

Reforming public sector pensions

Corin Taylor, Senior Policy Adviser at the IoD and Secretary to the Public Sector Pensions Commission, summarises the Commission's recent report, which set out options for public sector pensions reform.

ABOUT THE COMMISSION

It is increasingly clear that, with ever growing longevity, reform is necessary to ensure that public sector pensions remain financially sustainable for the long term. So the IoD joined forces with other organisations and individuals, including the Institute of Economic Affairs and Policy Exchange, to set up the Public Sector Pensions Commission, which is chaired by a Fellow of the Institute of Actuaries, in the autumn of 2009 (www.public-sector-pensions-commission.org.uk).

The Commission's terms of reference are to improve transparency and public understanding of public sector pension costs and present to the new Government a realistic set of options for reform of the present public sector pension arrangements.

The Commission is made up of the following individuals:

- **Peter Tompkins, Fellow of the Institute of Actuaries, Chairman**
- **Philip Booth, Institute of Economic Affairs, Vice-Chairman**
- **David Acland CBE DL, CHK Charities Ltd**
- **Ros Altmann, independent pensions expert**
- **Dr Andrew Lilico, Policy Exchange**
- **Neil Record, Institute of Economic Affairs**
- **Malcolm Small, Tax Incentivised Savings Association**
- **Corin Taylor, Institute of Directors, Secretary**

SNAPSHOT

- The IoD has joined with other organisations to set up the Public Sector Pensions Commission (www.public-sector-pensions-commission.org.uk). This article summarises its report.

- Increasing longevity and an ageing population mean that pension arrangements in any sector need to be looked at again.

- The true costs of public sector pensions are hidden by the effect of artificial government discount rates. Total contributions from employees and employers average around 20 per cent of salary but, measured properly, the main public sector pensions are worth at least 40 per cent of salary on average.

- 94 per cent of public sector employees are in defined benefit pension schemes, compared with just 11 per cent in the private sector. And most public employees still retire at 60. Yet recent pay analysis shows that more generous pensions are no longer a substitute for lower public sector pay.

- There are a number of options for reform, which the Commission hopes will be seriously considered by the official commission set up by the coalition Government.

Following extensive consultation with experts from across the pensions spectrum, the Commission's report was published on 7 July 2010, to widespread media coverage. This article presents a summary of the Commission's report, *Reforming Public Sector Pensions: Solutions to a growing challenge*, which can be found at www.public-sector-pensions-commission.org.uk.

THE CONTEXT: AN AGEING POPULATION

The reason why pension arrangements in any sector need to be looked at again is quite simple. People are living longer. This is a wonderful development, but it means that pensions have to be provided to more people for a greater number of years than originally intended, and that therefore reform is inevitable:¹

- **In 1951, male life expectancy was only 66. Many men working in manual jobs would not have lived long enough to claim the then-new basic state pension. Now, life expectancy for men and women is around 80, and people reaching the age of 65 are living almost another 20 years on average. In 50 years' time, life expectancy at 65 could reach 35 years. Certainly for individuals who retire at 60 – not unusual in the public sector – many people could spend longer retired than working.**
- **Official projections suggest that, in 50 years' time, it is possible that every person over 65 could be supported by just two people of working age, compared with four today, while there could be only one person of working age to support each dependent person (including children) overall.**

THE COST OF PUBLIC SECTOR PENSIONS

Unfunded public sector pension liabilities are growing rapidly, threatening to lead to unsustainable annual costs unless reforms are undertaken. Those public sector schemes which are funded, such as the many local government pension schemes, are facing similar rises in cost to those met by private sector employers. Council taxpayers may be cushioned in the short term from the full extent of those costs by current funding rules, yet in the long term the falls in investment income and rises in life expectancy threaten to impose major financial constraints on councils in the future.

