FPC(10)7

FIREFIGHTERS' PENSION COMMITTEE

HUTTON COMMISSION AND RELATED MATTERS

Note by CLG

CLG have kept the Committee informed of developments since the General Election and, in particular, the setting up of the Independent Public Service Pensions Commission under Lord Hutton and public service pension references in the Pre-budget Forecast from the Office for Budget Responsibility. Copies of the documents are annexed.

The terms of reference for the Commission require Lord Hutton to conduct a fundamental review of public service pension provision and to make recommendations on arrangements that are sustainable, affordable and fair in the long term. He has been invited to produce an interim report by the end of September 2010 which should consider the case for delivering savings within the spending review period to contribute towards the reduction of the structural deficit; and the final report by budget 2011.

Lord Hutton has made clear that nothing is being ruled in or out.

As a first stage ahead of his interim report, Lord Hutton has said that he will be assessing the current position, identifying problems and considering the objectives that should set the framework for any change. He has invited evidence and views by the end of July to assist him with considering

- affordability, fairness, impact on mobility and plurality of current public service provision of the current public sector pension schemes and;
- the objectives that should guide public service pension in future.

He has asked also for any thoughts or observations on whether, given the long term nature of structural reform, there is a case for more immediate action on public service pensions, in the context of affordability and fairness, and, if so, what options there might be to deliver savings within the spending review period.

It is anticipated that FPC members will have submitted their responses to the Commission by the end of July to meet phase 1 of the review. Longer term issues for reform will be canvassed in due course.

The Commission Secretariat have confirmed that responses to Lord Hutton will be placed on the Commission's web site.

Consequences for the work of the Firefighters' Pension Committee

Following publication of the Actuarial Valuation report, CLG initiated discussion on Options for the future (FPC(10)3) and Cap and share (FPC(10)4). What emerges eventually from discussion within the FPC will clearly be influenced by the policy outcomes of the Hutton Commission.

CLG consider that the FPC should take forward its discussion of all the options, including the need to develop the arrangements for cap and share, so that CLG is well placed to take action following decisions by the Government in the Spending Review and eventually as part of Budget 2011. The relevance of views and contributions from the devolved administrations will need to be picked up, with the assistance of representative colleagues.

The Committee is invited to discuss and agree that further discussion of options for the future and cap and share should be the main items for discussion beginning with the meeting on 25 August.

Communities and Local Government
July 2010

Annex to FPC(10)7

Independent Public Service Pensions Commission: terms of reference

To conduct a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights.

In reaching its recommendations, the Commission is to have regard to:

- the growing disparity between public service and private sector pension provision, in the context of the overall reward package – including the impact on labour market mobility between public and private sectors and pensions as a barrier to greater plurality of provision of public services;
- the needs of public service employers in terms of recruitment and retention;
- the need to ensure that future provision is fair across the workforce;
- how risk should be shared between the taxpayer and employee;
- which organisations should have access to public service schemes;
- implementation and transitional arrangements for any recommendations; and
- wider Government policy to encourage adequate saving for retirement and longer working lives.

As part of the review, the Commission is invited to produce an interim report by the end of September 2010. This should consider the case for delivering savings on public service pensions within the spending review period – consistent with the Government's commitment to protect those on low incomes - to contribute towards the reduction of the structural deficit.

The Commission is invited to produce the final report in time for Budget 2011.

Scheme coverage

- For civil servants:
  - Principal Civil Service Pension Scheme
  - Principal Civil Service Pension Scheme (Northern Ireland)

- Armed Forces Pension Scheme

- For NHS employees:
  - NHS Pension Scheme
  - NHS Superannuation Scheme (Scotland)
  - Health and Personal Social Services Northern Ireland Superannuation Scheme

- For teachers:
  - Teachers' Pension Scheme (England and Wales)

- Scottish Teachers' Superannuation Scheme
- Northern Ireland Teachers' Superannuation Scheme

- For Local Government:
  - Local Government Pension Scheme (England and Wales)
  - Local Government Pension Scheme (Scotland)
  - Northern Ireland Local Government Pension Scheme

- Police Pension Scheme (administered locally)
- Firefighters' Pension Scheme (administered locally)
- United Kingdom Atomic Energy Authority Pension Schemes
- Judicial Pensions Scheme
- Department for international Development – Overseas Superannuation Scheme
- Research Councils' Pension Schemes

In addition to the schemes mentioned above, there are a number of smaller schemes and many established to cover only one senior appointment which do not specifically need to form part of the review but which will be required to act on the recommendations.

<u>Extracts from the Office for Budget Responsibility's Pre-Budget Forecast June 2010</u>

Public service pensions

4.85 The net public service pensions expenditure forecast is measured on a National Accounts basis, and measures benefits paid less contributions received by central government pay-as-you-go public service pension schemes. Chapter 5 includes a discussion of public sector pension liabilities.

4.86 The forecasts of receipts to pension schemes from pension contributions are based on assumptions about the growth in the wage bill of employees and contribution rates. Our assumptions for growth in wage bills are consistent with our overall assumptions for the implied future path of DELs in this forecast, though they do not represent the Government's plans for DEL for 2011-12 onwards. Current contribution rates are assumed to increase from 2012-13 onwards to raise £1 billion a year extra income on account of policy agreed at the 2005 Public Services Forum by the previous Government on cap and share provisions.

4.87 The gross expenditure forecast is based on the demographics of each individual pension scheme, reflecting both the demographics for existing pensioners and the demographics of the workforce. This means expenditure rises steadily across the forecast period as the age profile of each scheme's membership changes. The main economic determinant of gross pensions expenditure is RPI inflation (used to uprate benefits paid).

