflection of risk* is part of the assessment of cost. (In the arguments presented below, I assume that risks to government income are incorporated into market interest rates on government borrowing and discount rates on public investment.)

It is desirable that the pension system support *plurality in the provision of public service*, but undesirable that the discount rate be moved from the level which fairly reflects true costs in order to support plurality in public service provision. Other policy interventions should be used to promote this objective if problems are seen to arise from the fact that public sector employers have genuine cost advantages in the provision of employee pensions.

It is desirable that the discount rate be set in a way that is *transparent and simple*, but inter-temporal economics and actuarial science are difficult subjects which often defy simple explanation; and the economics of unfunded pension schemes is not widely understood. The rate should be set according to the correct principles, and effort put into explaining these principles; rather than the rate being set on a basis chosen *because* it is transparent and simple.

It is desirable that the rate be reasonably *stable*. Given that the decisions being guided by the rate are necessarily long-term decisions involving inter-temporal choice over decades, the parameters which guide that choice should be stable. Any proposal for choice of the rate which could involve significant and frequent changes

must be conceptually wrong. It is desirable that practice in the public sector should mirror good private sector practice as much as possible, and review of the SCAPE discount rate on a similar frequency to which funded pension schemes conduct actuarial reviews seems appropriate.

Question 3: Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

Option (a) - a discount rate consistent with private sector and other funded schemes

The advantage of this option is that it creates a ‘level playing field’ in pension costs between the public and private sectors. However, the public sector has certain advantages in the provision of pensions (favourable access to financial markets, strong employer covenant, economies of scale in pension administration) so it should be cheaper for the public sector to provide pensions than even the largest and most secure private sector employer. Setting the SCAPE rate lower than the discount rates used in private sector pension valuation would imply that it is inherently more costly to provide pensions in the public sector, and this is clearly wrong. It follows that the rates used in private sector pension valuation provide a useful *floor* for the SCAPE rate.

As an illustration of such floor rates, one could take the rates derived in the recent report of the Government Actuary [2] on the calculation of the rebate for opting out of the state second pension: in his ‘best estimate’ calculations (the ones which the Secretary of State actually used to set the rebate), he uses discount rates of RPI + 3.9% for a scheme member 25 years from retirement, RPI + 3.1% 10 years from retirement, and RPI + 1.7% at and after retirement, all derived from the returns to typical pension fund asset portfolios. On the somewhat more risk averse ‘typical funding’ basis, he derives rates of RPI + 2.75% pre-retirement and RPI + 1.25% post-retirement. Paragraph 3.6 of the consultation document suggests rates would be “in the region of 2.5 per cent to 3.0 per cent above RPI inflation” if this approach were followed; and this range is not out of line with the Government Actuary’s rates.

Option (b) - a discount rate based on the yield on index-linked gilts

A representative recent example of the case for making the SCAPE rate equal to the yield on index-linked gilts is the 2010 report of the ‘Public Sector Pensions Commission’ (PSPC) [5] (*not* Lord Hutton’s Independent Public Service Pensions Commission) which (p.20) states: “Firstly, this [government pension] commitment is an asset to the employee which is every bit as valuable as an index-linked gilt.

When calculating the value of a pension it is therefore reasonable to discount the amount of the pension at the rate of return from index-linked gilts."

This argument is incorrect, firstly because a public pension commitment is *not* "every bit as valuable as an index-linked gilt" – this year the government has switched the indexation of public pensions from RPI to CPI, reducing at a stroke the value of its pension commitments by something like 15% on average. Had the government done this to index-linked gilts, it would have been regarded by the financial markets as in default. Furthermore, it is questionable whether pension scheme members value the index-linked pensions provided by unfunded public pension schemes more highly than the index-linked pensions provided by funded schemes which are typically not invested wholly in indexed gilts. More fundamentally, the question to hand is *not* how pension scheme members value pensions, but what it costs the employer to provide the pension.

Turning then to the question relevant to this consultation, the cost to the public sector employer, the PSPC argues: "Secondly, the Government is using the money from pension contributions to pay for current spending – it is doing this instead of borrowing using, for example, index-linked gilts. As such, the rate of return it should pay should be the same whether it borrows by taking pension contributions from public sector employers and making pension promises in return or by issuing index-linked gilts."

The first point to make about this is one cannot simply use the market price of indexed gilts as the cost to the government of an indexed obligation. The market price of indexed gilts tells us the value of such a bond *to the private sector*. But the UK government is not a private buyer of indexed gilts, it is a monopoly seller, and we should not expect the opportunity cost to a monopoly seller of a product to be equal to the market price. Of course, other governments can sell indexed bonds, but bonds issued by different governments are not perfect substitutes, and the UK government should expect the price of indexed gilts to fall the more bonds are issued, that is to say, the interest rate to rise the more it borrows. The value of an indexed gilt to the public sector is the marginal revenue from its sale not its sale price; equivalently, the marginal cost of borrowing is not the interest rate but the marginal increase in borrowing costs as borrowing rises.

