Public Service Pensioners' Council

Hamilton House, Mabledon Place, London WC1H 9BD. Telephone: 020 7380 4765 FAX: 020 7383 3454

Lord Hutton
Independent Public Service Pensions Commission
1 Horse Guards Road
London
SW1A 2HQ

28th July 2010

Dear Lord Hutton

PSPC RESPONSE TO INTERIM REVIEW 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 take the opportunity to submit evidence to the Commission. We acknowledge that the main focus of the Commission will be on current and future arrangements for active members of public service pension schemes. Recent events have, however, convinced us that pensioners' organisations need to participate in a conversation which could affect the future of millions of public service pensioners.

Section 1 – Accrued rights

Hutton Commission

The terms of reference for the Hutton Commission begin with the following:

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.

It is therefore taken as axiomatic in the remit that accrued rights will be protected. It is the view of the Public Service Pensioners' Council that such protection includes the right to indexation on the present and longstanding basis. We therefore ask you to comment on the merits and propriety of the Government's proposed change to the indexation arrangements in your interim report.

The Move from RPI to CPI

Indexation of pensions in payment to the Retail Prices Index (RPI), has been in place since the implementation of the Pensions (Increase) Act 1971. Generations of public service pensioners have planned their retirements on the assumption that they would have RPI-linked pensions throughout retirement.

General Secretary: ANDREW MORRIS

ASSOCIATIONS REPRESENTED: Association of HM Inspectors of Schools OFSTED Section Committee • Association of HM Inspectors of Schools (Scotland) • Association of Local Authority Chief Executives • Association of Teachers and Lecturers • Association of School and College Leaders • British Broadcasting Corporation Pensioners Association • Civil Service Pensioners' Alliance • Civil Service Pensioners' Alliance (Scotland) • Educational Institute of Scotland • Forces Pension Society • Foreign and Commonwealth Association • National Association of Head Teachers • National Association of Retired Firefighters • National Association of Retired Police Officers • National Association of Schoolmasters Union of Women Teachers • National Union of Teachers • Overseas Service Pensioners' Association • Prospect • Public and Commercial Services Union • Retired Police Officers' Association (Scotland) • Retired Prison Governors Association • Retired Teachers' Association (Northern Ireland) • Scottish Retired Teachers' Association • UNISON • University and College Union

The June 2010 Emergency Budget announced a switch from RPI to the Consumer Prices Index (CPI) for the state second pension, and consequently through the legislative link, to public service pensions. We believe this to be a breach of promise that will cost public service pensioners tens of thousands of pounds each during the course of their retirements.

Experience shows that the CPI is routinely lower than the RPI. A comparison of the difference between the September RPI and CPI figures – the figure used annually for uprating pensions - using ONS data gives a yearly average difference of 0.67 per cent.

Table 1: Comparison of September CPI and RPI September figures 1989 – present.

Year	RPI (%)	CPI (%)
1989	7.6	5.2
1990	10.9	8.1
1991	4.1	7.1
1992	3.6	3
1993	1.8	3
1994	2.2	1.5
1995	3.9	3
1996	2.1	2.3
1997	3.6	1.8
1998	3.2	1.4
1999	1.1	1.2
2000	3.3	1
2001	1.7	1.3
2002	1.7	1
2003	2.8	1.4
2004	3.1	1.1
2005	2.7	2.5
2006	3.6	2.4
2007	3.9	1.8
2008	5	5.2
2009	-1.4	1.1
Average	3.36	2.69
Difference	0.67	

Assuming RPI of 3 per cent and CPI of 2.33 per cent a year, over the course of a 25-year retirement, a public service worker with a £10,000 pension will receive over £30,000 less because of the switch from RPI to CPI,. This is a huge loss of purchasing power during retirement. It must be remembered that linking pensions to prices rather than earnings at retirement 'freezes' any link to real increases in standards of living during retirement. Switching from RPI to CPI will cause public service pensioners to lose yet further ground.

There are two major reasons that CPI is routinely lower than RPI. The first relates to the constituents of the respective indices. CPI excludes items related to housing costs, including mortgage interest payments, council tax, housing depreciation, buildings insurance and surveyors' and estate agents' fees. It would be expected that these costs would continue to rise ahead of other costs over time, leading to a tendency for RPI to continue to be higher than CPI.

The second reason why CPI is lower than RPI relates to the underlying methodology of the indices, due to the RPI being an arithmetic mean of price changes and CPI being 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.'

In other words, the move from RPI to CPI is likely to cost pensioners 0.5 per cent a year even before the impact of the different index constituents is considered.