Unfunded liabilities

The estimates of the outstanding public sector pension liabilities made by the Government differ greatly from those made by independent experts. A key reason for this is the choice of

¹ Office for National Statistics, English Life Tables Nos. 1-16; Office for National Statistics, 2008-based Period and Cohort life expectancy tables; Office for National Statistics, 2008-based National Population Projections, Principal projection; Public Sector Pensions Commission calculations

discount rate (which in the case of the Government has been confused and confusing), for which there are essentially three approaches in use:

- **Government Reporting Rate.** Until 2005, the Government used a fixed real discount rate of 3.5 per cent per annum, “based on a review of long-term historical patterns of real rates on gilts”.² From financial year 2005-06 onwards, the Financial Reporting Advisory Board decided to adopt a discount rate based on yields of AA-rated corporate bonds of more than 15 years maturity. This was reported to be in line with the FRS17 and IAS19 private sector accounting standards for funded schemes, which require an employer’s pension costs and liabilities to be measured using market rates of return from AA-rated bonds. In the context of unfunded public sector pensions, this has no objective justification, other than to try to compare like with like when looking at public sector and private sector benefits. However, private sector benefits are at far more risk of default than public sector pensions and it appears incorrect to suggest that the benefits are therefore comparable using private sector accounting treatment.
- **Government Funding Rate.** Like any pension provider, the employer (in this case the Government) chooses a rate of discount for determining the level of employer contributions. This has most recently been 3.5 per cent in excess of inflation, even though the Government borrows money at a much lower rate (around 0.8 per cent above inflation at the current time). This makes the cost of benefits look only a fraction of their real cost to present and future taxpayers. For reasons which have never been explained, despite the change to the Reporting Rate above, the 3.5 per cent above inflation approach continues to be the one which determines the artificial employer and employee contribution rates in place in the public sector.
- **True Economic Cost.** The Government is promising index-linked pensions to public employees in the future with the same certainty as it promises to pay bondholders the interest on Government borrowing by way of gilts. The only true economic comparison must be made using consistent discount rates, in other words around 0.8 per cent in excess of inflation, which is what is paid out when index-linked gilts are sold.

The reason why the choice of discount rate matters is that the higher the discount rate, the lower the liabilities appear.³ The Government’s choice of a real discount rate has been consistently

² Financial Reporting Advisory Board, Seventh Report, June 2004, Section 2.10

³ The sensitivity of the total outstanding liabilities to the discount rate is approximately a 20 per cent change in liabilities for each one percentage point change in the discount rate

⁴ Debt Management Office and HM Treasury data, cited in Neil Record et al., *Public Sector Pensions: The UK’s Second National Debt*, Policy Exchange, 2009, Graph 8

more than a percentage point higher than the real yield on gilts.⁴ Consequently, there has been a number of authoritative estimates of outstanding public sector pension liabilities made by organisations outside government, often based on a discount rate equal to index-linked gilt yields (ie. how much it really costs the Government to borrow the money it needs), which provide much higher totals than the Treasury's estimates.

The official and independent estimates are given in the table below. Estimates of outstanding liabilities range from £770bn to £1,176bn – between 53 per cent and 81 per cent of 2008 GDP and between £30,000 and £45,000 per household in the UK.⁵

TABLE 1

Most recent estimates of outstanding unfunded public sector pension liabilities

Source	Latest year covered	Outstanding liabilities, £bn	Percentage of 2008 GDP	£ per household
HM Treasury	2007-08	770	53.3%	30,000
Policy Exchange using HM Treasury assumptions	2007-08	794	54.9%	31,000
CBI	2009-10	1,010	69.8%	39,000
Institute of Economic Affairs	2006-07	1,071	74.1%	41,000
Policy Exchange	2007-08	1,104	76.3%	43,000
Towers Watson	2009-10	1,176	81.3%	45,000

Whether the Government's estimate or the independent estimates of outstanding liabilities are used, the total amount is larger than the pre-economic crisis level of government debt; indeed, if the future debt for public sector pensions is included, public debt could well have been over 100 per cent of GDP before the economic crisis began. With net government debt now increasing rapidly, outstanding public sector pension liabilities are significant and cannot be ignored.

Annual costs

Like the national debt, outstanding public sector pension liabilities will not need to be paid off in a single year, but if they continue to grow, they would lead to very high annual costs that would largely fall on taxpayers. If, as discussed above, the ratio of workers to pensioners falls, these annual costs may well become intolerable.