There is only one set of circumstances in which the PSPC's second proposition is correct: if the government faces a limit to its borrowing from the bond market *and* if the bond market treats gilts and pension debt as equivalent forms of government debt in the calculation of that limit *and* if the government faces an unchanging cost of borrowing up to that limit. In this case, an addition to pension contributions and obligations reduces by an equivalent amount the sum which the government can borrow in the bond market. The opportunity cost to the government of a pension promise is foregone bond market borrowing, and this marginal borrowing rate will be the indexed gilts rate only if the demand for indexed gilts is perfectly elastic. If the government acquires an additional £100 pension obligation payable in

10 years, it has to reduce its borrowing by the amount that at the indexed gilt rate would correspond to a £100 repayment in 10 years time, so the opportunity cost in present value terms is £100 discounted at the gilt rate.

The Appendix to this paper discusses the basic economics of unfunded pensions and shows that if the bond market treats gilts and pension debt as equivalent forms of government debt, then unfunded pension schemes could be painlessly switched into being funded schemes, holding only indexed gilts. In this case, the two pension schemes are strictly equivalent. It might then indeed be appropriate to use the indexed gilt rate as the SCAPE rate to value the unfunded scheme, as this is the appropriate rate for valuing the equivalent funded scheme.

Indexed gilts are a safe but expensive way to provide indexed pensions, which takes us back to the comment made on option (a): a public pension scheme which is more expensive than a conventionally funded private scheme is inefficiently designed and should be replaced.

If public pensions were in a funded scheme wholly invested in indexed gilts or in a strictly equivalent unfunded scheme, employers and employees would be paying much more for their pensions than they would in a funded scheme with a 'normal' portfolio of assets. As is set out in more detail in the Appendix, public pension schemes would be paying a high price for providing the government with cheaper borrowing than they would face in the open market. This would be both inefficient and unfair.

In any case, the key assumption here about the bond market seems simply to be untrue. One might think that the financial markets *should* rationally treat pension debt as equivalent to government financial debt. Media discussion of the fiscal problems of different countries and of the difficulties that some central European countries have recently faced in the bond markets because of their funded public pension schemes show, however, that financial market do not behave in this way; not least, perhaps, because the markets are aware that governments can default on pension promises more easily than on government bonds.

To sum up: if Giorgio Armani gives you a £2000 Armani suit, would you value this gift at £2000, though the suit cost him less than this to produce, it is not something you would spend £2000 of your own money on, and a hole labelled CPI indexation has been cut in each pocket?

Although the case for the use of the indexed gilt rate has superficial plausibility and has received much attention in recent years, it crumbles under close scrutiny.

Option (c) - a discount rate in line with expected GDP growth

The rate of expected GDP growth is very relevant to consideration of public sector pensions policy. The report of Lord Hutton's Independent Public Service Pensions Commission rightly gives much emphasis to the ratio of net public pension pay-

ments to GDP as an important indicator of the scale of the public policy problem. In interpreting the path of this ratio, it is, of course, necessary to take account of contextual issues, such as the changing size of the public sector and the demographic structure of different parts of the public sector workforce, but it remains an important statistic.

There is a reasonable argument to be made that the valuation of unfunded pension schemes is a scholastic exercise and that one should simply focus on the role of public pensions in the fiscal landscape, for which the ratio of pension payments to GDP is the key indicator. This is certainly a very respectable argument to make in relation to state pensions. One doesn't then need a discount rate. But if one wants to consider important issues that are not captured in the fiscal statistics, like employment cost comparisons in public and private sectors, a pension valuation and a discount rate are needed. There is, then, simply no available argument that translates the fiscal statistics into a discount rate related to GDP growth. The GDP growth rate is an important statistic in establishing the fiscal significance of public pensions, but it has no role in establishing a discount rate for pension valuation.

Option (d) - a Social Time Preference Rate

The case for using a social time preference rate (STPR) is that this is the rate used in the appraisal of public investment, so it should equal the rate of return on the marginal public investment project. As the Appendix sets out in more detail, an unfunded pension scheme makes pension savings available to the Treasury. Therefore the opportunity cost of the pension scheme depends on the answer to the counterfactual question: what would the Treasury do if it did not have access to the pension contributions? One possible answer, that it would sell fewer gilts, leads in certain circumstances to option (b); but another possible answer is that Treasury borrowing via unfunded pension schemes allows additional public investment, which earns a return equal to the social time preference rate.

In an unconstrained market for government borrowing, the government should increase its borrowing so long as the marginal cost of borrowing is less than the STPR and should increase public investment as long as the marginal return on public investment is greater than the STPR. At the optimal levels of government borrowing and investment, the marginal cost of borrowing and the marginal return to investment are both equal to the STPR. It matters not whether the pension contributions which flow in to the Treasury from employee contributions and SCAPE transfers allow an increase in public investment or a reduction in public borrowing in the market – the rate of return on both is the STPR and this should therefore be the SCAPE rate.

On the face of it, the UK government is currently very far from this optimum: the STPR is set at 3.5% above RPI and the government can borrow in the indexed gilts market at less than 1% above RPI. Does this mean that the government should

abandon the path of fiscal consolidation and increase its borrowing? It does not. The government has explicitly argued that if it increased borrowing above the currently planned level, the bond market would exact a heavy price.

One interpretation of this is simply that increased borrowing would quickly drive up the gilts rate; equivalently, would quickly drive down the price of gilts. The government believes that it faces a steeply downward sloping demand curve for gilts: the marginal revenue from the sale of gilts is well below the price of gilts; equivalently, the marginal cost of borrowing is well above the market rate of interest on gilts. One cannot be sure that the level of government borrowing is optimised – the optimal rate of fiscal consolidation is a judgement not a calculation – but the best estimate of the marginal cost of borrowing is the STPR since at the optimal level of borrowing the two would be equal. In this case too, both the marginal return on public investment and the marginal cost of public borrowing are equal to the STPR, so the SCAPE rate should be set equal to the STPR.

