House of Commons

Committee of Public Accounts

The impact of the 2007–08 changes to public service pensions

Thirty-eighth Report of Session 2010–12

Report, together with formal minutes, oral and written evidence

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The Committee of Public Accounts

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The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/pac. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Philip Aylett (Clerk), Lori Verwaerde (Senior Committee Assistant), Ian Blair and Michelle Garratty (Committee Assistants) and Alex Paterson (Media Officer).

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Summary

In 2007-08, new pension schemes were introduced for civil servants, NHS staff and teachers. The changes were in response to Treasury requirements for savings in taxpayer costs to make public service pensions affordable.

Three main changes were made. First, the age at which a scheme member could draw a full pension was increased from 60 to 65 years for new members. Second, employee contributions were increased by 0.4% of pay for teachers and by up to 2.5% of pay for NHS staff. Third, a new cost sharing and capping mechanism was introduced to transfer, from employers to employees, extra costs that arise if pensioners live longer than previously expected. The Coalition Government announced additional changes in 2010, including indexing pensions to the Consumer Prices Index rather than the Retail Prices Index, which are expected to reduce costs further.

Government projections suggest that the 2007-08 changes are likely to reduce costs to taxpayers of the pension schemes by £67 billion over 50 years, with costs stabilising at around 1% of Gross Domestic Product (GDP) or 2% of public expenditure. This would be a significant achievement. We would, however, encourage the Treasury to publish a clear measure or benchmark of affordability which indicates the level of spending on public service pensions it considers sustainable. Officials appeared to define affordability on the basis of public perception rather than judgement on the cost in relation to either GDP or total public spending.

We are concerned that the Treasury did not test the potential impact of changes in some of the key assumptions underpinning the long-term cost projections. These include assumptions about the rate of growth in GDP, the size of the public service workforce, and the wider impact of the 2007-08 changes on increased payments in means-tested benefits and reduced receipts from taxation and national insurance. In addition, the Treasury has not tested whether reducing the value of pensions would affect the public sector's ability to recruit and retain high quality staff.

We heard concerns that the discount rate used to set pension contribution levels was too high. A lower discount rate leads to higher contributions from employees and employers, reducing the long-term cost of pension schemes to taxpayers. Following a Treasury review including a public consultation, the Government has now set a new, lower discount rate which was announced in the 2011 Budget. This has removed uncertainty about the appropriate level of the discount rate.

Three-fifths of the savings to the taxpayer were expected to come from the cost sharing and capping mechanism. Under this mechanism, employees would bear a greater share of costs, potentially paying 70% more for their pensions over the next 50 years if life expectancy continues to increase more than expected. However, implementation of the mechanism has been deferred, initially because of the Treasury's discount rate review. Implementation remains on hold while the Government decides how to respond to the Independent Public Service Pensions Commission (the Hutton Commission), which has recommended that cost sharing and capping be developed into a 'cost ceiling' that sets an

upper limit on the amount the Government contributes to employees' pensions. An early decision to implement cost sharing and capping is important for providing certainty to both employees and employers.

Pensions form a substantial share of the total salary package received by public service employees. We are concerned that employees do not have a clear understanding of the value of their pensions because they are not provided with clear and intelligible information to enable them to make rational decisions. This may mean the benefits of public service employment are not fully appreciated by current and prospective employees, potentially diminishing the influence of pensions as a recruitment and retention tool.

Public service pensions policy is not joined up with planning in other areas of public policy and spending. Whilst this is not a new issue, we still found it concerning given the potential impact that pension changes could have on areas such as future demand for means-tested benefits. There is little evidence to judge whether wider pension policy measures are effective, including measures such as tax relief and other incentives to encourage people to save for their retirement.

Further changes to public service pensions are expected in the near future. In the 2011 Budget, the Government announced that it had accepted the Hutton Commission's recommendations for long-term structural reform of public service pensions as the basis for consultation with public sector workers, unions and other interested parties. Following this consultation, it will set out proposals in autumn 2011. This provides the opportunity for the Government to develop a clear strategic direction for public service pensions. We look forward to the Government's detailed proposals and, following their implementation, a period of much-needed stability and certainty for long-term public service pensions policy.

We took evidence on two reports from the Comptroller and Auditor General, looking at the cost of public service pensions and the impact of the 2007-08 changes.[1]

1 C&AG's Report, *The cost of public service pensions*, HC 432, Session 2009-2010 and C&AG's Report, *The impact of the 2007-08 changes to public service pensions*, HC 662, Session 2010-2011

Conclusions and recommendations

1. **Government projections show that the expected cost of public service pensions has reduced substantially because of changes made in 2007 and 2008.** The Treasury expects the cost of pension payments to retired civil servants, NHS staff and teachers to stabilise over the next 50 years at around 1% of GDP, as a result of the 2007-08 changes. This would be a significant achievement. The exact range of savings is unclear because sensitivity analyses were not conducted on significant areas of uncertainty such as the size of the public service workforce. The Treasury acknowledged the need for more robust analysis in future, and we welcome its commitment to carry out deeper sensitivity analysis when considering further pension changes.

