

JOHN RALFE CONSULTING

Ms Niki Cleal
Director
Pensions Policy Institute
King's College
26 Drury Lane
London WC2B 5RL

16th November 2012

Dear Ms Cleal

PPI Report on public service pension schemes of 23rd October 2012

Thank you for your reply ¹ to my letter ² about the PPI Report on the costs of public sector pensions.³ The PPI's submission to the 2011 Treasury Consultation ⁴ is very helpful in understanding the PPI's position, and for completeness, I include my submission as an appendix.

Can I make three comments on the PPI's position?

1 Using expected GDP growth of CPI + 3% as the discount rate

The PPI's Report calculates public sector pension costs using the Treasury method of discounting expected pensions at CPI + 3%, representing expected GDP growth, which the PPI supported in its submission to the 2011 Treasury Consultation on the discount rate. Your letter says:

"The PPI's consultation response proposed that the discount rate that the Government should use in setting the rate of employer contributions to the public service schemes is one which approximates the expected return on the assets which underpin the public service pension schemes. In the case of unfunded public sector pension schemes, the assets which effectively pay for the future pensions of public service workers are expected future tax revenues. As tax revenues are linked to the growth rate of the economy as a whole, PPI proposed

¹ http://www.johnralfe.com/public/PPI_letter_1_to_John_Ralfe_November_7th_2012.pdf

² http://www.johnralfe.com/public/John_Ralfe_Letter_to_Pensions_Policy_Institute_November_2012.pdf

³ <http://www.pensionspolicyinstitute.org.uk/default.asp?p=12&publication=332>

⁴ http://www.johnralfe.com/public/PPI_response_to_HMTs_PSP_SCAPE_discount_rate_consultation_March_2011.pdf

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that the Government adopt an approach to the discount rate which approximates expected GDP growth."

The PPI's consultation response implies:

1 Employer cash contributions to a private sector pension scheme represent the economic cost to the employer of providing the pension.

2 Employer contributions are based on the expected return on assets held in the pension fund, so that if a fund holds equities employer contributions would be lower than if it held bonds.

3 The expected return on assets is therefore the correct discount rate for private sector pension liabilities and costs.

It may be helpful to look at how interest and principal payments on corporate bonds are discounted to a present value.

In finance theory and practice the correct discount rate for, say, a 30-year unsecured corporate bond, with 25 years to maturity, is the company's marginal borrowing cost for a new 25 year bond.

If underlying interest rates fall, or the corporate spread narrows, then the discount rate will fall and the price of both an existing, and new bond, will rise. If underlying interest rates rise, or the corporate spread widens, the discount rate will go up and the price of both an existing, and new bond will fall. This is the Law of One Price in action.

If the bond was privately-placed, but secured on a pot of financial assets the discount rate would reflect these characteristics – the underlying corporate credit risk, reduced for security and increased for illiquidity.

It would be incorrect to value the private placement by discounting the interest and principal payments at the expected return on the financial assets held as security. This would produce the absurd conclusion that a company could issue a secured private placement for £100, whilst incurring a liability of only £75, magically creating £25 of value.

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Equally, it must be incorrect to value corporate pension liabilities by discounting pensions at the expected return on the assets held as security in the fund. This would produce the absurd conclusion that a company could reduce the value of its pension liabilities by switching its pension fund assets from bonds to equities, breaking the Law of One Price.

This is very eloquently expressed by the PPI Chairman of Council, who said in 2004, *"Value is not magically created if a pension fund invests the money in equities. GBP400m of bonds is, after all, worth the same as GBP400m of equities. ... It is worth remembering that, when it comes to pension fund investment, there are no free lunches, only rather too much smoke and mirrors to confuse the unwary,"*⁵

Corporate pension liabilities are a form of secured corporate debt, (partly inflation linked), just like a secured long-term private placement. Both are unconditional obligations, legally binding on the company and secured on a pot of financial assets.

In economic terms, corporate pension liabilities and costs are calculated by reference not to the expected return on assets held in the fund, but by reference to matching assets, ie bonds, regardless of what the fund actually holds.

The best matching asset for public sector pensions is ILGs (adjusted for the RPI/CPI differential) as both are government guaranteed and both are inflation linked.

The Treasury does seem to believe that holding equities in a private sector pension fund reduces pension costs and includes a panel from the Hutton Report⁶ (p4). This says the cost of a £100 payment in 10 years time is £67, if a fund holds bonds, but only £46, if a fund holds equities.