4.88 The assumptions used mean that receipts to pay-as-you-go schemes rise slightly across the forecast period. However, this effect is more than offset by the changes in demographics which cause net public service pensions expenditure to increase year-on-year, by an average of 20 per cent in real terms from 2009-10 to 2014-15.

Existing information on public sector liabilities and longer-term fiscal pressures

5.20 Given the variety of conceptual approaches to sustainability, a key principle for good government should be transparency. This applies particularly with respect to liabilities which are currently off-balance sheet. This section sets out existing information on key public sector liabilities and likely future pressures on public spending and revenues, discusses why these matter for fiscal sustainability, and identifies how we can further improve our understanding and analysis of them.[5]

5.21 These liabilities and fiscal pressures include:

- an ageing population, with demographic trends putting upward pressure on health care and pension spending. The annual impact of demographic change on the public finances is projected to amount to almost 4 per cent of GDP by 2049-50;
- Private Finance Initiative (PFI) contracts, representing a high profile example of a pre-commitment of future expenditure. The total estimated unitary charges payable under PFI for 2010-11 are £7.8 billion. As of the end of 2009-10, the capital cost of signed PFI projects was approximately £56 billion, of which approximately £43 billion was off-balance sheet;
- unfunded public service pension liabilities, in terms of accounting are the largest example by far of an obligation arising from events now and in the past. The last Government Actuary's Department estimate of this liability, published in December 2009, was £770 billion. In addition to these liabilities, there is a long-term overall deficit in the funded Local Government Pension Scheme which is effectively a liability underwritten by taxpayers; and
- contingent liabilities, examples of which include nuclear decommissioning and guarantees provided to the banking sector.

Ageing pressures

5.22 The percentage of the UK population aged 65 and over increased slightly from 15 per cent in 1983 to 16 per cent in 2008. Over the same period, the percentage of the population aged 16 and under decreased from 21 per cent to 19 per cent. This trend is projected to accelerate. By 2033, 23 per cent of the population will be aged 65 and over, compared to 18 per cent aged 16 or younger.

5.23 The ageing of the population is a demographic and social issue. But it is also relevant to the position of the public finances: directly, by affecting public spending and tax receipts, and indirectly, through its impact on economic growth.

5.24 Age groups differ in the extent to which they contribute to tax receipts and consume public services. Stylised age profiles illustrate how separate items of revenue and spending are distributed over a representative individual's lifetime.[6] If all such items are summed over a lifetime, it is apparent that large spending items (such as health and pensions) occur outside working years. An increasingly old demographic structure therefore can have implications for fiscal sustainability.

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[5] For an in-depth discussion of government financial liabilities beyond public sector net debt see *Government financial liabilities beyond public sector debt* in the *Economic & Labour Market Review, Volume 3 No 7*, Office for National Statistics, July 2009.

[6] For a discussion of age profiles see Box 2.A of the *2009 Long-term public finance report*, HM Treasury.

Public service pension liabilities

5.36 Public service pensions are occupational pension schemes that form part of the remuneration of current public sector employees but represent a long-term liability to make future payments to pensioners. Occupational pension schemes may collect contributions and use them to build up a fund of assets to match the liabilities of the scheme (the net present value of future payments to pensioners, in respect of rights accrued to date) to ensure they are sustainable in the long term. When pensions come to be paid, they are financed from the fund. This approach is operated in the private sector and in parts of the public sector, notably by the Local Government Pension Scheme.

5.37 But unlike private sector employers, government can be considered 'permanent' and has the power to tax. This characteristic of governments, as opposed to private corporations, is the basis for running most UK public service pension schemes with no fund, on a pay-as-you-go (PAYG) basis. With no fund, a scheme relies on the sponsoring employer (i.e. ultimately the government) to supply cash as needed and any contributions collected can be used to help to finance today's cashflows to pensioners.

5.38 Although the PAYG system has some advantages for government in terms of fiscal management, for example in avoiding the kind of investment risk faced by funded schemes, the lack of a fund to back liabilities imparts a level of fiscal inflexibility regarding future shocks to revenue. For example, a negative GDP growth shock could mean that the cost of paying current pension obligations displaces other expenditure and thereby causes distortions.

5.39 Net annual public expenditure on the PAYG public service pension schemes equals the amount spent on paying cash benefits to pensioners of those schemes less any contributions received.[12] The cost of this expenditure is covered by government revenue, as it falls due. The most recent published data on projected costs were presented in the Treasury's *2009 Long-term public finance report*, with a projected annual cost of around 2 per cent of GDP over the next fifty years. This assumes the schemes remain as now and reflects the costs of new members who will join during that period.

5.40 It is also possible to use published resource accounts in central and local government to estimate the total PAYG public service pension liability (the net present value of future payments to pensioners, in respect of rights accrued to date). Using this mechanism the Government Actuary's Department (GAD) has estimated the liability at £770 billion as at 31 March 2008. The size of this figure depends on assumptions about a number of factors, such as the mortality of current and future pensioners within the schemes, as well as a discount rate in order to express future cash flows as a single figure in today's terms. The main schemes covered are those for the NHS, teachers, civil service, armed forces, police, firefighters, judiciary and the UK Atomic Energy Authority.

5.41 In terms of the annual accruing liability in these schemes, the most appropriate measure is probably the current service cost. Current service cost represents the amount that discounted pension scheme liabilities will increase over the year by reason of the additional year's service of active members of the pension scheme. The current service cost for all PAYG public service pension schemes was around £26 billion for the year ending 31 March 2008.

5.42 We will continue to assess public service pensions, drawing on the work of GAD and the Office for National Statistics (ONS), and we expect the publication of the WGA to establish a figure for the total public sector liability, covering both unfunded and funded schemes.

[12] Chapter 4 forecasts AME costs for most public sector unfunded schemes, which are projected to rise significantly over the forecast period.