2. **Uncertainty about the discount rate used to set pension contribution levels has in the past undermined confidence about how future costs of pensions are valued.** The discount rate is used to determine the annual levels of employer and employee contributions to pension schemes. A lower discount rate leads to higher contributions from employees and employers, reducing the long-term cost of pension schemes to taxpayers. The Treasury told us that the existing discount rate was too high and, following a public consultation, the Government set a lower rate. At the same time the Government committed to reviewing the discount rate every five years. In order to maintain certainty for both employees and employers in the future, we expect these reviews to be conducted promptly and transparently.

3. **Cost sharing and capping is the change intended to deliver 60% of the projected cost savings over the next 50 years, but it is not yet clear when it will be implemented or in what form.** The delay so far in implementing cost sharing and capping is largely due to the time taken to revise the discount rate. Additional uncertainty has arisen from the Hutton Commission's recommendation to replace cost sharing and capping with a cost ceiling that fixes an upper limit on the amount the Government contributes to employees' pensions. The Government will consult on the Hutton recommendations before setting out its proposals for further change in autumn 2011. As soon as possible following the consultation, the Treasury should publish its timetable for implementing cost sharing and capping or an alternative scheme, as well as the expected cost savings.

4. **There is no measure defining an affordable level of expenditure on public service pensions, against which actual costs can be compared.** The Treasury reports on public service pension costs as a proportion of GDP, but has no criteria by which to judge their affordability. The Treasury should set out what it believes is an affordable level of spending so it can assess the cost of public service pensions against a clear benchmark.

5. **Employees are not given the information they need to understand the value of their pensions.** This hinders their ability to make rational decisions about important matters such as alternative employment options or whether to stay in, or opt out of, a

pension scheme. Public service employers should make clear to prospective and existing employees the financial value a pension adds to their salary package. The Treasury should work with employers and pension schemes to ensure clear and relevant information is provided to employees on the value of their pensions, and that this information is regularly updated and its usefulness to staff assessed.

6. **It is not clear whether wider measures to encourage pension saving through occupational schemes are effective.** The UK's pension model has traditionally relied on strong occupational pensions to supplement the state pension. However, the progressive decline in the number and value of occupational pension schemes, particularly in the private sector, means that many people are not saving enough for their retirement. The Treasury encourages pension saving through occupational and other schemes by spending substantial sums of money on tax relief and reductions in national insurance contributions, but has not explained whether these measures are cost-effective and well-targeted. The Treasury should clearly set out the costs and benefits of each measure of pension support, who benefits from each form of support, and how it judges the success of each measure.

7. **Changes to public service pensions affect other areas of public spending, such as means-tested benefits, but not all of these impacts have been identified and assessed.** For example, increasing the amount that employees have to contribute to pension schemes could result in more people opting out of their pensions and having to rely on means-tested benefits, leading to extra costs to the public purse. Important implications of this kind need to be evaluated and understood. In particular, the Treasury should ensure that decisions to change public service pensions take into account the potential impact on spending on means-tested benefits.

8. **Further reforms expected in the near future present the opportunity for the Government to determine a stable, long-term direction for public service pensions.** The Treasury announced in the 2011 Budget that it will propose further changes to public service pensions once it has consulted public sector workers, unions and others on the Hutton Commission's recommendations. The Treasury should set out clear objectives for any further changes, develop consensus around those changes and put in place arrangements to monitor progress. It should then aim for a period of stability so that employees' confidence in the value of their pensions is not undermined by fears that further changes will be made.

1 Achieving affordability

1. Projections by the Government Actuary's Department suggest that the changes made in 2007-08 to the civil service, NHS and teachers' pension schemes will bring substantial savings in taxpayer costs worth £67 billion over 50 years and stabilise their costs at around 1% of GDP.[2] Additional changes announced in 2010 are expected to reduce costs further. These changes include using the Consumer Prices Index rather than the Retail Prices Index to uprate pensions in future, and a phased increase in employee contribution rates to most schemes by an average of 3% of pay.[3]