⁵ Pensions Week March 8th 2004 "Marks & Spencer borrows £400m to plug scheme deficit" by Nick Fitzpatrick

⁶ http://www.hm-treasury.gov.uk/consult_unfunded_pensions.htm

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Does the PPI believe that the economic cost to a company of providing a pensions is reduced if the pension fund hold equities, with a higher expected return, than if it holds bonds with a lower expected return?

If the PPI does believe this, how does it reconcile this with the Law of One price?

All the major international accounting standards – FRS17, IAS19 and FAS87 - support the argument from financial economics and the Law of One Price, and require annual pensions costs and liabilities to be discounted using a corporate bond rate. None of these accounting standards are new, with FRS17 – the most recent – published in 2000.

*"Defined benefit scheme liabilities should be discounted at a rate that reflects the time value of money and the characteristics of the liability. Such a rate should be assumed to be the current rate of return on a high quality corporate bond of equivalent currency and maturity" (para 32) defined by the ASB as a AA bond.*⁷

By way of disclosure I should declare I was a consultant to the ASB on FRED20 and FRS17.

Appendix IV para 16 explains why using the "expected return on assets" is wrong.

"Some argue that even if there is no close correlation between equity and salary growth, it is appropriate to use the expected return on equities as the discount rate if the scheme is invested therein because, over the long term, that return is relatively secure. However, the higher return expected on equities is a reward for the risk involved in equity investment. Unless the risk matches that associated with the liabilities, discounting the liabilities at the higher return anticipates the expected benefit of equity investment without recognising the risks involved. The higher return should instead be recognised as it is earned over the period the equities are held."

⁷ <http://www.frc.org.uk/Search-Results.aspx?searchtext=frs17&searchmode=anyword>

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2 "Value to individual employees versus cost to taxpayers"

You explain that the PPI Report is about the value of pension benefits to individual employees, expressed as a percentage of salary, and that the Report, *"does not attempt to quantify the cost to the taxpayer of providing the public service pension schemes."*

However, the Report itself says *"... an Effective Employee Benefit Rate of 15% for a member of a public service pension scheme means that the scheme member would have to be given a 15% increase in their salary by their employer to compensate for the loss of the pension scheme."*

This 15% increase in salary to compensate for losing the pension benefit is a value to the employee, but is also a cost to the employer, or for public sector pensions, the taxpayer. Distinguishing between the value of public sector pensions to individual employees and the cost to the taxpayer is a distinction without a difference.

Since you believe that the cost to the taxpayer is not the same as the value to the individual employee, could you please provide the costs to the taxpayer?

3 "PPI methodological advisory group"

You explain that, *"Our approach to setting the discount rate for this project was reviewed and agreed by the PPI's methodological advisory group which had a broad membership including representatives from actuarial firms, unions, public service pension funds, academics, PPI Council and the Government. No member of the group suggested that we should be using a discount rate linked to index-linked gilts for this project."*

Given that ILGs was one of the four options considered in the Treasury Consultation Paper, as well as the well known arguments from financial economics, embodied in accounting practice, it seems strange that there was such unanimity against ILGs.

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Since you have referred to this group, in the interests of openness, could you please disclose the names of all its members?

There are many examples of economists and pension experts who support using ILGs, in addition to the 23 who sent the letter to George Osborne.

Let me quote Donald Kohn, a Member of the Bank of England's Financial Policy Committee, who said in 2008, when he was Vice-Chairman of the Federal Reserve Board:

*"... public pension benefits are essentially bullet-proof promises to pay. We all have read about instances in which benefits were lost when a private-sector pension sponsor declared bankruptcy and terminated the plan. In the public sector, that just hasn't happened, even when the plan sponsor has run into serious financial difficulty. For all intents and purposes, accrued benefits have turned out to be riskless obligations. **While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate.**"⁸ (My emphasis. NB although he is talking about the US, the same conclusion applies to the UK).*

David Wilcox, a senior economist at the Washington Federal Reserve, also said in 2008:

"The economics of how cash flows with no credit risk should be discounted are utterly unambiguous and non-controversial. They should be discounted using rates derived from securities with no credit risk."⁹

⁸ <http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm>

⁹ Comments before the Public Interest Committee of the American Academy of Actuaries September 4, 2008

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Conclusion

I repeat what I said in my earlier letter. Understating the real cost of public sector pensions, both in absolute terms, and in relation to the private sector, discourages proper, informed debate on this crucial issue,. At the macro-level, it allows the current generation of taxpayers to continue to pass on an economic cost to be paid by future generations.