Appropriateness of CPI

We do not accept that the CPI is a more appropriate measure of inflation than RPI for pensioners. The Government itself seems desperately confused over what should be contained in inflation indices. The Budget Red Book contains the following: *The Government will use the CPI for the price indexation of benefits and tax credits from April 2011. The CPI provides a more appropriate measure of benefit and pension recipients' inflation experiences than RPI, because it excludes the majority of housing costs faced by homeowners (low income households are subsidised separately through Housing Benefit, and the majority of pensioners own their home outright).* On the other hand, the Banking section of the Coalition Agreement 'Our Programme for Government' says '*We will work with the Bank of England to investigate how the process of including housing costs in the CPI measure of inflation can be accelerated*'.

Pensioners are still subject to council tax, which is excluded from the CPI calculation. Pensioners who are homeowners still have to pay for the upkeep and repair of their properties. An increasing number of pensioners still have a mortgage to service. Even if the last point is excluded, if the government's rationale for switching indices is that pensioners typically own their homes outright, then it would be logical to switch indexation from RPI to RPI-X, RPI excluding mortgage interest payments, rather than CPI.

The true reason for the switch from RPI to CPI is not that it is more appropriate but, as already stated above, that it is a means of saving money. If the Government is truly serious about linking pension increases to the real inflation experienced by pensioners, then the PSPC would welcome the adoption of a Pensioners Price Index. We note the Institute for Fiscal Studies' finding in March 2009 that while the inflation faced by the average household in January 2009 was 2.1 per cent, pensioner households faced far higher inflation because of their greater spending on food and fuel. True inflation for the over-80s in January 2009 was 7.1 per cent.

Breaches of promise

Prior to the election, the climate of unremitting negativity surrounding public service pensions had led our members to question whether their pension rights were safe. On our behalf the Civil Service Pensioners' Alliance sought clarification on index-linking from each of the three main political parties to protect accrued rights.

We welcomed the fact that all three parties gave their assurances that there were no plans to change index-linking arrangements. At a meeting held on 30 March 2010, Angela Eagle said on behalf of the Labour Party *"Following the agreement for change reached with the unions in 2007, we are satisfied that public sector pensions are affordable, sustainable and fair.* ***We have no plans to change the current index-linking arrangements.****"*

In a letter dated 27 April 2010, Philip Hammond the then Shadow Chief Secretary to the Treasury, wrote in a letter to the Civil Service Pensioners' Alliance that: *"Indexation of pensions in payment is an established part of pensions legislation.* ***The Conservative Party has no plans to change the current index-linking of public sector pensions in payment.*** *We*

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

agree with the view that the right to indexation of pensions already accrued is part of the accrued pension rights and those rights will be protected."

The then Liberal Democrat Shadow Pensions Minister, and now Pensions Minister, Steve Webb MP also said in a letter dated 12 April 2010: *"We are very clear that all accrued rights should be honoured: a pension promise made should be a pension promise kept. Therefore we would not make any changes to pension rights that have already been built up.* ***I have confirmed that I regard accrued index-linked rights as protected****."*

At the Public Service Pensioners' Council's Pre Election Conference in March 2010, all three pensions spokespeople (Angela Eagle MP, Nigel Waterson MP and Steve Webb MP) stressed that any changes to public sector pensions would have a long lead-in time and would be subject to full consultation.

Scheme literature also indicated that pensions would be linked to the Retail Prices Index in retirement. In the Treasury leaflet: 'A guide to the provisions for increasing public service pensions' (1987) the following was stated ' *What are the percentage increases received? Most public service pensions will receive the percentage increase that applies to the State Earnings Related Pension. This increase is based on the rise in retail prices.*

Similarly, the section of the members' guide 'Your Guide' (correct at 1/7/10) in the Teachers' Pension Scheme states the following *'Your pension will be increased to take account increases in the cost of living. This is known as index-linking because the increases are related to rises in the Retail Prices Index*'. The Civil Service Pensions guide 'Your Classic Benefits explained' (December 2009, p24) contains the following explanation of the term 'index-linked': '*Your pension is guaranteed to increase in line with inflation, as measured by the Retail Prices Index (RPI)*'. You will note the lack of caveats expressed in both cases. It is understood by professionals that the scheme regulations outrank guidance, but this knowledge is not shared by the general public. Any reasonable member of the public would conclude that their pension indexation was guaranteed.

There is a private sector parallel, where due to FSA leaflets that said the private sector DB schemes were 'safe', the Government was eventually forced to set up the Financial Assistance Scheme because people may have relied on these assurances. In this case the Government was not even a direct party to the contract that existed between employer and employee. Here the Government is a party to the contract, and the misrepresentation is, if anything, even more straightforward.