The first way of looking at annual costs is by examining how the payments to pensioners in the unfunded schemes are met. Because the schemes are unfunded, payments this year to retirees are met by this year's employer and employee contributions, with

⁴ HM Treasury, *Long Term Public Finance Report*, December 2009, Box 6.B; Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, Graph 87 and Graph 9; CBI, *Getting a grip: The route to reform of public sector pensions*, April 2010, Exhibit 2; Neil Record, *Sir Humphrey's Legacy: An Update*, Institute of Economic Affairs, January 2008; Towers Watson press release, 22 March 2010; Office for National Statistics, *Blue Book 2009*, Table 1.2 (GDP at market prices); Office for National Statistics, *Regional Trends*, December 2009, Table 10.16 (number of UK households)

the Treasury making up the difference.

The table below gives the most recent Treasury data at the time of writing. In 2010-11, payments to retirees in the unfunded public sector schemes are projected to total over £25bn, of which £20.5bn will be made up by employee and employer contributions with the remaining £4.5bn paid by the Treasury.

TABLE 2

Payments to retirees in the unfunded public sector pension schemes and how these are met

Year	Pensions in payment, £m	Of which employer and employee contributions, £m	Balancing Treasury contribution, £m
2003-04	16,080	14,279	1,801
2004-05	16,377	15,119	1,258
2005-06	17,641	17,368	274
2006-07	19,080	17,934	1,147
2007-08	21,356	19,066	2,290
2008-09 (estimated)	22,562	19,500	3,062
2009-10 (projected)	24,151	20,033	4,118
2010-11 (projected)	25,286	20,684	4,602

The burden on taxpayers is, however, greater than the “balancing Treasury contribution” column, since around two thirds of the “employer and employee contributions” column comes from the employer. While employee contributions are clearly not a burden on taxpayers, since they are a proportion of the employee’s salary, the contributions from employers are an extra cost to taxpayers.

The Commission has estimated that in 2010-11, the £25bn of payments to retirees in the unfunded public sector schemes will be made up of £18bn from taxpayers (£13.5bn of employer contributions and £4.5bn from the Treasury) and £7.5bn from employees in these schemes. £18bn is over £700 per household in the UK.

CHART 1

Pensions paid to retirees in the unfunded public sector pension schemes and the taxpayer cost



But the payments to retirees are not the full story. The other figure that needs to be taken seriously is the liabilities that are being built up each year, which will have to be paid off in the future. This is known as the “current service cost” and equals the pension contributions needed to pay for pensions accrued in the year. As was explained earlier, the figure for liabilities accrued in the year will be very sensitive to the choice of discount rate.

Whether the Treasury’s or independent estimates of the current service cost are used, it is clear that liabilities are building up faster than contributions are being paid, as is shown in the table below.

TABLE 3

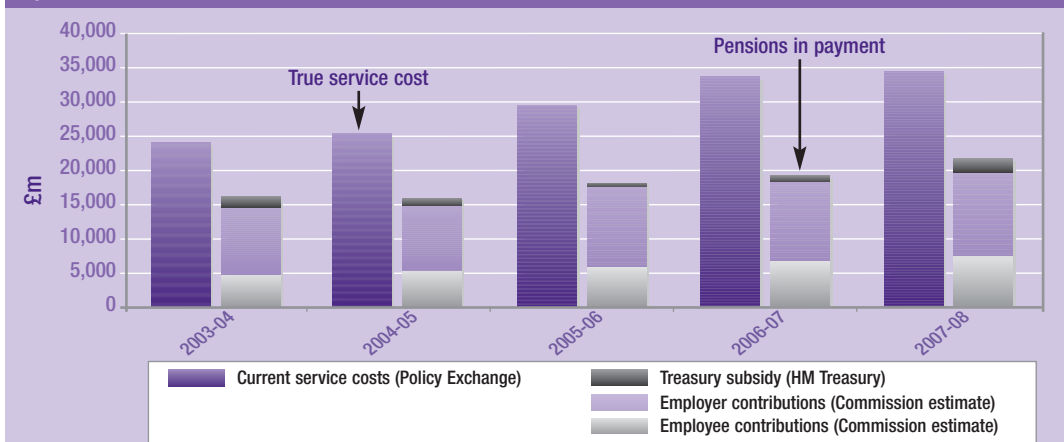
Unfunded public sector pension schemes’ current service costs