Another interpretation of fiscal constraint, however, might be that the government faces a quantity constraint in the bond market – it may borrow up to a certain level, but any borrowing beyond this point would precipitate a crisis of confidence.

The crucial question in this case is whether the quantity constraint on borrowing includes pension obligations or not. In reality, the bond market seems to focus only on explicit government debt in considering fiscal solvency, in which case the government would face a limit to its borrowing in the gilt market which is independent of pension funding. In the situation where the STPR exceeds the government's cost of borrowing, an increase in public pension contributions allows the government to increase public consumption or investment – the rate of return on the pension savings is the STPR, and once again the SCAPE rate should be set equal to the STPR.

The logically appealing but implausible case where the bond market imposes a borrowing limit on government which encompasses pension debt as well as explicit financial debt *is* different. Now an inflow of pension contributions represents an increase in government debt and will require a reduction in other government borrowing. It does not permit an increase in investment or consumption. The government borrows from the pension scheme instead of borrowing in the bond market at the gilts rate, so the rate of return on pension savings is the gilts rate (or the marginal cost of borrowing, higher than the gilts rate, if the demand curve for gilts is downward sloping). This is the case already discussed under option (b) above; recall that it is argued there that if this were the state of the world, there would be a compelling case for an immediate switch to funding of public pensions.

With the exception of this implausible case, the conclusion is clear: **the STPR is the best measure of the rate of return to unfunded pension contributions** and if one wants the valuation of public pension funds fairly to reflect true costs, the SCAPE rate should continue to be set equal to the STPR.

There is then a separate issue of whether the STPR is currently set at the right

level. That raises wider and deeper issues about government policy that go far beyond the scope of this consultation. Nevertheless, it is worth commenting briefly on the level of STPR. When the SCAPE rate was initially set, the level of STPR was not very different from the return on gilts, but the widening gap between the two rates makes it more important to have confidence that STPR is set at the correct level.

The building blocks of the STPR are described in paragraph 2.10 of the consultation document: 1.0% for catastrophe risk – essentially the risk that the citizens for whose benefit public investments are currently being made will not be able to enjoy these benefits because of a catastrophe such as a nuclear war which wipes out the citizens and/or the investments; 0.5% for pure time preference; and 2.0% to reflect the growth of per capita consumption: because future citizens are expected to be richer than current citizens, less value is attached to the marginal consumption of future citizens than to the marginal consumption of current citizens. Each of these elements embodies difficult and subtle judgements.

The Stern report on climate change [6] made considerable use of the STPR, but made a judgemental case that 1.5% is too high an allowance for discounting and catastrophe risk together. Stern takes the 'moral' view that the possibility of population extinction is the only case for weighting the interests of future generations differently from current generations; and one can argue that the end of the cold war has significantly reduced the risk of catastrophe or extinction. On the other hand, other commentators take the 'realistic' view that the decision-making of democratic governments necessarily gives more weight to the interests of current voters than to the interests of their descendants and this would argue for a higher rate of pure discounting. Partha Dasgupta [1] and others argue that the judgement about the relative value attached to the consumption of future generations embodied in the use of the 2% growth rate of per capita consumption in the STPR formula is insufficiently egalitarian and that this growth rate might be more appropriately multiplied by 2 or 3.

There are respectable arguments therefore that the STPR should be lower than the current level of 3.5%, but equally respectable arguments that it should be higher.

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantages and disadvantages?

I have no further approaches to offer.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

Taking into consideration all the arguments presented in this submission, I recommend that **the SCAPE rate continue to be set equal to the STPR**. The STPR itself, however, needs to be regularly reviewed; and the Government needs to take a view on the factors which determine the actual value of the STPR, issues which I believe are beyond the scope of the current consultation exercise.

Further, if the STPR differs significantly from the rates of return typically used to value funded pension schemes, and if both of these rates differ significantly from the rate of return on government bonds, the reasons for the differentials need to be interrogated on a regular basis.

Question 6: Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often this should take place?

It is desirable that practice in the public sector should mirror good private sector practice as much as possible, and it would be appropriate to review the SCAPE discount rate as frequently as funded pension schemes conduct actuarial reviews.

Appendix:
The economics of funding unfunded pensions

Introduction

The interim report of Lord Hutton's Independent Public Service Pensions Commission (IPSPC) [3] had a brief discussion (paras 4.67-4.75) of the possibility of moving public service pensions on to a funded basis, but dismissed this as impractical, not least on the grounds that it would require some cohorts of public sector employees to pay twice – paying taxes or borrowing to cover the unfunded pensions of their predecessors while at the same time paying contributions into their pension fund.

It is understandable that the report should dismiss a shift to funding of public service pensions at this stage: it would not be feasible to adopt such a far-reaching reform on the time-scale within which Lord Hutton was asked to make recommendations, nor would a shift from unfunded to funded pensions address the central issue for the IPSPC – the fact that public sector employees are currently making contributions which cover a relatively small fraction of the likely cost of their pensions.