2. Some of the assumptions underlying the projections have not been tested. The Treasury carried out sensitivity analysis on one key assumption, the age to which pensioners are expected to live, but did not do so for other assumptions.[4] Important areas of uncertainty are: the validity of assumptions that the public sector workforce will remain static over time and that long-term GDP growth will average 2.2% a year to 2050;[5] the rate of opt-out from the schemes if employee contributions rise;[6] and the impact of declines in the value of public service pensions on the attractiveness of public service employment and on payments of means-tested benefits.[7]

3. At the time of our hearing, a further area of uncertainty was the discount rate used to determine the annual level of employee and employer contributions to public service pension schemes. Since the late 1990s, a discount rate of 3.5% above the Retail Prices Index has been used.[8] Dr Ros Altmann told us that this was too high for schemes to be sustainable and that a lower rate based on the government borrowing rate would be more appropriate.[9] A lower discount rate would result in higher pension contributions from either employees or employers, or from both.[10]

4. The Treasury acknowledged that the existing discount rate was "beginning to look a bit on the high side",[11] and recognised that this may have a distortionary effect since departments will not bear the full costs of the people they employ.[12] It conducted a public consultation on setting a new discount rate, which concluded on 3 March 2011.[13] Following our hearing, the Government announced in the 2011 Budget that the discount rate would be set at 3% above the Consumer Prices Index. This is 1.3% lower than the

2 Q 58; C&AG's Report, HC 662, para 5

3 Qq 58, 70; C&AG's Report, HC 662, para 2.6

4 Q 68; C&AG's Report, HC 662, para 10

5 Qq 23, 61-63, 68; Ev 21

6 Qq 143, 148, 151; C&AG's Report, HC 662, para 10

7 Qq 83-85, 144-147; C&AG's Report, HC 662, para 12

8 Q 69. This discount rate is equivalent to 4.3% above the Consumer Prices Index over the long term, based on Office for Budget Responsibility analysis.

9 Qq 29, 38-39

10 Qq 28, 77; C&AG's Report, HC 662, para 3.14

11 Q 69

12 Q 100

13 Qq 69, 100; C&AG's Report, HC 662, para 4

current rate and is based on the long-term expectation of GDP growth. In future, the level of the discount rate will be subject to review every five years.[14]

5. The review of the discount rate has held up implementation of cost sharing and capping,[15] a key element of the 2007-08 changes which is projected to deliver 60% of the overall savings in taxpayer costs to 2059-60.[16] Cost sharing and capping is a mechanism designed to ensure that the taxpayer does not bear the extra cost of people living longer than expected and therefore drawing their pensions for a longer period. If longevity increases beyond projections, the mechanism increases employee contribution rates and/or reduces the value of pensions received in the future.[17] The mechanism is to be applied at the actuarial valuations of pension schemes which routinely take place every three or four years.[18]

6. The delay in implementing cost sharing and capping created a risk that employees might face higher and more sudden increases in contribution rates than would otherwise have been the case.[19] Since our hearing, the Hutton Commission has recommended developing cost sharing and capping into a cost ceiling for schemes, which would set an upper limit on the amount the Government contributes to employees' pensions.[20] It also recommended controlling future costs by linking the age at which members can draw a full pension to the state pension age.[21] In the 2011 Budget, the Government accepted these recommendations as the basis for consultation with public sector workers, unions and other interested parties.[22] However, until the Government sets out firm proposals in the autumn, it will not be clear whether or how cost sharing and capping will be implemented, or the likely impact on employee contribution rates in the future.

7. While the Government Actuary's Department projections suggest that the 2007-08 changes will stabilise public service pension costs as a proportion of GDP, it is not clear whether this means they can be considered affordable.[23] The Treasury monitors its preferred financial measure of affordability, taxpayer cost as a proportion of GDP, but has not set out a benchmark level of expenditure which it considers to be affordable.[24] There are also other measures of affordability which could be used, such as public service pension costs as a proportion of public expenditure, or the level of public service pensions compared to private sector pensions.[25]