Year	Current service cost – HM Treasury, £m	Current service cost – Policy Exchange, £m	Employer and employee contributions received, £m	Current service cost in excess of contributions – HM Treasury, £m	Current service cost in excess of contributions – Policy Exchange, £m
2003-04	15,357	23,400	14,279	1,078	9,121
2004-05	15,309	25,300	15,119	190	10,181
2005-06	20,918	29,300	17,368	3,550	11,932
2006-07	21,074	33,700	17,934	3,140	15,766
2007-08	24,426	34,100	19,066	5,360	15,034
2008-09	25,504	-	19,500	6,004	-
2009-10	21,915	-	20,033	1,882	-
2010-11	22,744	-	20,684	2,060	-

The chart below illustrates how the pensions paid to retirees, and the taxpayer share of these, has been growing rapidly in recent years. It also shows how the current service costs, properly measured, are far greater still.

CHART 2

The cost of pensions paid to retirees in the unfunded public sector pension schemes and the current service cost



If costs continue to rise, as looks likely without reform, then one has to question whether future taxpayers will be willing or able to fund a growing annual debt servicing burden, a growing age-related spending burden,⁶ and a rising annual public sector pensions bill at the same time, without large cuts to public expenditure elsewhere.

Value of pensions

Just as estimates of the unfunded liabilities or annual current service costs of public sector pensions are sensitive to the choice of discount rate, so is the value of the pension as a proportion of salary.

There are several estimates of the value of public sector pensions to their membership. The following table gives the Pensions Policy Institute estimates based on the Government's accounting convention of an investment return of 2.5 per cent per annum. The average effective employee benefit rates range from around 35 per cent of salary for existing members of the uniformed services schemes to around 19 per cent for new members in the NHS and Teachers schemes.

TABLE 4

Average effective employee benefit rates based on government accounting discount rate

Scheme	Pre reform, % of salary	New members, % of salary
Civil Service	28%	21%
Teachers	22%	19%
NHS	22%	19%
Local Government (reformed for all members)	20%	20%
Police	35%	29%
Firefighters	35%	24%
Armed Forces	39%	38%

Market value estimates are around double. The Pensions Policy Institute has also provided estimates of the average effective employee benefit rates based on index-linked gilt yields (rather than AA corporate bond yields), finding that the average effective benefit rate across the public sector is 44 per cent of salary. The Pensions Policy Institute applied the calculation to new members only, so the pre-reform schemes would see even higher average effective benefit rates.

TABLE 5

Average effective employee benefit rates based on index-linked gilt yields, new members

	% of salary
Main four public sector schemes (NHS, Civil Service, Teachers, LGPS)	41%
Uniformed services schemes (Police, Firefighters, Armed Forces)	71%
Overall public sector	44%

⁶ On state pensions, health care and long term care, for example

Employees significantly undervalue the benefit, and employers undervalue the cost, of their pensions

This is a crucial problem. Total contributions from employees and employers average around 20 per cent of salary, but, on average, the pension is worth twice as much. Employees therefore significantly undervalue the benefit, and employers undervalue the cost, of their pensions.

Interestingly, the Bank of England offers its employees a non-contributory funded final salary scheme very similar to the unfunded public sector schemes. In 2005 the Bank revised the discount rate that it uses to calculate the current service cost and the employer contributions in order to make the costs of the scheme transparent. The Bank now uses index-linked gilt returns as its discount rate, which meant that the contributions now required to finance new accrual for Bank staff rose to 44.3 per cent of pensionable payroll. As it happens, the Bank's pension fund now holds most of its assets in index-linked gilts.⁷

This Bank of England contribution rate is remarkably similar to the valuation of new pension accrual in the main government unfunded schemes when index-linked gilt yields are used to compute the cost, shown in the previous table.

OTHER PROBLEMS WITH PUBLIC SECTOR PENSIONS

In addition to cost, there are several other issues that need to be addressed, chiefly the wide and growing gap between the public and private sectors.