But a shift to funded pensions would have significant advantages in preventing a recurrence of the problem which the IPSPC is addressing. Public sector employers would be making cash contributions to actual pension funds rather than notional contributions to the Treasury's SCAPE fund, and public sector employees too would be making cash contributions, so the division of contributions between employer and employee would be transparent, and the issue of the adequacy of their joint contributions would be addressed in regular actuarial valuations of the pension schemes.

It is therefore worth considering whether the next *post*-Hutton step in the reform of public service pensions should be a shift to funding. This note looks at the basic economics of such a change.

How to switch the funding basis of public service pensions

It is sometimes said that unfunded, or pay-as-you-go, pension schemes are characterised by having the consumption of the retired paid for by the incomes of the working generations. But that's a fact of economic life, not a feature of an unfunded pension scheme: the consumption of the retired inevitably comes out of the production of the working generations. What characterises an unfunded pension scheme is the special nature of the financial arrangements which give the pensioners their claim on retirement consumption.

The invisible assets of an unfunded pension scheme are the obligations of the Treasury to pay (inflation-proofed) pensions. The pension scheme can be swit-

ched overnight (on 'day zero') to a funded basis if the government simply prints up index-linked bonds whose value and maturity structure correspond to the expected pattern of existing pension obligations. The bonds are handed over to pension fund managers, who also from this point on receive and invest employer and employee contributions and pay pensions. The value of the new bonds would be an eye-watering sum, of the order of £1000 billion, but their creation would be an essentially costless operation, apart from the costs of administrative and legal change and the printing costs of the new government bonds. Implicit government bonds are turned into formal bonds. The nominal stock of government debt will, of course, have nominally increased very considerably, by an amount of the order of £1000 billion, roughly the same as the current level of UK government net financial debt, so the reported 2010 ratio of debt to GDP would rise from 62% to something like 125%.

The implications of this change depend on what are the investment rules for the public pension funds.

Regime 1: investment only in non-tradable SCAPE bonds

The simplest interpretation arises if the bonds which the government creates for the public pension funds are not tradable – call them SCAPE bonds. Apart from their non-tradability, there would be one other feature of these bonds that would distinguish them from indexed gilts – they would be have to be indexed to CPI not RPI.

The pension fund 'managers' have no management to do apart from ensuring that the maturity profile of the SCAPE bonds created by the government matches the expected profile of future pension payments. There is a non-trivial and important accountancy task to be undertaken: valuing the SCAPE bonds and ensuring that the inflows of employee and employer contributions are sufficient to cover the costs of the additional SCAPE bonds which the fund would now buy from the Treasury. In the event that actuarial reviews of the pension schemes revealed that the schemes was underfunded, then there would be a pension deficit, which would be the liability of the government as guaranteeing employer.

New contributions would be invested in SCAPE bonds; and pensions would be funded from the interest payments on the bonds and the proceeds of bond redemptions.

It should be clear that the changes described above are *entirely* a matter of accountancy. There are no changes to public sector cash flows – pension contributions flow into the Treasury as before, and pension payments come from the Treasury. Importantly, there is no change in the indebtedness of the UK government – all that has happened is that debt which is currently implicit in the operation of SCAPE is made explicit as a stock of SCAPE bonds, plus possibly in due course reported funding deficits or surpluses. An adverse reaction by financial markets or

the bond rating agencies to the creation of a pile of SCAPE bonds valued initially at around £1000 billion would happen only if markets were subject to accountancy illusion; or had failed previously to realise that public pension obligations are government debt. In short, an adverse market reaction to an accounting change would raise serious questions about the role of rating agencies and bond traders whose understanding of public debt would be revealed as going no deeper than newspaper headlines.

Regime 2: investment only in gilts

Now go one step further and suppose that instead of supplying the public pension funds with non-tradable SCAPE bonds, the government issues them with indexed gilts. (If all indexed gilts remain linked to RPI while pension obligations are indexed to CPI, then the bond issue would have to be of whatever mix of RPI-indexed gilts and non-indexed gilts best matched the CPI-indexed pension obligations; but the essential argument remains unchanged.) If the pension fund managers are not permitted to trade in the financial markets, the position is essentially the same as in regime 1. The initial stock of £1000 billion of extra gilts is created at no cost, pension contributions flow into the pension fund which is obliged to buy gilts, so this cash flows into the Treasury as before, pensions are paid from interest earnings on and redemptions from the fund's stock of gilts, and this cash flows from the Treasury as before.

The only difference between this regime and regime 1 is that the pension fund is invested in gilts of the same type as are sold in the open market. They are tradable but not actually traded. Instead of the outstanding stock of gilts and bills valued at a little over £1000 billion (sitting alongside an implicit or explicit SCAPE debt of around £1000 billion) the value of the outstanding stock of debt would be in the region of £2000 billion.

The difference between this regime and regime 1 is partly a matter of accountancy, partly a matter of credibility. The debt which is currently implicit in the operation of SCAPE is made explicit not as a stock of SCAPE bonds, but as an addition to the stock of outstanding gilts. An adverse reaction to the gilt stock more than doubling overnight might be more likely than an adverse reaction to the creation on an explicit SCAPE fund, but it would on the face of it equally irrational.

However, the creation of a large stock of tradable bonds even if they are not traded does raise legitimate questions in investors' minds about possible changes in investment policy. The financial markets might react on the basis of a belief that the funds would be allowed in future to invest in a wider range of instruments, and it is to this possibility that I now turn.

Liberalising public pension fund investment

If the public pension fund managers were given freedom to invest, interesting economic questions arise: how the financial markets respond to the new situation, how the costs of government borrowing might change in consequence, and whether public sector pension provision might be changed as a result. A conventional actuarial valuation of public pension funds in regime 2 would in current circumstances result in high estimates of the cost of pension promises, and therefore high contribution rates to keep the fund out of deficit.

Indexed gilts are at least nominally an expensive way to fund pensions in current circumstances, because the real return on indexed gilts is currently very low – effectively all public pension funds would be invested in assets which are safe but apparently have a low rate of return. If the contribution rates required to fund such pensions were high, there would be pressure on the fund managers to move to a more conventional asset portfolio including equities and corporate bonds as well as indexed gilts. The expectation would be that such a portfolio would earn a higher rate of return, the required contribution rates would be lower, and there would be an element of investment risk, but acceptably low not just because of the pooling of investment risk in a diversified portfolio but also because of the pooling of investment risk between different cohorts of scheme members. Now there would be real changes.

Regime 3 – liberalisation of investment of new contributions

Suppose then that public pension fund managers were obliged to hold on to their inherited stock of government bonds, but were allowed to invest new contributions in other assets. One might expect that they would take advantage of this freedom initially to invest all new contributions in corporate bonds and equities. There would be good reason for financial market responses.

There would be an increased market demand for equities and corporate bonds, and an increased supply of government bonds, as the government lost part of its captive market in the public pension funds and had to borrow more in the open market. Again, absolutely no grounds for alarm – the increased rate of borrowing in the open market by the government would be a switch in government borrowing not a real increase, and there would be no major change in rational solvency calculations (though the rise in government bond yields would be an adverse factor in such calculations).

The interim report of the IPSPC quoted ([3], Table 4.A) an Office of Budget Responsibility forecast that by 2014-15, public service pension payments will exceed £30 billion per year. If the Hutton reforms raise contributions to an actuarially appropriate level, then the net financing needs of the public pension schemes would arise only from demographic imbalances in the schemes. Most public pen-

sion schemes currently have numbers of pensioners which are large relative to the numbers of active contributing members (the NHS being the notable exception) so actuarially determined contributions will fall short of £30 billion. Assuming the public service pension funds were allowed to invest new contributions in non-gilts, there could be an annual flow of a bit less than £30 billion into corporate bonds and equities from the public sector pension funds, and a reduction in the funds' holdings of gilts of a bit over £30 billion. Set alongside the existing levels of net borrowing by the UK government (between £35 billion and £45 billion annually throughout most of the period from 2001 to 2007), the market value of the stock of outstanding UK gilt and Treasury bills of just over £1000 billion, the value of non-government UK-issued bonds in excess of £2000 billion, the flow of public pension contributions would have material effects on relative prices in financial markets, lowering the cost of capital to the private sector and raising the cost of borrowing to the Treasury.

While the loss of a captive market for government debt might be a source of inconvenience to the Debt Management Office and a rise in the cost of government borrowing would be an unwelcome real increase in public expenditure, removing an artificial restriction on the investment of a large slice of the nation's saving would amount to removing a distortion in the capital market, and in principle this is a desirable move. The government should have to compete for funding with the private sector on fair terms.

It is often said that, at present, the yield on indexed gilts is artificially low, because the government does not issue enough of such debt to satisfy the appetite of private pension funds. And since the government is acquiring large volumes of indexed implicit debt in the form of obligations to pay indexed public service pensions and state pensions, a certain reluctance to issue large volumes of indexed gilts is understandable. Removing the government monopoly on bond sales to public service pension funds might help to deal with this alleged distortion.

Regime 4: complete liberalisation of public sector pension fund investment

If the public service pension fund managers were given a completely free hand to rearrange their portfolios and tried to off-load a large fraction of the government debt they were given on day zero, there could well be considerable turbulence in the markets. It would not be in the interest of the pension funds (or the government) if portfolio adjustments took place at a rate which led to large falls in the value of the main assets of the funds. But even if the pension funds were restrained in their use of their investment freedom, the prospect of £1000 billion of UK government debt coming on to the market might cause considerable nervousness. There would be a strong case for using regime 3 to gain experience of greater liberalisation before contemplating any liberalisation towards regime 4.

The governance and management of public pension funds

There would be important governance issues to consider. What kind of employer covenant would sit behind the public service pension funds? How would the funds be managed? What arrangements would keep fund management costs to an acceptable level, avoiding the scandalous levels of charges which have bedevilled many private sector pensions? Managing the costs of providing funded pensions has been a major policy theme from Adair Turner's Pensions Commission to the recent RSA report by David Pitt-Watson [4]. Freeing public pension savings from the constraint of compulsory investment in government bonds only then to have a high proportion of contributions swallowed up in high costs would not be an increase in economic efficiency.

Funding the state pension

The arguments advanced in this Appendix would mostly apply to the question of switching the state pension to a funded basis. State pension obligations are, however, even larger than public service pension obligations, so the potential for creating financial market turbulence is even greater. Furthermore, National Insurance contributions are now generally regarded as simply a part of the income tax system. The state pension is funded out of taxation not out of contributions and it has universal coverage, so the need to check whether contribution rates are fair and adequate does not apply. The case for changing the funding basis of the state pension is less strong.

Is there a 'pay-twice' problem?