The correct discount rate should be based on the yield on long-dated index-linked gilts, (adjusted for the difference between consumer price inflation and retail price inflation), since public sector pensions and ILGs share similar characteristics. Both are obligations of the UK government, both are contractually committed, legally-binding and both are inflation-linked.

The Report's preface says, "*The objective of the report is to aid understanding about the potential impact of the Coalition Government's proposed reforms to the public service schemes.*" As currently written, the Report fails in this objective and undermines the credibility of the PPI as a trusted, independent and authoritative organisation.

A revised Report is necessary to demonstrate the PPI's independence and intellectual rigour, which is undermined by the incompleteness and inadequacy of the Report as it stands.

I repeat my request that the PPI publish a revised version of the Report, which:

- a. discusses the discount rate issues outlined here and in the attached letter to Mr Osborne from 23 pension experts, which have been well aired in print.
- b. includes costings based on ILGs, as well as the official CPI + 3%.
- c. explains the different conclusions which these ILG costings entail.
- d. explains how the total cost, including member contributions, of a private sector DB pension is 28% of salary versus only 24% for the new public sector pension, when the underlying terms are similar.

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Based on your letter I would also like to ask:

1 Does the PPI believe that the economic cost to a company sponsor of providing a pension is reduced if the pension fund hold equities, with a higher expected return, than if it holds bonds with a lower expected return, ie bonds?

If the PPI does believe this, how does it reconcile this with the Law of One Price?

2 Since the PPI believes that the cost to the taxpayer is not the same as the value to the individual employee, could you please provide the costs to the taxpayer?

3 Since you have referred to the PPI's methodological advisory group, in the interests of openness could you please disclose the names of its members.

I look forward to receiving your reply.

I would be grateful if you would copy this letter to the Members of the PPI Council and the Nuffield Foundation.

Yours sincerely,

John Ralfe

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Public Service Pensions Discount Rate Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
1 Horseguards Road
London SW1A 2HQ

2nd March 2011

Dear Sirs

Public Service Pensions Discount Rate Consultation

I have pleasure in responding to this important Consultation and I attach a brief biography as Appendix 3.

It is crucial that the correct discount rate is used to measure and recognise the real economic cost of new public sector pension promises in the year the promises are made:

- "*What is not measured is not managed*". At the micro-level, individual public sector bodies cannot be run efficiently if pension costs, often material, are understated.
- "*No taxation without representation*". At the macro-level, the current generation of taxpayers should pay for the full cost of the services they are using, including salaries and pensions. Otherwise this cost is passed to future generations of taxpayers, which is fundamentally undemocratic.
- Using an incorrect discount rate makes it impossible to properly measure and compare the real economic savings of potential changes to public sector pensions, such as increasing the normal retirement age.

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My conclusions are:

a The correct Discount Rate to measure the economic cost of new public sector pension promises is the yield on long-dated index-linked gilts (see Appendix 1 Q&A 3)

Public sector pension promises and ILGs have similar relevant characteristics: both are obligations of the UK government, both are contractually committed, legally-binding contracts and both are inflation-linked.

However, from the viewpoint of individual members, public sector pension promises and ILGs as financial assets differ in two second-order respects:

- pensions have significant tax advantages over ILGs. If a member received a cash equivalent salary it would be taxed at the marginal rate in employment, but pensions are taxed at the marginal rate in retirement, typically lower and 25% of the pension value can also be taken as a tax-free lump sum. These tax advantages suggest the economic cost should be based on a *lower* discount rate than ILGs.
- Unlike pension promises, ILGs are liquid and can be sold to third-parties, suggesting the economic cost should be based on a *higher* discount rate than ILGs.

It is difficult to estimate the impact of these second-order effects, but as a practical matter, it is reasonable to assume they cancel each other out.

A discount rate based on private sector pensions would understate the annual cost - unlike public sector pension promises, funded private sector promises carry the credit risk that the sponsor becomes insolvent with inadequate pension assets to pay the pensions.

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A discount rate based on expected GDP growth or the Social Time Preference Rate would understate the annual cost – just like discounting future gilt payments at the expected GDP growth or STPR would understate the economic liability when issuing a gilt.