Disparity with the private sector

- **In 2008, 94 per cent of public sector employees were members of a defined benefit pension scheme, compared with just 11 per cent in the private sector.⁸ Indeed, in the same year, only 42 per cent of male private sector employees, and 31 per cent of female, were members of any employer-sponsored pension at all.⁹**

⁷ NB: The Bank of England scheme is funded, and its 2005 actuarial review found that, valued at gilt rates, the scheme was only 84 per cent funded. To make up this gap, actual contributions from the Bank are currently significantly higher than 44.3 per cent of pensionable payroll. For a more detailed description of the Bank of England's measures, see Neil Record et al., *Public Sector Pensions: The UK's Second National Debt*, Policy Exchange, 2009, p.51

⁸ Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 2.1 and Table 2.3; Office for National Statistics, public sector employment time series data, private sector employment time series data

⁹ Office for National Statistics, *Pensions Trends*, Chapter 7, May 2009, data for Figure 7.6

- In all public sector schemes except for the Local Government Pension Scheme (LGPS), the normal pension age for existing members is still 60 or below, compared with a state pension age of 65 and a normal pension age of 65 for most members of private sector occupational schemes.
- 56 per cent of active members in the public sector are members of schemes with a normal pension age of 60, compared with just 25 per cent of active members of occupational DB and DC schemes in the private sector. 69 per cent of active members of private sector occupational DB and DC schemes are members of schemes with a normal pension age of 65, compared with just 37 per cent in the public sector.¹⁰

Inequity within schemes

There is a great deal of inequity between employees within final salary schemes. Older employees, those who stay within the public sector and those with higher earnings growth benefit far more than lower paid and younger employees.

Outsourcing of government services

When public services are outsourced to private contractors, private employers have to offer pension benefits to employees to match the public sector. But private companies have to pay the real cost of the pension promises, not the artificially low cost charged to public sector employers. There is not a level playing field and this distorts outsourcing processes to the detriment of private companies.

Pay comparison

Previously, it may have been right to argue that generous pensions in the public sector made up for lower pay, meaning that the overall package was a fair deal. This cannot now be argued with any degree of credibility.

The raw comparison for annual pay and for hourly pay, for both full time and part time employees, shows that earnings in the public sector are higher for most employees.¹¹

There is a wide and growing gap between the public and private sectors

¹⁰ Office for National Statistics, *Occupational Pension Schemes Annual Report 2008*, Table 2.19

¹¹ Office for National Statistics, *Annual Survey of Hours and Earnings 2008*, Table 13.5a and Table 13.7a

- For full time employees, gross annual pay is higher in the public sector for all but the top 25 per cent, while for part time employees only the bottom 10 per cent are better paid in the private sector.
- Gross hourly pay is higher in the public sector for all but the top 10 per cent of full time employees, while for part time employees, gross hourly pay is higher at all levels in the public sector.

The raw pay gap is clearly not the complete story, since public sector employees do tend to be better qualified than their private sector counterparts, though the risks of job loss are also different in the two sectors. The Institute for Fiscal Studies (IFS) has found that, controlling for education, age and qualification, the public sector hourly wage premium falls from a raw gap of 19 per cent to 2 per cent for men, and from a raw gap of 26 per cent to 7 per cent for women.¹²

Overall, after adjusting for the different characteristics of the public and private sector workforces, public sector employees still earn slightly more than their counterparts in the private sector. The oft-quoted argument for more generous pensions as a compensation for less generous pay does not any longer hold true.

Failure to reform

Reforms to all the main public sector pension schemes came into effect between 2005 and 2008. But they were significantly watered down from original plans. Rightly, past accrual was largely untouched by the reforms, but new accrual was not changed either. It is essential to make changes to future accrual (while protecting past accrual), otherwise it will take far longer to achieve the necessary savings.

The second major failure was the limited nature of the reforms for new entrants. While the normal pension age for new employees in most public sector schemes has now risen to 65, with the exception of the Local Government Pension Scheme it remains at 60 or below for existing employees.

This means that if, for example, a 20 year-old joined the civil service in 2006, he or she could draw an unreduced pension in 2046 at age 60, at a time when the state pension age under current policy will be 68. By the time this person retires their life expectancy at 60 might be 30 years or more. Even when the

Public sector employees earn slightly more than their counterparts in the private sector

¹² Institute for Fiscal Studies, *Green Budget*, February 2010, Table 9.3

majority of public sector employees are retiring at 65, there will still be a three-year gap between the age at which they retire and the state pension age.