Paragraph 4.73 of the IPSPC interim report [3] stated: "Any change to funded from unfunded status would also involve significant transition costs. The contributions in respect of current employees that are used at present to help finance pensions in payment would have to be diverted to the new pension funds. Those unfunded pensions in payment would then have to be financed through extra government borrowing or taxation. That could cost £20 billion or more a year for many years and the cost would only decline very gradually over the 21st century. That extra financing cost makes it very difficult, particularly at a time of fiscal consolidation, to move unfunded pensions on to a funded basis."

The analysis presented above in this note would modify these arguments. There is no double burden, nor is there a need for extra government borrowing or taxation. Hidden government borrowing would be replaced by explicit government borrowing but if pension fund managers were free to invest in a range of financial assets, there would be significant portfolio re-allocation effects in the financial markets which could raise the cost of government borrowing.

There may indeed be a double burden on current working generations, but it does not arise from the funding basis of public service pensions. Current contribution rates are evidently too low, and there is limited scope to redress this in relation to existing pensioners or workers close to retirement. The government therefore has a net debt (considering bonds and pension obligations together) that is larger than it would have been had past pension contributions been higher. The burden of repaying that debt will fall on current and future working generations, but unless the country runs into a fiscal solvency crisis, we can choose how to distribute the burden between current and future generations. It is not the case that the working generations of some period of transition to full pension funding have to bear the burden of the debt: it can be spread over a number of working generations, independently of the timetable of the pension funding transition.

Should the bond market become anxious about the fiscal solvency of the UK government, it would become necessary to have a fiscal consolidation so as to reduce the overall level of debt – then the burden of debt reduction would fall on a particular generation, who would of course at the same time be making their own pension contributions. But on the assumption that the bond market understands that unfunded pensions are government debt, a change in the funding status of public service pension schemes *should* have no effect on the likelihood of a fiscal crisis, except in the second-order sense that any rise in the government's borrowing rate would alter solvency calculations somewhat.

Citizens of a country with an over-borrowed government do indeed have a 'pay twice' problem – they have to pay for their consumption, public services and pensions while at the same time contributing to paying off past debts. Underfunding of pensions may have made a contribution to the creation of this problem, but the problem is a fiscal problem not a pension problem, and a change in the funding basis of public service pensions would not create, significantly worsen or solve the fiscal problem.

A modest experiment

The IPSPC's agenda for its final report included consideration of a 'hybrid' pension design for higher paid public sector employees, where salaries up to some benchmark level would be eligible to pay contributions to defined benefit pensions; while in respect of salary payments above the benchmark level, contributions could be made to a defined contribution (DC) scheme. If this hybrid model had been pursued by Lord Hutton, then having the DC part of the pension be in a funded scheme could have been regarded as a modest experiment in the funding of public pension provision. Furthermore, the funded, DC, state-sponsored NEST scheme being established as a result of the Turner report would have been an obvious vehicle for the DC part of a public service hybrid pension; not least because this would help achieve economies of scale. In the event, the hybrid option was not pursued in the IPSPC final report.

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The Leading Public Service Union

NIPSA Response to the Consultation on the Discount Rate used to set unfunded Public Service Pension Contributions

March 2011

NIPSA RESPONSE TO THE "CONSULTATION ON THE DISCOUNT RATE USED TO SET UNFUNDED PUBLIC SERVICE PENSION CONTRIBUTIONS"

1. NIPSA, the Northern Ireland Public Service Alliance, represents over 45,000 members across all areas of the public sector in Northern Ireland, including staff in the National Health Service, NI Civil Service and Local Government functions.

2. At the consultative event held by HM Treasury in Belfast on 22 February 2011 Officials advised that the review of the discount rate was purely a technical exercise which of itself had no implications for the levels of contributions that would be levied on employees. It was explained however that the setting of a lower discount rate could result in increased overall contributions from employers and employees although any increases to employer rates would be funded by central government allocations to public bodies which in turn would repay the higher contributions back to central government.

3. While paragraph 1.2 of the consultative document states that ***"the split in respect of how these contributions are shared between employers and employees is a question of pension scheme design that is beyond the scope of this consultation"***. NIPSA is clear that the objective of the review is to create the conditions for justification of further increased employee contribution rates. The review of the discount rate does in our view ***"drive a coach and horses"*** through the existing ***"cap and share"*** arrangements that have been agreed between the trade unions and employers/government in the range of non funded public service pension schemes.

4. Paragraph 1.31 of the HM Treasury consultative document refers to the level of employer contribution rates in unfunded public service pension schemes as ***"a key barrier to greater plurality of public service provision, potentially reducing efficiencies and innovation in public service delivery from independent providers".*** This reference relates directly to the Fair Deal policy review which is being taken forward separately by the Westminster

Government. This reference, in itself, undermines any portrayal of the consultation on the discount rate as a purely technical exercise and highlights the clear political objective of government to make it easier for private and voluntary sector organisations to compete for the delivery of public services.

5. Nonetheless if the case for any even playing field for both public and private sector competition for public service work is accepted as reasonable it is not clear how overall increased or decreased contribution rates will make it easier for private sector bids for public sector work. It would seem that provided the pension costs for private sector bidders reflect the cost of public sector pensions, the impact would be neutral. However the current government is planning to dilute the current Fair Deal arrangements to facilitate the further liberalisation of the public sector and any increases in public sector contribution rates combined with a withdrawal of the obligation on the private sector organisations to provide comparable pensions to those enjoyed by staff in the transferred/transferring functions can only be regarded as contributing to the creation of a non level playing field favouring the private sector at the expense of the public sector.