The official cost of unfunded public sector pensions, based on a real yield of 3.5%, is around £15bn a year, but the real economic cost, based on an ILG yield of 1%, is double at £30bn.

b The correct Discount Rate must be the same for all public sector schemes, whether they are funded or unfunded

The Consultation Document excludes funded public sector schemes, especially the Local Government Pension Scheme, from its scope (1.23).

Since the LGPS is set up under the same legislation as unfunded public sector schemes, the credit risk is the same, and the discount rate, of ILGs, must be the same. The LGPS credit risk may be considered to be *lower*, since its members would have recourse to financial assets in the event of a default.

c The correct Discount Rate should be used primarily to measure and recognise the economic cost of new pension promises in the financial accounts of individual employers (see Appendix 2)

Public sector financial reporting is based on accrual accounting, not crude cash accounting, so it is important to ensure individual financial accounts recognise the economic cost. Cash contributions will be similar to the P & L cost over a number of years, but need not be the same in any one year.

Please feel free to ask any questions.

Yours sincerely,

John Ralfe

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Appendix 1

Questions & Answers

1. Chapter 1 sets out the expected impacts of a lower discount rate. Are there any other impacts arising from a change in the discount rate?

Chapter 1 covers all the expected impacts of a lower discount rate.

2. Chapter 3 sets out the objectives for the Government in setting the SCAPE discount rate. Are there any other objectives that should be taken into account?

Chapter 3 covers all the objectives which should be taken into account.

3. Chapter 3 sets out four options. What are the advantages and disadvantages of the four options identified by the Commission for the approach to setting the SCAPE discount rate?

a A discount rate consistent with private sector and other funded schemes

The Consultation Document suggests that regular contributions for private sector schemes are based primarily on the fund's asset allocation and represent the real economic cost of new pension promises.

However, UK companies derive their pension costs under IAS19 or FRS17, with the cost of new pension promises based on a high quality or AA corporate bond rate, regardless of the pension fund's asset allocation.

Furthermore, the FRS17/IAS19 service cost should be considered not simply as "an accounting cost", but a reflection of the real economic cost of new pension promises.

This view was recently reinforced by Ofcom, which examined whether the annual pension cost it allows BT to charge its customers should continue to be the IAS19 cost or should be its annual cash contribution.

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In the December 2009 Consultation Document, Ofcom said that "BT's ongoing cash contributions are less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and its Trustees". ¹⁰ (9.54)

This conclusion was repeated in Ofcom's July 2010 final response, "the cash contribution measure is less of a reflection of the true economic costs of current pension obligations, and more a reflection of a complex bargaining process between the company and the pension scheme's Trustees". ¹¹ (4.21)

An FRS17/IAS19 discount rate, based on a AA or high quality corporate bond, reflects the credit risk that the corporate sponsor will become insolvent, with inadequate pension assets to pay all the pensions. Since there is no such credit risk in public sector pensions, backed by the government, an FRS17/IAS19 rate would understate their economic cost.

Pension costs for private sector schemes may also be moving towards using a risk-free rate. The international Discussion Paper from January 2008 led by the UK Accounting Standards Board ¹², suggests the pension discount rate for corporate pensions should be the risk-free rate, not high quality corporate bond rate, which was reaffirmed in the Summary Paper of January 2009 ¹³.

The Consultation Document reprints part of the Interim Report of the Independent Public Sector Pensions Commission, which suggests that the economic cost to a company of a (pension) promise depends on the assets it holds to pay that pension. A £100 promise payable in 10 years time, could cost £67.56, if it holds gilts or £46.32, if it holds equities (p4).

This is a fundamental misunderstanding of the economic cost of long-term (pension) promises, which depends on the credit risk of the promise. If the promise is just the unsecured credit risk of the company, the discount rate is the company's marginal borrowing cost. If the (pension) promise is

¹⁰ <http://stakeholders.ofcom.org.uk/binaries/consultations/btpensions/summary/pensions.pdf>

¹¹ <http://stakeholders.ofcom.org.uk/binaries/consultations/751766/summary/pensionscondoc.pdf>

¹² <http://www.frc.org.uk/images/uploaded/documents/PAInE%20January%202008.pdf> (4.28)

¹³ <http://www.frc.org.uk/images/uploaded/documents/Pensions%20Redeliberations%20Report1.pdf>
(3.4.4)

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backed by assets, the credit risk is reduced, because of the security provided, the discount rate is lower and the cost is higher.

