

The recent General Election afforded the Government a break from its grapples with the rising cost of pension provision for public sector employees. Now, the debate is set to resume, reports Seamus Ward.

features

# tackling the pensions timebomb

■ **In trade union terms, senior civil servants are a calm lot. Whitehall's pinstripe platoons have not been on strike in more than two decades and the last time they balloted on industrial action was 1981.**

Yet in March they came mightily close to downing fountain pens and joining teachers and council workers on the picket line. What could have raised their ire and brought such strange bedfellows together? Labour's attempts to reduce the cost of public sector pensions.

Pensions will always be a touchy subject in the public sector. Many public sector workers believe they have accepted wages that are lower than the private sector in

return for better pensions and earlier retirement. So it was no surprise when unions insisted pension reforms unveiled by the Government last autumn meant no jam today and no jam tomorrow.

The threat of strikes was only headed off by promises of further talks. Labour, terrified of the political impact of a mass public sector strike on the eve of this month's general election, decided to bring the unions in for further negotiations and made clear its intention to revoke the changes in the local government scheme that were implemented on 1 April. Until talks are concluded the future shape of the pension schemes is in limbo.

#### present arrangements

There are seven public sector pension schemes, covering police, fire officers, teachers, NHS staff, armed forces, civil servants and local government. Most are unfunded – each year's liabilities are paid out of current revenue. Only the local government scheme is funded – the liabilities are paid from assets held. There are also quasi-public sector schemes, such as the funded universities and colleges scheme.

The latest Government figures estimated the liabilities of unfunded public sector schemes to be £425bn in April 2003. But actuaries Watson Wyatt believe this is wrong as the

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## tackling the pensions timebomb (continued)

Government used a discount rate of 3.5% (a figure set by the Financial Reporting Advisory Board). Watson Wyatt believes the discount should be 1.76%, in line with Government index-linked gilts, raising the unfunded public sector pension liability to £690bn.

The Government believes the FRAB figure is too high and will use a discount of 2.8% in its 2005/06 valuation. This would put the liabilities at £550bn – more than twice the pension liabilities of the FTSE 100 companies.

In 2003/04, £18bn or 1.6% of GDP was paid out in public sector pensions. The amount paid out in liabilities (£16.5bn) dwarfed the amount brought in by members' contributions (£3.8bn), producing a net cost of £12.7bn.

The local government scheme costs around £3.5bn a year, paid from local government revenue. Members also make contributions and the scheme aims to raise profits through investments. The scheme has liabilities of £92bn but its assets stand at £83bn. However, the latest estimate from CIPFA puts the local government scheme's deficit at £30bn.

As salaries increase, people live longer and with more public sector staff (an additional 10% between 1998 and 2003), pension liabilities can only rise. This has forced the Government to act.

Peter Robinson, senior economist at the Institute for Public Policy Research, says governments have been slow to reform public sector pensions but believes we should not approach the problem with a gloomy outlook. "There is some very good news here. We are all living a lot longer but the corollary of that is the pension system was never designed to keep people in retirement for as long as it is being asked to," he says.

"British public sector workers aged 40 can expect to live through to their late 80s. If they retire at 60 they will expect payment for another 25 or 30 years after having worked for 40 years. That arithmetic doesn't add up."

### tackling the shortfall

The Blair Government's own report on pensions – led by former Confederation of British Industry director general Adair Turner – agreed there was a shortfall. Its first report last October suggested this could be met by a combination of increasing taxes or the National Insurance Contributions devoted to pensions, higher personal saving and later retirement. More detailed proposals are expected in its second report this autumn.

The schemes are moving to a standard retirement age of 65 from 60 – this is not the age at which staff can retire but the earliest they can retire on full pension. The unions were incensed as public sector workers tend to retire in their early 60s.

Their anger was fuelled further by proposals that will reduce the value of public sector pensions. The NHS and Civil Service schemes are considering moving from final salary to career average salary as a means of determining pension benefits. Some schemes (teachers, NHS and local government) may stop paying a lump sum in addition to a pension, though pensions will be higher. However, the police and fire fighters' schemes propose to introduce lump sums, with lower pensions.

Only new members will feel the full impact of the changes, though they will apply to existing members' benefits earned after the reforms are introduced. Members' contributions will change in all but the



teachers', civil service and armed forces schemes. In the NHS, members' contributions will be standardised at 6%, while in local government it will rise from 6% to 7%. The value of 'gold standard' pensions for police, fire fighters and soldiers will be reduced following a reduction in their accrual rate, though this will be compensated with a drop in members' contributions.

The Government is also proposing an accounting change in the fire service pension scheme to bring it in line with the other unfunded schemes. Currently, pensions are paid from fire authorities' operating accounts but in future they will be paid from separate pensions accounts, with the Government making up any shortfall with a special grant. The Government believes this should counter volatility in pension spending and protect frontline services' funding.

The IPPR's Peter Robinson believes the reforms are sensible. "The switch to an average salary rather than final salary as a way of determining people's benefits is good news for less well paid workers but not such good news for the better paid. It will make public sector pensions more equitable."

But he warns the reforms will not stop the rise in pension liabilities. Even if the reforms are introduced, it is believed the net cost of unfunded schemes will rise to 2.3% of GDP by 2033 before levelling off at 2.2%.

"Even on the Government's own figures, spending on public sector pensions as a proportion of GDP will continue to rise over the first half of this century. With a bigger share of the country's revenue going on public sector pensions, choices elsewhere will be more difficult," he says.

In other words, future governments will have to choose between cutting other areas of expenditure or raising taxes.

#### impact on public services

What impact could the changes have on the public services? Some commentators have suggested public sector workers will no longer accept lower pay and in a tightening labour market, workers will abandon the public sector.

Robinson does not believe this will be the case. "After the changes are introduced, on average a public sector pension will still be significantly more generous than the average private sector pension. So the public sector will still have an edge in retaining and recruiting staff. There is always an issue here in terms of the gap between people's perception and reality but over time people will recognise they are getting a good deal relative to most companies' pension arrangements."

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#### benefits

The Pensions Policy Institute agrees. It says that currently public sector pension benefits are worth an extra 5% to 20% of salary compared with those in the private sector.

"After the full impact of the reforms, public sector pensions will typically be worth an extra 3% to 18% of salary, compared with private sector pensions. Benefit improvements make up for much of the reduction in benefit value from the change in normal retirement age," it adds.

This may be of little comfort to public sector staff worried they may no longer be able to look forward to a comfortable retirement. The Blair Government wanted a 'fresh start' on pensions and with the election now out of the way the talks can begin. But ministers beware – unions will not give up their members' pension rights easily. ■

Seamus Ward is a freelance journalist