Conclusion

The PSPC believes that the switch in indexation arrangements for public service pensions from RPI to CPI will cost public service pensioners tens of thousands of pounds.

The Commission's terms of reference refer to "protecting accrued rights". We would be very grateful to receive clarification as to how the Commission interprets this part of its remit, as it seems overwhelmingly clear to us that accrued rights are not being protected.

As the Commission is being asked to conduct a fundamental structural review, while protecting accrued rights, we believe that in its first report it must address the question of the switch from RPI to CPI indexation, and whether this constitutes a breach of accrued rights. To ignore the subject, and to proceed blithely under the heroic assumption that accrued rights are being protected when they are not, risks damaging the perceived independence of the Commission in the eyes of stakeholders, which will lessen the credibility of its final report.

Section 2 - Pensions for active members

Although the Council's main purpose is to represent the interests of those who have retired, we recognise the importance of good pension provision for current and future public service pensioners. Any debate around public service pensions should be based on evidence, rather than deliberate misconceptions.

The role of public servants includes many sensitive, important and sometimes dangerous tasks. It is entirely right that their pay and pension arrangements be therefore sufficient to encourage the right calibre of candidate to be recruited, and for them to be able to undertake their duties with confidence.

In this context, pensions are an integral part of public service workers' total remuneration package and should be viewed as deferred pay. Through the use of the pension mechanism, public service workers are smoothing consumption through their lives by deferring part of their pay until their retirement. This long-term attitude to spreading income over a lifetime should be congratulated, not castigated, especially in an era of longer life expectancy.

All defined benefit public service pension schemes are single schemes. High-flyers are not separated out with superior pension entitlement. The future head teacher joined the same scheme as the classroom teacher. The future chief constable joined the same scheme as the constable. This even-handed approach is worth celebrating and contrasts with the private sector – where superior entitlement for directors is common practice.

Public service pension schemes are presented as expensive and unreformed. However, it is important to recognise that public service pensions have already been through a process of evaluation and reform. The principles for pension reform in the Teachers', NHS and Civil Service schemes were agreed by the Government and the TUC in the Public Services Forum (PSF) on 18 October 2005. Those principles recognise that public service pensions are a key benefit of public service employment and should be celebrated as such; it was important to maintain their good quality through retaining defined benefits and index-linking.

It was also recognised that changes in demographics, employment patterns, and the legal and regulatory framework required public service pension schemes to be modernised and to be sustainable. The PSF agreement explicitly recognised that each scheme covered would have a cost envelope that would be respected.

Normal pension ages have already risen in public service schemes as a result of the PSF agreement. The normal pension age in the teachers', NHS and civil service schemes for new joiners is 65, up from 60. Normal pension ages have also increased for schemes not covered by the PSF agreement.

As with normal pension ages, employee contribution rates have already risen in public service schemes. In the teachers' pension scheme, contribution rates have risen from 6 to 6.4 per cent for all staff. The local government pension scheme has introduced a banded contribution structure, where contributions increase from 5.5 per cent for workers earning less than £12,600, to 7.5 per cent for workers earnings more than £78,700. The average contribution rate is 6.4 per cent, up from 6 per cent under the previous arrangements.

In addition, many public service schemes have introduced cost sharing and cost capping arrangements. These share the burden of cost increases between employers and employees, but place an absolute limit of the employer contribution, protecting public finances. In the

Teachers' Pension Scheme, for example, there is a 14 per cent ceiling on the employers' contribution rate from the 2008 actuarial valuation onwards.

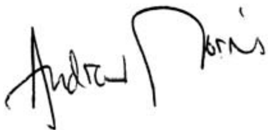
These reforms have only been in place for a short time, and should be given a chance to work through the cost-sharing mechanisms contained in the schemes' own actuarial valuation mechanisms. The December 2009 HM Treasury report 'Long–term public finance report: an analysis of fiscal sustainability' modelled costs under different scenarios in Chart 6.E (p48). It found that costs as a percentage of GDP would remain constant, at or below 2 per cent, between 2018-19 and 2059-60. The cost of funding public service pensions is sustainable.

The Hutton Commission's terms of reference for its interim report, to be published by the end of September 2010 is to '*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*'. This is a fundamental error which misunderstands the nature of pension funding. Pensions are a long-term endeavour, not a source of short-term revenue. Scheme contribution rates and the benefits provided should be decided through the schemes' individual valuation processes. Otherwise the notionally funded schemes are not notionally funded in any meaningful sense, they are just another source of Government revenue.

Next Steps

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