Under GAAP the present value of an unsecured long-term payable would be discounted at the company's marginal borrowing cost. The present value would not be reduced if the company earmarked a portfolio of assets to meet the payable.

b A discount rate based on the yield on index-linked gilts

Public sector pensions should be discounted at the yield on ILGs, because they share similar relevant characteristics.

- Both public sector pensions and ILGs have the same credit risk- they are obligations of the UK government.

- Both public sector pensions and ILGs are contractually committed payments, which the government can only avoid by defaulting. Not paying the promised public sector pensions would be a breach of contract, and end up in the Courts, exactly like missing a gilt payment.

- Both public sector pensions and ILGs are inflation-linked, subject to the differential between RPI indexation in ILGs and CPI indexation in public sector pensions.

Public sector pensions are deferred pay earned by public sector employees, the equivalent of giving ILGs to be redeemed at retirement. This means annual public sector pension payments are financing payments, like paying interest and principal on gilts.

c A discount rate in line with expected GDP growth

The Consultation Document explains that the rationale for discounting public sector pensions in line with expected GDP growth is to "*reflect the fact that pensions from the unfunded schemes will be paid for out of future tax revenues, not a fund of assets*". (3.9)

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It could also be argued that gilt interest and principal payments "*will be paid for out of future tax revenues*", so that government debt issued in any year should be valued by discounting future payments in line with expected GDP growth. But gilt payments are financing in nature, so the correct discount rate is the market gilt rate for the relevant maturity.

The Treasury produces forecasts of categories of age-related spending projections, including public sector pensions, as a percentage of forecast GDP for 50 years.¹⁴ The Treasury seeks to forecast and manage each spending category so that it remains "*affordable and sustainable*" as a percentage of forecast GDP, taking into account expected productivity growth and demographic changes.

The other categories - education, health, long term care and even state pensions - are all forms of discretionary payments to citizens, the same as "operating expenses" for a company. To maintain "affordability" of any of these a government can, subject to the ballot box, reduce this spending, including state pensions by, for example, increasing the pension age.

Unlike health, education or state pensions payments, a government cannot reduce public sector pension payments to maintain "affordability". Public sector pensions are not discretionary payments to former public sector employees, but deferred pay earned by them as part of their legally binding contract of employment.

d A Social Time Preference Rate

The Consultation Document explains that the rationale for discounting public sector pensions at the STPR is that "*it represents the alternative public sector investment opportunities for the funds used to pay public sector pensions*" (3.11)

It could be argued that the STPR "*represents the alternative public sector investment opportunities for the funds used to pay gilts*", so government debt

¹⁴ http://collections.europarchive.org/tna/20100407221114/http://www.hm-treasury.gov.uk/d/pbr09_publicfinances.pdf

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issued in any year should be valued by discounting future payments at the STPR.

A future government can choose to spend more on health and less on education, based on a cost benefit analysis using the STPR, but it cannot choose to spend less on repaying gilts, which are contractually committed.

Because public sector pension payments are also financing payments, like gilt payments, it is grossly misleading to value the cost of new pension promises by discounting projected pension payments using the STPR.

The STPR is the equivalent in the private sector of the company's cost of capital and is used in cost-benefit analysis to compare future positive net cash flows, (income or costs saved), with Present Value costs, to establish if a particular public sector project has a positive NPV.

To arrive at a proper NPV, and correct investment decision, the net positive cash flows must only include operating cash flows and exclude all financing cash flows. Repaying gilts, and paying public sector pensions are financing, not investment, in nature.

4. Are there further approaches to setting the SCAPE discount rate that the Government should consider?

There are no further approaches which the Government should consider.

5. Which approach to setting the SCAPE discount rate do you recommend, and why? Following your preferred approach, what actual discount rate do you consider would be appropriate?

The annual cost of new pension promises should be calculated by using the long-dated ILG rate, adjusted for the CPI/RPI differential. The Commission suggests the RPI yield is 0.8%.

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The cost of new pension promises should exclude any expected salary growth, as recommended in the ASB Discussion Paper of January 2008,¹⁵ with the cost of salary increases recognised only when the salary increase is awarded. If public sector schemes move to Career Average benefits this will become irrelevant.