TABLE 6

The gap between the public sector normal pension age (for most schemes) and the state pension age

Year	Public sector normal pension age (for most schemes)		State pension age	Difference	
	Closed group	New members		Closed group	New members
2006	60	60	65/60	5/0	5/0
2020	60	65	65	5	0
2026	60	65	66	6	1
2036	60	65	67	7	2
2046	60	65	68	8	3
	(virtually no existing employees)			(virtually no existing employees)	

OPTIONS FOR REFORM

Transparency and decentralisation

Any reform to unfunded public sector pension schemes has to start with transparency. This is not an option but an essential pre-requisite. An historical failure to account properly for the costs of the unfunded schemes has undoubtedly made it easier to delay reform and means that employees undervalue the benefit, and employers undervalue the costs, of their pensions.

Meaningful agreements between public sector employers and employees are not possible unless both sides understand the economic trade offs that are involved. With a proper understanding of costs, the Government can then take a more rational approach to setting public spending in this area and employers and employees can determine benefit packages to their mutual agreement.

The reform options set out in the Commission's report apply equally well to a national or a decentralised approach. With a decentralised approach, different public sector employers could choose different options – this could allow much greater flexibility and regional variation.

All reform to apply to new accrual

It is vital that any reforms apply not just to new members but to new accrual of pension for existing members as well. Previously accrued rights should generally be protected.

Immediate changes

A simple and immediate way of altering the financial burden on the taxpayer is to increase employee contribution rates, as has occurred in Ireland. For illustration, a 2 percentage point across the board increase in employee contribution rates would reduce the Exchequer cost by up to £2bn in the first year. But this would be no substitute for the longer-term reform options considered by the Commission.

Reform options

Each of nine possible reforms assessed by the Commission has its pros and cons. But each option, on its own or in combination, could be a realistic way forward:

- **Increasing pension ages.** People are living longer, the state pension age is increasing, both in the UK and in other developed countries, and normal pension ages are rising in the private sector. Increasing normal pension ages for new accrual in the public sector would be fair, and would save a considerable amount.
- **Reducing accrual rates.** A proportionately less generous accrual rate allows a pension of the same annual amount to be accrued from a longer working life. A number of private sector companies that have retained defined benefit pensions have reduced the generosity of accrual rates.
- **Career average schemes.** Career average schemes would reduce the inequities arising from final salary arrangements, which benefit older employees and those whose salary rises rapidly before retirement. The career average approach would also be a better fit to today's labour market, encouraging older employees to remain in employment even on a lower salary. It is used across part of the public sector already; it is also used in some private sector DB schemes.
- **Salary ceilings.** A ceiling on the level of pensionable pay (not on the pension paid out, as has been suggested by the Conservatives) would only reduce the pension accrued by someone with a salary higher than the ceiling. It would therefore make no difference to the pension received by lower-paid employees, and would address the fact that the higher paid benefit to a greater extent from current public sector pension arrangements.
- **Reducing index-linking.** Capping the degree of inflation indexing of pensions would save money if inflation were to increase, although it would also introduce a greater degree of risk to employees. In the public sector, full index-linking to the RPI is almost universal; most private sector schemes only index-link new benefit accrual up to 2.5 per cent a year.
- **National insurance and contracting-out.** Members of public sector pension schemes are generally contracted-out of the State Second Pension (S2P), as indeed, are

some members of private sector occupational schemes. This means that members do not accrue S2P rights, but they pay a lower level of national insurance. The rationale for paying lower national insurance is that taxpayers will not have to pay for S2P in future years, because the employees' private pension scheme will provide that. However, with an unfunded public sector scheme, taxpayers will have to pay these costs in future anyway. In addition, it can be argued that, given that public sector pensions are generally payable from age 60 (for existing members), compared with 65 rising to 68 for S2P, public sector employees should either not be contracted-out, or should remain contracted-out but pay higher employee pension contributions.

