Public Service Pensioners' Council

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Lord Hutton
Independent Public Service Pensions Commission
1 Horse Guards Road
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Dear Lord Hutton

PSPC RESPONSE TO FINAL CALL FOR EVIDENCE

Introduction

The Public Service Pensioners' Council was established almost fifty years ago with the aim of protecting the interests of retired public servants. It brings together the various organisations of retired public servants and the retired members' sections of public sector unions, in order to provide a united voice to Government and the main political parties on issues of concern to public service pensioners.

The PSPC is pleased to make a further submission for the Commission's final report. This submission focuses on the principal issue of concern to the PSPC – the protection of accrued rights and the threat posed by the proposed switch from RPI to CPI indexation. It also responds to the Commission's question on the future design of public service pension schemes and the notion of pension adequacy. This latter is certainly a subject where the perspective of pensioner organisations such as the PSPC can add to the debate.

The Commission's terms of reference are to conduct a fundamental structural review of public service pensions within the context of protecting accrued rights. In its initial submission, the PSPC asked you to comment on the merits and propriety of the Government's proposed change to the indexation requirements. Unfortunately you did not take the opportunity to do so. We would like you to comment on this issue in your final report, as we think the change in indexation arrangements constitutes a breach of accrued rights.

As you know, the June 2010 Emergency Budget announced a switch from the Retail Prices Index to the Consumer Prices Index (CPI) for the state second pension and consequently, to public service pensions. The PSPC maintains its belief that the CPI is not fit for purpose as an indexation method. It was designed as a macroeconomic policy tool, but is being shoe-horned into service as an indexation method for pensions and benefits simply because it provides a lower average outcome than the RPI.

The increase in public service pensions is calculated from the September inflation figures. Since the year 2000, the average gap between the RPI and the CPI has been over 0.8 per cent a year. If we assume RPI at 3 per cent and CPI at 2.2 per cent, a public service worker with a £10,000 pension will receive over £36,000 less because of the switch from RPI to CPI over the course of a 25-year retirement. This is a huge loss of purchasing power. An individual may enter retirement with an adequate pension but gradually lose this purchasing power over the years. It must be remembered that, when an individual retires on an income based on any form of price indexation, they lose any link during their retirement to the real increases in standards of living that are accrued by the working population. Switching to CPI means that pensioners will fall even further behind.

The clear implication of the switch to CPI is that public service pensioners will become poorer relative to the rest of society. Your interim report highlights that the cost of paying unfunded public service pensions will fall from 1.9 per cent of GDP in 2010-11 to 1.4 per cent of GDP by 2060. The largest part of that fall can be accounted for by the switch to CPI. The Council does not believe that pensioners becoming relatively poorer is an acceptable option.

The PSPC is aware that there are two major reasons why the CPI is lower than the RPI. The first is due to the RPI being based on an arithmetic mean, and the CPI being largely based on a geometric mean. The Treasury has estimated in the CPI technical manual 2007 edition[1] that 'the CPI annual rate would typically have been about 0.5 percentage points higher if the elementary aggregates had been calculated using arithmetic means as in the RPI.' The assumption within the CPI, that individuals will adjust to price rises by substituting into cheaper goods, does not sit easily with pensioners' experiences. Due to their fixed incomes, pensioners are likely to be purchasing goods and services as cheaply as possible, and so have less scope to substitute.

The second reason relates to the constituents of the indices. CPI excludes items related to housing costs, including mortgage interest payments, council tax, housing depreciation, buildings insurance and surveyors' and estate agents' fees. The PSPC has always argued for earnings indexation of state pensions. One reason for this is that pensioners have to buy in services, especially as they get older. Housing maintenance is a perfect example of this. Pensioner homeowners have to buy these services, which will have an earnings-linked component, and yet the cost of these services is not currently included in the inflation measure by which the government proposes to increase public service pensions.

You will know that the statistical profession has substantial reservations on the use of CPI in its current form. In a letter of 6 October 2010, Sir Michael Scholar KCB, Chair of the UK Statistics Authority said, 'We believe that the CPI should become the primary measure of consumer price inflation but only when the inclusion in the index of owner occupiers' housing costs has been achieved'. We understand that the ONS has an active development programme for the CPI, and we hope that including owner occupiers' housing costs in CPI is pursued with all reasonable speed. We would also hope that an index which focuses on the actual price inflation experience for pensioners could be constructed. The PSPC believes that CPI is not fit for purpose in its current form. The PSPC opposes the switch from RPI to CPI, but believes that if the Government wishes to make this change, that it should commit to do so for one parliamentary term only.

In our submission to your Interim Report, the PSPC asked you to consider the merits and propriety of the switch from RPI to CPI. It is not enough to recognise that it will save money. A decision was taken which overturned members' long-held belief, rightly or wrongly, that they were guaranteed a pension linked to the RPI in retirement. This belief was succoured through successive generations of scheme literature, which stated a link to the RPI. Many people even bought added years, thinking that it was a contract linked to RPI, when the Government's current interpretation is that the indexation these purchases will be linked to CPI going forward.

[1] Section 9.9 http://www.statistics.gov.uk/downloads/theme_economy/CPI_Technical_Manual.pdf

This type of behaviour does not encourage a savings culture, and we urge you to comment further in your final report.

Scheme Design (Q1)

The PSPC starts from the perspective that it is important to recognise the importance of good pension provision for current and future public service pensioners. The role of public servants includes many sensitive, important and sometimes dangerous tasks. Pay and pension arrangements should be good enough to recruit and retain the right calibre of candidate to be recruited, and for them to be able to undertake their duties with confidence.

In this environment, it is impossible to understate the role of certainty in pension provision – the PSPC does not think it sensible that public servants have to constantly monitor their pension position. The pension that members receive should be predictable, and certainly not dependent on the vagaries of the stock market. The PSPC opposes defined contribution pensions for public service workers for this reason.

Risk-Sharing (Q2–Q9)

The PSPC believes, for reasons outlined above, that the Consumer Prices Index is not currently fit for purpose as an indexation measure.

The Interim Report mooted career average as a preferable alternative to final salary pension schemes. The PSPC believes it would be a grave error to use CPI as the indexation factor in any career average scheme. If this happens, the early years spent in a pension scheme will be comparatively less valuable, and consequently less important. The proposed changes to student fees mean that graduates could leave universities saddled with £40,000+ of debt, with a 9 per cent repayment rate on incomes above £21,000. They will also need to save to join the housing ladder in a time of reduced access to mortgage finance. Under these circumstances, many would already have been tempted to opt-out of public service pension schemes, even without a move to career average.

If the further average 3 per cent rise in employee contributions goes through, it may become an extremely marginal decision as to whether or not it would be beneficial to join a career average scheme with CPI indexation. If the early years offer comparatively little towards the final pension amount, the PSPC questions whether hard-pressed graduates could unambiguously be advised to pay 8 or 9 per cent of their salaries for the privilege.

It could also be a marginal decision for younger workers with lower skill levels in deciding whether to join a career average scheme with CPI indexation, because of uncertainties over future career path, and possible future interactions with means-tested benefits.

Adequacy (Q10-13)

The PSPC argues that adequacy in retirement is largely a matter of relativity rather than an absolute threshold. Defined benefit occupational pension schemes seek to deliver an income in retirement that is related to the individual's earnings during working life. The alternative is to view adequacy as an absolute measure, where a public service pension combined with a full state pension which placed the individual above the poverty line would be seen as adequate. The PSPC believes that people themselves see adequacy in a relative rather than absolute sense.

The PSPC believes that a full state and occupational pension should be enough to guarantee adequacy, as to argue otherwise is to believe that people should have to make voluntary provision on top of an occupational pension to get an adequate pension. This is strikingly naïve.

People will not make voluntary pension provision in this way as they will believe, rightly, that this is the job of their occupational pension scheme.

The PSPC recognises that there is a role for additional pension contributions, whether in the form of defined benefit added years or additional pension, or money purchase AVCs. Individuals who will not have a full career service record can use these to fill gaps, or to secure an ‘excellent’ pension above that which would normally result from application of the scheme rules. Individuals boosting their pension doing this tend to be comparatively well informed. Cutting the average level of pension and then trusting to voluntary action assumes a faith in rational utility-maximisation that does not exist outside economics textbooks.

We have now moved to a position where two-thirds of private sector workers do not have access to an employer pension contribution. Are we really to believe that these people will voluntarily make their own arrangements for retirement? If they do not, then under the current system, costs are defrayed back to future taxpayers through the means-tested benefit system. The introduction of NEST indicates that not even the Government believes that people will take voluntary action left to their own devices. It does not therefore seem sensible to rely on voluntarism to bolster public service pensions.

To suggest that household income could be examined rather than individual income is a fig leaf for cuts and is certainly not a workable idea in practice. It assumes that everyone has a working spouse who would bring in pension income. This is not the case. It also ignores the growing number of single-person households, whether this is a lifetime single status, or occasioned by divorce. In these households it is clear that people would have to rely on their own resources, unless the unwise assumption of continuing maintenance payments is made. There is also the unspoken assumption that resources are pooled evenly within households. The work over many years of Professor Jan Pahl demonstrates that this is not the case. Ultimately, the PSPC believes that pension income has to be judged on an individual basis.

Adequacy also involves the maintenance of a standard of living throughout retirement. This makes the indexation of pension benefits paramount. We refer back to everything we have said above about RPI and CPI indexation.

Transition Issues (Q23-25)

It is important with any transition process that the disruption to those who have planned for their retirements be kept to an absolute minimum. People believe that where they have made plans in good faith, that they should be able to put those plans into operation. Forcing people to uproot plans damages confidence in the pension system and a savings culture. It also aids those siren voices who say that pensions and other savings are a ‘con’, as the Government can change the system at any point for its own benefit.

The recently announced increase in the state pension age is almost a copybook example of how not to do a transition process. The 1995 Pension Act had a 15-25 year lead-in to the equalisation of the male and female pension age at 65 between 2010 and 2020. It seems likely that an Act will be passed next year bringing forward the equalisation of the state pension age to 65 by November 2018, and an increase in the state pension age to 66 by April 2020. If this happens, people will have had 7-9 years notice of the change. People in their late fifties will have to change their retirement plans as a result.

The PSPC believes that if any changes are made to normal pension ages for public service pensions, then there should be protection arrangements in place for public service workers for at least ten years. This would enable those who have laid down plans to retire based on these plans.

Conclusion

The PSPC hopes that you have found the issues raised in this submission useful. The PSPC would be happy to deal with questions following from the Commission's study of this submission, and would provide further written or oral evidence on request.

Yours sincerely

ANDREW MORRIS
General Secretary