PPI submission to HM Treasury's consultation on the discount rate used to set unfunded public service pension contributions

Introduction

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision makers to take informed policy decisions on pensions and retirement provision.

2. This response focuses on the impacts arising from a change in the discount rate and evidence relevant to the Government's decision making in relation to selecting a discount rate to be used when calculating contributions to the unfunded public service pension schemes.

3. The comments in this response only refer to the discount rate to be used by the Government to calculate contributions to the unfunded public sector pension schemes. In other situations, a different discount rate may be appropriate.

Impacts arising from a change in the discount rate (Question 1)

4. Unfunded public sector pensions are paid for by a combination of employer and employee pension contributions and a balancing item from the Treasury. The discount rate does not affect the cash spent each year on public sector pensions; it affects the split between the amount funded by employee and employer contributions and the Treasury balancing item.

5. If the Government were to reduce the SCAPE discount rate then the implication is that the total contributions required to pay for the unfunded public sector pension schemes would rise. If this change were to result in an increase in the pension contributions to be paid by public sector employers who offer staff public sector pensions, then this will increase the costs of employing staff for these employers relative to the costs of investing in capital. This may affect the allocation of resources by public sector employers between labour and capital. It may also make the costs of offering such public sector pensions more apparent to public sector employers.

6. The consultation document suggests that it is not the Government's intention that a change in the discount rate should put additional pressure on departmental budgets over the course of the Spending Review. This implies that the Treasury will increase departmental budgets to allow for any increased costs of providing pensions that may arise from the Government adopting a lower discount rate in calculating the employer contributions. The short-term impact of a change in the discount rate may therefore be very little in terms of the overall impact on the cost to the Treasury.

7. If the protection of departmental budgets does not extend beyond the period of the Spending Review then a change to the discount rate may have a material impact on departmental budgets. An increase in the costs to the employer of providing public sector pensions may lead to tensions with other Departmental spending plans. There may therefore be long term impacts on managing the budgets of government departments and setting priorities if pension contributions increase.

8. Some independent providers who are not funded by government but are permitted to participate in a public sector scheme may face real cost implications immediately as a result of the change in the discount rate. For example, independent schools may participate in the Teachers' Pension Scheme. Adjustments to the discount rate that increase employer contributions could have a material financial impact on such providers.

Objectives to be taken into account when setting the SCAPE discount rate (Question 2)

9. The Government has set out potential objectives to be considered when setting the SCAPE discount rate, that it should:
   - be a fair reflection of costs
   - reflect future risks to Government income
   - support plurality of provision of public services
   - be transparent and simple
   - provide stability.

10. The consultation document notes that there are tensions between some of these objectives and that some objectives may be more important than others. Given that the primary purpose of the SCAPE discount rate is to calculate the total contributions required to pay for the unfunded public sector schemes, the objectives of being a fair reflection of costs and reflecting future risks to Government income seem particularly important.

Principles in setting the SCAPE discount rate (Questions 3, 4 and 5)

11. The consultation document sets out four alternative approaches that could be taken by the Government to set the SCAPE discount rate. These options include
    - A rate consistent with the private sector and other funded schemes;
    - A rate based on the yield on index-linked gilts;
    - A rate in line with expected GDP growth; and
    - The Social Time Preference Rate

12. These options seem to cover the main alternative approaches that the Government could take so we have no further suggestions for new approaches.

13. In thinking about a reasonable approach for the Government to take in setting the SCAPE discount rate it may be helpful to first consider how contributions are set in pension schemes in the private sector.

14. Funded pension schemes in the private sector invest the employer and employee contributions in assets in order to maintain a large enough fund to cover the expected pension promises built up. Pay-as-you-go public sector pensions are unfunded; current pensioners are paid from contributions from public sector scheme members and employers (plus a transfer from the Treasury in the event of a shortfall). Public sector employer contributions for the unfunded schemes are paid for from Departmental spending budgets and therefore are ultimately funded by general taxation.

15. The principle generally used to set the discount rate when calculating the employer contributions in the private sector is to base the discount rate on the expected growth rate of the assets in the fund. A private sector pension invested in equities would be likely to use a higher discount rate to calculate employer contributions than one which was invested in gilts. This reflects the additional risk premium that is assumed to be attached to equity investment. The discount rate may also be adjusted to allow for the employers financial strength and long term commitment to the scheme (the employer covenant).

16. The unfunded public sector schemes do not have a pool of assets underlying the pension promises in this way. Current payments to public sector pensioners in the unfunded schemes are made out of current Government spending.

17. It is therefore the ability of future Governments to raise future tax revenues which serves as the ultimate source of funding for future public sector pension promises. The expected growth in future tax revenue would be analogous to the asset income generated by the assets

underpinning a pension scheme in the private sector. Therefore the private sector approach of basing the discount rate on asset growth would lead to a public sector discount rate based on the expected growth of tax revenue for calculating the appropriate level of contributions.

18. The growth in Gross Domestic Product (GDP) is a measure of the growth in the overall economy. This means it may be considered to be a reasonable proxy for the growth in future tax revenues and may therefore be an appropriate approach for the Government to use in setting the discount rate to calculate the contributions needed to pay for the unfunded public sector pension schemes. However, it should be noted that as there is uncertainty about the expected future growth of tax revenues and of GDP, it may also be appropriate for this uncertainty to be reflected in an adjustment to the discount rate.

19. For example, in private sector pension schemes an adjustment to the discount rate may be made in order to reflect the strength (or lack of) of the employer covenant. In cases where risks are higher, it is usually considered prudent to make a reduction to the discount rate in order to increase the resulting employer contributions.

Possible reviews of the SCAPE discount rate (Question 6)

20. The SCAPE discount rate should be a long term assumption reflecting the long term nature of the pension benefits accruing. However regular but fairly infrequent reviews should be made for the purpose of ensuring that the discount rate is not out of step with prevailing economic conditions. For example, if the long run rate of economic growth and therefore the expected growth in future tax revenues in the UK were expected to change, then this would also affect the expected future tax revenues from which public sector pensions are paid and may warrant an amendment in the SCAPE discount rate.

21. The Government may want to conduct a review once every few years (perhaps at the same time as other key assumptions, such as mortality, are assessed) to ensure that the current SCAPE discount rate remains appropriate in the context of the UK's economic climate. Very short term and frequent reviews should be avoided because there is a risk that frequent changes to the discount rate may cause fluctuations in employer contributions and increases in administration costs which do not really reflect any changes to anticipated cashflows.