6. At the consultative event in Belfast on 22 February HM Treasury Officials were questioned about the equality impact assessments of the outworkings of the review. They were reminded that the Northern Ireland equality legislation in particular Section 75 of the NI Act 1998 placed particular responsibilities on the government to assess the potential negative impacts on a range of groups in society. There is a need for an initial Equality Impact Assessment prior to or at least at the earliest stages of the consultation. This approach has not been adopted and NIPSA would have serious concerns about the absence of a full equality impact assessment on this issue.

7. Notwithstanding the HM Treasury view that this exercise has no implications for the contribution rates for employees, any additional pressure on employee contribution rates will inevitably drive lower paid public servants out of their occupational pension schemes as wages and salaries are frozen and restricted and price inflation increases with a disproportionate negative impact on low and middle income earners. A recent GMB union survey on this issue demonstrates this to be the probable outworkings of any increased employee contribution rates. This view is shared by the Local Government Association as set out in the letter of 16 February from Baroness Eaton to the Chancellor of the Exchequer.

8. In addition to the above NIPSA would emphasise the following points:-

   (a) Any change to the discount rate would have no bearing on the actual liabilities and amount of money paid out by government to members of unfunded public service pension schemes.

   (b) The Hutton Report (Interim) stated that the current discount rate was at the high end of what was appropriate confirms implicitly that the current discount rate is within an acceptable range and there is no necessity for change.

   (c) The cap and share arrangements must be factored into the consideration of the discount rate and care should be taken not to undermine the joint approach by employers and trade unions to address affordability.

   (d) The Pensions Policy Institute views that the affordability and sustainability of public sector pensions is a matter relating to the government's view on the importance of providing public sector pensions.

   (e) The switch to the CPI measure from the RPI will reduce the cost of public service pensions, anywhere from 15 to 25%.

   (f) Recent government estimates that the liabilities have been on an upward trend do not equate to any real underlying cost increase of public sector pensions to the taxpayer. In fact the 2007/08 changes and post 2010 election decisions have significantly reduced the projected liabilities.

9. It is against this background that consideration needs to be given the specific questions posted by the HM Treasury consultative exercise.

Question 1: Are there any other impacts arising from a change in the discount rate?

10. A reduction in the discount rate will increase political pressure for further increases in employee contribution rates. This will have broader impacts

which would include making membership of a public service pension scheme less attractive especially to low and middle income employees, driving employees out of these schemes or reducing the potential membership and as a consequence increasing the number of public sector employees who will be dependent on state benefits in their retirement.

Question 2: Are there other objectives that should be taken into account by government in setting the SCAPE discount rate?

11. At face value the objectives laid down at section 3 of the consultative document appear to be reasonable. However we would not regard ***"support for a plurality of provision of public services"*** as a legitimate objective. It represents an attempt to set discount rates in a way which favours the opening up of public service provision to the market. This should not be a factor in the review of discount rates.

12. The ability to attract and retain highly motivated and skilled personnel to the public service must be factored into the consideration of the discount rate. Public sector pensions are regarded by staff as an integral part of the overall remuneration package and discount rates should be set with a view to retaining the support of the public sector workforce for what it regards as a fair and equitable remuneration system which includes pension provision.

Question 3: What are the advantages and disadvantages of the four options indentified by the Commission for the approach to setting the SCAPE discount rate?

13. NIPSA favours the retention of the present method ie the Social Time Preference Rate (STPR) provided the various elements of it are justifiable. There is an onus on the government to justify any move from the current utilisation and structure of the STPR. Consultees are asked to justify the use of the current rate. Instead the government should explain in detail its rationale for departing from the existing arrangements. No evidence has been produced by the government.

Question 4: Are there further approaches to setting the SCAPE discount rate that the Government could consider? If so, what are their advantage and disadvantages?

14. As detailed at paragraphs 13 and 16 of this submission NIPSA does not favour a move away from the STPR and believes that stability of approach is essential to a sustainable long term approach to pension funding. The government should have identified any options that it considers viable rather than bottom trawling for options.

Question 5: Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

15. NIPSA in this submission has set out its views in respect of the case for the status quo in respect of the methodology for determining the discount rate. In doing so, the case has also been made to maintain the current discount rate, to do otherwise would cause irrevocable damage to both scheme sustainability and participation rates.

Question 6: Regular Review of SCAPE Discount Rate

16. In respect of the question of creating a mechanism for regular review of the SCAPE discount rate, we do not believe that regular reviews of the discount rate would contribute to the need for stability in the level of benefits and costs. The long term nature of pension liabilities and costs require a long term approach which provides employees and employers with an assurance that pensions of public servants are not subjected to potential political objectives and ultimately interference.

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

This response is submitted by Unite, the UK's largest trade union with almost 1.5 million members across the private and public sectors. The Union's members work in a range of industries including manufacturing, financial services, print, media, construction, transport and local government, education, health and not for profit sectors.