- **Funded defined contribution.** A move to less generous funded DC in the public sector would save a considerable sum of money in the long term, would remove the disparity between public and private sectors, and would shift longevity risks away from the taxpayer. Employees, would, however, face greater risks and the shift from pay-as-you-go to funded pension arrangements would entail significantly higher spending in the short term, as contributions would have to fund individual DC accounts as well as paying today's pensioners. It was easier for the private sector to switch from DB to DC precisely because private sector pensions were funded. However, it should be noted that this significantly higher spending would only be apparent because the accrual of public sector liabilities is not currently properly recognised in public sector accounts.
- **Notional defined contribution.** The difference between funded DC and notional DC is that notional DC arrangements remain unfunded, so there is no problem of paying twice in the short term. Notional DC could also offer a degree of guarantee around investment returns, for example guaranteeing that the notional value of individual accounts would grow in line with general economic indicators. This would reduce individual risk, and possibly also reduce individual return. Notional DC has been adopted in the state pension systems of a number of European countries.

Each of nine possible reforms, on its own or in combination, could be a way forward

- **Hybrid schemes.** Hybrid arrangements could usefully combine a number of the features of other types of pension arrangement, for example a core DB element with optional DC add-ons. Such schemes have been adopted in the private sector, and the public sector schemes also allow employee AVCs to be made.

A key objective is for reforms to result in 100 per cent of unfunded public sector pension costs being financed by employee and employer contributions. It is an important principle that you get what you pay for. Based on index-linked gilt yields, the main unfunded schemes are worth over 40 per cent of salary, but employees and employers combined are only charged around 20 per cent of salary. It becomes clear that there is a large gap between what public sector employees are getting, and what they and their employers are paying for.

As an example of the challenge facing any attempt to manage the full costs of public sector pensions, the table below sets out how the value to employees of the main public sector pension schemes could be brought down to 20 per cent of salary on average, if only one of the various options were chosen.

TABLE 7

How the employee benefit value of the main public sector pension schemes could be brought down to 20 per cent of salary if only one option were chosen

	Civil Service	NHS	Teachers	LGPS
Retirement age	80	79	79	80
Benefit accrual rate	1/80	1/105	1/105	1/110
Career average benefit accrual rate	1/80	1/80	1/80	1/85

It becomes clear from this table that employing one reform option alone is often not realistic. Especially if some form of DB scheme is maintained, it would be far better to enact a combination of reforms. The following box gives examples if the aim is to keep government/employer contributions to a maximum of 20 per cent.

The above examples show that there are a number of ways that the value to the employer of a public sector pension might be reduced to the 20 per cent that is currently contributed by employees and employers.

How much would be saved depends crucially on the changes enacted. The Commission estimated that a reduction of accrual rate to 1/80 or a switch to career average revalued earnings as the benefit structure would each save around £10bn per annum and an increase to a pension age of 65 for all members would save around half of that.

Ultimately, there is no single correct reform answer, but a number of viable options are present. The question of why the majority of the workforce should be expected to continue to pay

BOX 1


Example benefit structures costing 20 per cent of salary

- A final salary benefit of 1/90 of earnings for each year of service payable from the age of 70 would be worth 20 per cent of salary to the employee after payment of contributions at 6.5 per cent to the NHS scheme.
- An RPI-linked career average benefit of 1/80 of earnings for each year of service payable from the age of 65 would also be worth 20 per cent of salary to the employee in the Civil Service scheme after payment of employee contributions.
- An RPI-linked career average benefit of 1/70 of earnings for each year of service payable to teachers from the age of 65, with pensionable earnings limited to £75,000 per annum and pension increases linked to RPI only up to 2.5 per cent per annum might be worth around 20 per cent of salary in excess of employee contributions.

increasing amounts through their taxes to support pensions that they cannot afford for themselves does have to be raised, and there is not a shortage of solutions.

THE HUTTON COMMISSION

The coalition Government has established a commission to recommend reforms to public sector pensions, led by John Hutton, a former minister in the previous government. It will be publishing an interim report in September, and a final report next spring.

The establishment of this official commission is very good news. It will be far better to manage an orderly reform process, than to have to make a series of crisis cuts some time in the future. The reform options outlined above should be seriously considered. 

The Public Sector Pensions Commission's full report, *Reforming Public Pensions: Solutions to a growing challenge*, can be found at: www.public-sector-pensions-commission.org.uk

For more details of the official commission, please go to: www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm