Summary

- The total net public-sector pension liability recorded in the Whole of Government Accounts for 2014/2015 – £1,493 billion – was equal to 81 per cent of GDP. The liability had increased by almost a third (32 per cent) since 2009/2010.
- The Hutton reforms to public-sector schemes are expected to provide cost savings. But ongoing legal action, from trade unions and others, may yet derail changes already underway.
- In 2015 the government announced that the LGPS was to pool their investments in an attempt to provide cost savings and increase efficiency and performance.

In the public interest

With growing liabilities and the difficulties in implementing further reform, sustainably funding public-sector schemes is proving a challenge. David Adams finds out more

There aren't many things in the UK quite as complicated as its public-service pension schemes. In part it is the nature of the schemes themselves that creates much of this complexity. Only the local government pension scheme (LGPS) is funded, by return-generating assets as well as contributions. All the other public-service schemes are unfunded, with the cost of benefits met by the pension contributions paid in by current public-sector employees and employers – or, if those contributions are insufficient, by the Treasury.

That means the liabilities of these schemes can have a significant impact on the UK's public finances. In July 2016 the National Audit Office (NAO) revealed that the total net public sector pension liability recorded in the Whole of Government Accounts (WGA) for 2014/2015 – £1,493 billion – was equal to 81 per cent of GDP; and that the liability had increased by almost a third (32 per cent) since 2009/2010.

Right of centre politicians and think tanks tend to leap on such figures. For example, the Adam Smith Institute director Eamonn Butler called the public sector debt liabilities "crippling", "unsustainable" and "a hidden debt timebomb", following publication of the WGA in early 2016.

Hutton reforms

Changes to the schemes implemented following Lord Hutton's 2010 recommendations for reform will eventually curb increases in these liabilities to some extent. Those changes increased employee contributions, moved many public-sector pensions from a

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final salary to a career average basis; and aligned public-sector retirement ages with the state pension age. Further legislation passed in 2013 and 2014 led to the establishment of pension boards for many of the schemes, to improve governance and administration.

The Pensions Policy Institute (PPI) has estimated that the post-Hutton reforms reduced the average value of pension benefits for members of the NHS, teachers, civil service and LGPS schemes by more than a third (from 23 per cent of salary to 15 per cent); and would reduce long-term government expenditure on the unfunded schemes by about 25 per cent (from around 1.1 per cent of GDP by 2065 to 0.8 per cent).

Calculating liabilities

In July 2016 the Office for Budget Responsibility (OBR) published a fiscal sustainability analytical paper (FSAP) on the public-sector balance sheet. It noted that estimates of the net pension liability in the WGA had increased by over £100 billion three years in a row, growing by £190 billion in 2014/2015 and by more than 50 per cent since 2010/2011.

"But," the document states, "this does not mean that public-service pensions have become a much bigger source of risk to the future health of the public finances." It pointed out that the estimated liability had increased as a result of several technical factors and noted that the OBR's projections for net public-service pensions spending had remained 'relatively stable' over the same period.

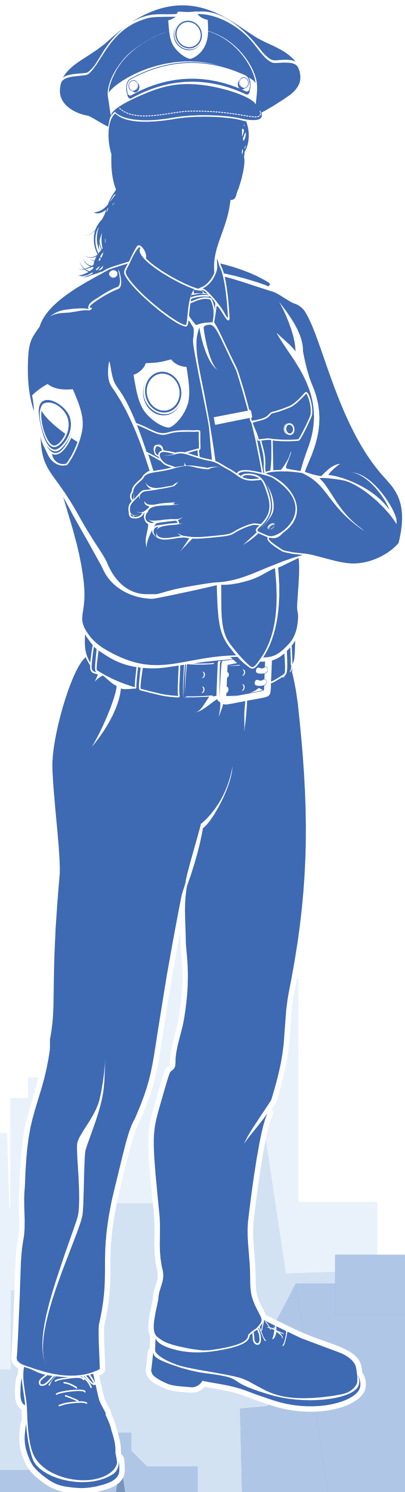
The OBR document then explained what is and is not included in the estimated liability, revealing in the process why trying to calculate the deficit of the public-service schemes is a little bit like trying to catch clouds with your fingers.

For example, the authors of the document describe the WGA net pension liability estimate as "one-sided ... it factors in a significant amount of future payments, but no future contributions". They also explain that although the discount rate used in the WGA and underlying accounts is based on the real yields of high-quality corporate bonds, in accordance with the government's financial reporting rules; the discount rate used to set employer contribution rates is based "on the Treasury's interpretation of *[the OBR's]* long-term GDP growth projection". That discount rate was set at 3 per cent in 2011, but reduced to 2.8 per cent in the March 2016 Budget – which will increase employer contributions from 2019/2020 onwards.

The OBR also complains about a lack of information provided by the Treasury to explain exactly how the line in the WGA balance sheet termed 'Changes in assumptions underlying the value of liabilities' moves the estimated liability – as this is sometimes the cause of the biggest contributions to year-on-year changes in the estimated liability.

If the financial picture is confusing, data management also presents challenges. The schemes may need to interact with dozens, sometimes hundreds of different employers and that can lead to big problems, as can the scale and complexity of the schemes. Analysis by the NAO published in early 2016 suggested that over three quarters of civil service pension records – 1.25 million – could be incomplete or incorrect.

But for many observers it is the financial issues that trump all other considerations. Centre for Policy Studies research fellow Michael Johnson suggests that if current trends continue, "in five to seven years' time the system will be collapsing ... There is going to be a £20 billion gap per year being plugged by the Treasury. That is going to cause an almighty stink".



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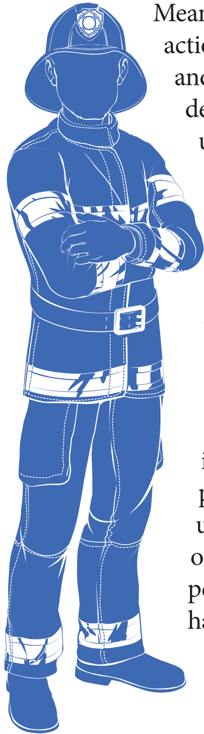
Reform



Meanwhile, ongoing legal action, from trade unions and others, may yet derail changes already underway. In January an employment tribunal upheld a complaint by 279 younger judges that they had been discriminated against when older judges were allowed to remain in their previous pension scheme until retirement or for an interim period. The case may have implications for members of other public-service schemes.

Even if more radical reform were attempted at some stage, as PPI head of modelling Tim Pike points out, such changes would not produce savings in the short term, because replacing the unfunded schemes with funded DC arrangements, for example, would increase financial demands in the near and medium term. Current pensions would still need to be paid for and liabilities already accrued could not be removed without (politically toxic) retrospective changes to benefits.

It is difficult to get the government departments with responsibility for managing the public-service schemes to provide any detail on any long-term strategies to improve financial sustainability of the schemes.

In response to a series of questions seeking clarification over the details of any such strategy for the police and firefighters' pension schemes, a spokesperson for the Home Office says: "This government has made clear its commitment to ensuring that public service pensions are affordable, sustainable and fair"; and that changes implemented in recent years "have put pension arrangements on a sustainable footing for the future, setting a fair balance of costs between public servants and other taxpayers, while continuing to provide good pensions for police officers and firefighters that reflect their roles."

LGPS

The LGPS also faces fundamental funding challenges – although Aon Hewitt public sector actuarial head Alison Murray warns against comparisons with the funding positions of private-sector DB schemes. "Valuations of those schemes are very focused on gilt yields and the end point and if you apply that model to the LGPS it looks horrendous," she says. "Those comparisons are misleading."

However, there does appear to be room for improvement around getting the best returns from LGPS assets. In 2015 the government announced that the administering authorities would pool their investments in an attempt to increase efficiency and performance. This should leave between eight and 12 funds, although the final shape of the new pooled arrangements is yet to be finalised.

Many LGPS funds seem to have been poorly served by the fund management industry. "Local-authority schemes were ripped off by fund managers and consultants," says Cass Business School Professor of Pension Economics and Pensions Institute director David Blake.

Johnson also condemns active fund management as having been "disastrous" for the LGPS. "Five years ago I thought that probably the sensible thing to do was to keep the LGPS funded, but I've now changed my mind," he says. "It is time to get rid of the asset management side of the equation and take the assets into a new UK sovereign wealth fund."

But without radical change to the current funding mechanisms further cuts to pension benefits paid to members are inevitable, says Johnson. "With the unfunded schemes, at some stage you either have to increase contributions, or reduce benefits, or both," he says.

He may be right, or, as governments can take financial actions unavailable to private-sector businesses, there may be another solution. At some stage we, as a nation, will need to decide how optimistic or pessimistic, comfortable or uncomfortable we are with the funding and purpose of these schemes. But we can probably only answer that question when we consider the future of the public sector as a whole.

Written by David Adams, a freelance journalist

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