6. Do you consider that there should be a regular review of the SCAPE discount rate? If so, how often should this take place?

To reflect the annual economic cost each public sector scheme should calculate its annual pension charge, as a percentage of salary, based on the ILG rate, which would be reviewed each year. Like the current calculation of FRS17 costs, it would be based on approximate "roll-forward" of the position at the latest Valuation, and there would be no marginal work involved. The annual percentage of salary would be communicated to each employer to include in its annual accounts.

The SCAPE discount rate of ILGs to set cash contributions should be reviewed at each Valuation, so the economic cost recognised and cash contribution may differ in any particular year.

Appendix 2

The correct Discount Rate should be used primarily to measure and recognise the economic cost of new pension promises in the financial accounts of individual employers

To increase transparency and consistency, financial reporting for all government bodies is now based on Generally Accepted Accounting Principles and the Financial Reporting Advisory Board was established to apply GAAP to government accounts. Moving from crude cash-accounting to GAAP enhances accountability for the financial performance of

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individual entities and ensures all costs, which, like pensions, may not be paid for some time, are recognised as they are incurred. ¹⁶

By focusing on the cash contribution, not the economic cost of new pension promises recognised in individual employer accounts, the Consultation Document seems to be encouraging a move from accrual accounting back to cash accounting.

The cash contribution should be similar to the economic cost over a number of years, and is likely to change at each periodic valuation, will not get far out of line with the annual economic cost.

The Consultation Document may be focusing on cash contributions because of the technicalities of FRS17 accounting. ¹⁷

At the moment each public sector pension scheme calculates an annual percentage cost of pensionable salary and an overall FRS17 cost for new pension promises, based on a AA corporate bond rate.

But individual public sector employers do not show these costs in their annual accounts, since they are responsible for paying only the required annual pension contributions and, unlike corporate pension schemes, have no further liability beyond this – the government, not employers, is responsible for paying pensions, including any shortfall.

Under FRS17 employers therefore account for their pension costs on a cash basis, based on the SCAPE methodology, even though the pensions are defined benefit - their *"contributions are set in relation to the current service period only (ie are not affected by any surplus or deficit in the scheme relating to past service of its own employees or any other members of the scheme)"* (FRS17 para 9a)

The NHS accounts, for example, explain that its pension cost equals its cash contributions, *"employees are covered by the provisions of the NHS*

¹⁶ See for example: <http://www.public-audit-forum.gov.uk/PAF%20Accruals%20Paper.pdf>

¹⁷ NB The Author was a Consultant to the ASB on FRS17

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*Pension Scheme...[which]... is accounted for as if it were a defined contribution scheme: the cost to the NHS body of participating in the scheme is taken as equal to the contributions payable to the scheme".*¹⁸

¹⁸ <http://www.official-documents.gov.uk/document/hc1011/hc04/0410/0410.pdf>

JOHN RALFE CONSULTING

26th April 2011

Rt Hon George Osborne MP
Chancellor of the Exchequer
HM Treasury
Horse Guards Road
London SW1A 2HQ

Dear Mr Osborne

Public sector pensions discount rate

You announced in the Budget that the annual cost of new public sector pension promises would be calculated using a discount rate of expected GDP growth above inflation and the formal reasons for this were published on April 6th.

We are writing to ask that you re-consider this decision which we believe fundamentally misrepresents the economics of public sector pensions and has serious pernicious consequences.

In our view the correct discount rate should be based on the yield on long-dated index-linked gilts, (adjusted for the difference between consumer price inflation and retail price inflation), since public sector pensions and index-linked gilts share similar characteristics. Both are obligations of the UK government, both are contractually committed, legally-binding and both are inflation-linked.

The Consultation suggests the argument for using expected GDP growth is that pensions are "*paid for out of future tax revenues*".

But gilt interest and principal payments are also paid for out of future tax revenues. This clearly does not mean that new gilt issues should be valued by discounting payments in line with expected GDP growth, rather than the market gilt rate.

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In using expected GDP growth, the Treasury has not explained how an obligation to pay a public sector pension differs from an obligation to pay gilts. If there is no difference, then pensions should be discounted at the gilt rate. The other possibility, that gilt payments should be discounted at the expected GDP growth rate, is immediately contradicted by the market.

The government's approach implies that it is cheaper for it to promise an inflation-linked pension payment to a public sector employee than it is to pay the coupon and principal on an index-linked bond.