Unite has about a quarter of a million members in public service pension schemes, whose pensions might be directly or indirectly affected by this Review

Executive Summary

- Unite supports fully the submission to the Consultation made by the TUC, which argues that the current basis on which the discount rate is determined remains valid, and this submission is intended to emphasise and expand on some aspects of it.
- This Consultation is an attempt to put an economic rationale on a politically driven initiative to reduce member benefits and increase member contributions

- The cost of public service pensions is under control and fully accounted for, as it should be, on a basis consistent with all other public expenditure
- The Government can provide pensions much more cheaply than private employers can; the lower cost of benefits is not a product of an inappropriate discount rate but rather its unique position as a provider
- The Government may wish to reduce the benefits of public service pension schemes but its case will not be strengthened by placing an artificial figure on what it costs to provide them which is inconsistent with the way other public expenditures are evaluated

The Unite case in detail

1. Unite does not believe there is any valid reason why the discount rate used to value the unfunded schemes needs to be changed, and that a rate of 3.5% above inflation remains appropriate.
2. In its Interim Report, the IPSPC (Hutton) Commission called for a review and asserted that the current rate was at the top end of a range of what might be appropriate. We believe this conclusion was driven by a failure to understand fully the basis on which the rate is set and a comparison with a range of generally inappropriate measures.
3. It is important to note first that the discount rate does not affect the cost of benefits provided by the schemes. The cost is determined by the benefit rules and factors such as the mortality, and changes in the numbers and pay increases of the members. These costs are already controlled by the provisions for cost sharing and capping in the largest schemes.
4. Assessments by the ISPSPC, the National Audit Office, and by the Office of Budget Responsibility (OBR) have all confirmed that the cost of benefits as a share of national income will fall substantially. This means there is no problem of affordability of the schemes given their current benefits and levels of member contribution

5. A change in the discount rate will affect the level of combined employer and employee contributions, as is calculated as being required to pay for the benefits. This is because an alternative conception of the discount rate is of a notional investment return earned on contributions, and if it is lower then more of the cost needs to be met from contributions (and vice versa).

6. A lower discount rate might lead to decisions either to reduce members' benefits, so as to reduce contributions, or to increase either members or employer contributions. The Treasury might save money either at members' expense or if public sector employers were required to set aside a greater proportion of their current spending to pay for pensions and their overall budgets were not increased to compensate. The latter would amount in effect to a cut is public spending.

7. In the Consultation Document it is stated that any change in the discount rate will not affect past service benefits and that Departmental Budgets will not be adversely impacted by any change in respect of the future. From this it can be concluded that the current discount rate will continue to apply for all past service benefits and that for the future the outcome of the review, in terms of any attempt to offset any increased contribution cost, will fall entirely on the members.

8. So, the purpose of the review is to support a case that either benefits are too high or that member contributions are too low.

9. As far as the Treasury is concerned money spent on providing pensions for public service workers is no more costly than money spent on any other type of public expenditure. It all comes from the same pot and is accounted for centrally. There is only one discount rate applied across all government spending and for this reason there is no economic logic in identifying issues peculiar to any particular area of spending when considering what that overall discount rate should be.

10. An alternative frame of reference would be to compare the government's general discount rate with that used overseas and on that basis our understanding is that the UK rate is at the lower end of the range which other countries consider to be appropriate.

11. It is only the discount rate in relation to public service pensions that is being reviewed, rather than the discount rate as it applies generally or the

discount applying to each type of spending. Even the discount rate used to assess the cost of something as closely related as State Pensions is not subject to review.

12. It is a fact that the Government is in a position which allows it to provide pensions much more cheaply than private sector employers can. It has the advantage of scale, greater financial strength and it can avoid the costs inherent in funding.

13. A lot of the suggestions that the cost of public service pensions are not properly accounted for is based on ignoring this cost advantage. The suggestion is that public service schemes only provide current levels of benefit because they are not properly accounted for. The prescription which follows is that benefits should be accounted for as if provided by a private sector employer, with the implication that they should be reduced.

14. This concept, generally, does not recognise that the discount rate used should reflect the different criteria as might be applied to a private sector employer. The comparator should be with a private sector employer with the very strongest employer covenant, not with private sector employers in general. On that comparison a discount rate of 3.5% above inflation would not actually be at all unreasonable.

15. A more legitimate debate might be on the question as to who should benefit from the Government's ability to provide pensions more cheaply. The answer should not simply polarise as whether it should be either the taxpayer or the scheme member.

16. The Government should see advantage in using pensions as a cost-efficient means of recruiting and retaining good staff to work in the public services. It is much cheaper for it to compete on pensions than on pay.

17. The use of a lower discount rate would amount to the Government deciding to forego its natural advantage as a pension provider and voluntarily handicapping itself.

18. The concept that the discount rate should be set so that pension provision was not a barrier to greater plurality of public services is going down this line. To follow it would be to allow the tail to wag the dog. In practical terms it would also fail to account for the fact that contractors

could have very different strengths of covenant and therefore different discount rates and pension costs.

19. Changing the discount rate will not alter the cost of the benefits to government, but it will create a distortion in government accounting.

20. If the Government wishes to make proposals for pension benefits and contributions then it should make those proposals on their merits, rather than seeking to justify them by manipulation of the discount rate.

This response is submitted on behalf of Unite by

Gail Cartmail
Assistant General Secretary – Public Services

28 February 2011

Enquiires relating to this submission should be submitted to :

Bryan Freake
Unite Pensions Officer
128 Theobalds Road
London WC1X 8TN

bryan.freake@unitetheunion.org

020 7611 2525

Submitted to discount rateconsultation@hmtreasury.gsi.gov.uk
(Closing date 3 March 2011)