By overstating the discount rate we understate both the current economic cost of public sector pensions and the real economic savings from the Hutton Report's recommendations. It also means that the efficiency of individual public sector bodies is overstated, as employment costs are understated and at the macro-level, the current generation of taxpayers is passing on an economic cost to be paid by future generations.

We must be clear that public sector pensions are not discretionary government spending, like health or education, which, subject to the ballot box, can be reduced to maintain affordability. They are deferred pay earned as part of a legally binding contract of employment, the equivalent of giving gilts to be redeemed at retirement and we believe their true cost should be properly measured.

In light of this we ask you to re-consider this decision.

Yours sincerely,

NB This letter is signed in a personal capacity and any institutional affiliation does not imply endorsement by that institution.

JOHN RALFE CONSULTING

Lawrence Bader
Fellow of the Society of Actuaries
Cary, NC, USA

Andrew G. Biggs
Resident Scholar
The American Enterprise Institute
1150 Seventeenth Street, N.W.
Washington, DC 20036, USA

Zvi Bodie
Professor of Management, Finance and Economics
Boston University School of Management
595 Commonwealth Avenue
Boston, MA 02215, USA

Jeffrey R. Brown
William G. Karnes Professor of Finance and Director of
the Center for Business & Public Policy
University of Illinois
515 East Gregory Drive
Champaign, Illinois 61820, USA

Jeremy I. Bulow
Richard Stepp Professor of Economics
Graduate School of Business
Stanford University
Stanford, CA 94305-5015

Wayne Cannon
Fellow of the Institute of Actuaries of Australia
Upper Kedron, Queensland 4055, Australia

John Ralfe Consulting Limited
24 Devonshire Road, West Bridgford, Nottingham NG2 6EU
Tel: 0115 982 1911 07779 574193 JohnRalfe@JohnRalfe.com
www.JohnRalfe.com
Registered in England and Wales: Number 04724749

JOHN RALFE CONSULTING

Bernard Casey
Principal Research Fellow
University of Warwick Institute for Employment Research
Coventry, CV4 7AL

Daniel Clarke
Departmental Lecturer in Actuarial Science
Department of Statistics
University of Oxford
1 South Parks Road
Oxford, OX1 3TG

Tony Day
Founder
Scarce Capital
13 Lyall Street
Hawthorne, 3122, Victoria, Australia

Jon Exley
Fellow of The Institute of Actuaries
Thornton Steward
North Yorkshire, HG4

Jeremy Gold
Jeremy Gold Pensions
22 West 26th Street
New York, NY 10010, USA

Philip Lawlor
London, SW16

David A. Love
Assistant Professor of Economics
Williams College
Williamstown, MA 01267, USA

John Ralfe Consulting Limited
24 Devonshire Road, West Bridgford, Nottingham NG2 6EU
Tel: 0115 982 1911 07779 574193 JohnRalfe@JohnRalfe.com
www.JohnRalfe.com
Registered in England and Wales: Number 04724749

JOHN RALFE CONSULTING

Jon Palin
Fellow of The Institute of Actuaries
St Peter Port
Guernsey

George G. Pennacchi
Professor of Finance
University of Illinois
515 East Gregory Drive
Champaign, Illinois 61820, USA

John Ralfe
John Ralfe Consulting
24 Devonshire Road
West Bridgford
Nottingham, NG2 6EU

Neil Record
Institute of Economic Affairs
2 Lord North Street
London, SW1P 3LB

Ronald J. Ryan, CFA
Chief Executive Officer
Ryan ALM, Inc.
60 East 42nd Street, Suite 2515
New York, NY 10165, USA

Crispin Southgate
London, SE21

Cliff Speed
Fellow of the Faculty of Actuaries
St Albans, AL3

John Ralfe Consulting Limited
24 Devonshire Road, West Bridgford, Nottingham NG2 6EU
Tel: 0115 982 1911 07779 574193 JohnRalfe@JohnRalfe.com
www.JohnRalfe.com
Registered in England and Wales: Number 04724749

JOHN RALFE CONSULTING

David Starkie
Senior Associate
Case Associates
271 Regent Street
London, W1B 2ES

Ian Sykes
Fellow of The Institute of Actuaries
Dublin, Ireland

Peter Tompkins
Fellow of the Institute and Faculty of Actuaries
London, NW1