14 HM Treasury, *Budget 2011*, HC 836, Session 2010-11, 23 March 2011, para 2.13

15 Q 124

16 Qq 70, 123; C&AG's Report, HC 662, para 2.7 and Figure 9, page 25

17 Q 134; C&AG's Report, HC 662, paras 3 and 3.3-3.4

18 Q 124

19 Qq 123-129, 139, 142; C&AG's Report, HC 662, para 6

20 Independent Public Service Pensions Commission, *Final Report*, 10 March 2011, Recommendation 12, page 13

21 Independent Public Service Pensions Commission, *Final Report*, 10 March 2011, Recommendation 11, page 13.

22 HM Treasury, *Budget 2011*, HC 836, Session 2010-11, 23 March 2011, para 2.12

23 Qq 58, 65

24 Qq 58, 65

25 Qq 19-20, 65

8. Public service pensions are paid either on the basis of an individual's final salary or on earnings averaged over his or her entire career (career average salary). Final salary schemes, which predominate, create anomalies that skew reward to high earners and those promoted late in their careers.[26] Some senior civil servants have built up pension benefits with a capital value of more than £2 million, which means that those individuals would receive pension payments of over £100,000 a year on retirement.[27] On average, however, public service pensions are not high: in 2008-09 the average annual pension received ranged from £5,900 for civil servants to £9,400 for teachers.[28] The Treasury told us that it had favoured all schemes moving to career average salary schemes in 2007-08 since this would produce fairer outcomes for most staff.[29] However, the civil service scheme was the only one that did so, and only for its new staff.[30] The Hutton Commission has since recommended widespread adoption of career average salary schemes.[31]

26 Qq 10, 80

27 Qq 95-96; Ev 21

28 Qq 11, 80; C&AG's Report, HC 432, Figure 3, page 13

29 Qq 80, 91

30 C&AG's Report, HC 662, para 12

31 Independent Public Service Pensions Commission, *Final Report*, 10 March 2011, Recommendation 7, page 10

2 Improving clarity and transparency

9. Public service staff do not have a good understanding of the value of their pensions, in part because employers and schemes do not provide them with clear and intelligible information.[32] This means employees are not able to make fully informed decisions when planning for their retirement and considering alternative employment options. It also limits the ability of public service employers to use pensions effectively to aid recruitment and retention.[33]

10. The Deputy Director of the NHS scheme told us that four in ten members did not understand what size pension they were going to get and, as a consequence, some had to delay retiring by three years because their pension was smaller than they had expected.[34] In 2011, the NHS scheme will begin to issue annual benefit statements to its members and in the future it plans to include details of the capital value of the pensions built up.[35] These are welcome developments.

11. For some years now, there has been a lack of clarity about the role public and private sector occupational pensions should play within the UK pension system.[36] The system has relied heavily in the past on good occupational and personal pensions to top up a state pension which provides a much lower share of retirement income than is typical across European Union and OECD countries.[37] However, this model has been undermined in recent decades by a significant decline in the extent and value of private sector occupational pensions.[38] Public service pensions have not declined by as much, and have appeared increasingly out of line with private sector pensions.[39] The Treasury told us that while there should be no "race to the bottom", it believed public service schemes should move more in the direction of private sector schemes.[40]

12. Government support, in the form of tax relief and national insurance rebates, is used to encourage individuals to save for their retirement through occupational and personal schemes. This support amounts to around £35 billion a year, equivalent to more than 2% of GDP.[41] However, it is not clear how the benefits of this support are distributed, or whether the spending could be put to better use elsewhere. The Treasury told us that the cost of the national insurance rebate alone is forecast to be £6.8 billion in 2012-13, which

32 Qq 26-27, 86, 110; C&AG's Report, HC 662, para 3.13

33 Q 36

34 Q 86

35 Q 86

36 C&AG's Report, HC 662, para 3.7

37 Q 1

38 Qq 2, 94-95, 122; C&AG's Report, HC 662, para. 1.9

39 Qq94-95

40 Q 86

41 Qq 41, 48

would be enough to fund a £10 to £15 a week increase in the basic state pension for each recipient.[42]

13. There is a further concern that the level of taxpayer spending on public service pensions could appear disproportionate to the amount spent on encouraging other savings for retirement through tax and other incentives.[43] The 2007-08 changes have transferred an increasing share of the future costs of public service pensions from taxpayers to employees. However, perceptions remain that an unwarranted level of taxpayer support is directed to public service pensions when compared with that available to private sector workers, who make up four-fifths of the total workforce.[44]

14. The implementation of the 2007-08 changes to public service pensions did not sufficiently take into account impacts on other areas of public policy and spending. For instance, there was no assessment of the impact that higher employee contributions and lower public service pensions would have on the number of people opting out of their schemes.[45] Higher opt-out rates would in turn increase future demand for means-tested benefits. Moreover, the Treasury was not able to tell us whether wider public service reforms which would give rise to new types of delivery bodies, such as GP commissioning consortia and free schools, would affect employees' eligibility to belong to public service pension schemes in future.[46]

15. More changes to public service pensions are expected over the next three years to implement decisions announced by the Government in 2010, and to respond to recommendations in the Hutton Commission's March 2011 final report on public service pensions.[47] There are costs associated with continually changing pension arrangements. These include increased administration costs and the potential impact on employees' confidence in the value of their pensions.[48] The Treasury accepts that it was a weakness of its approach to the 2007-08 changes that it did not set out clear and measurable objectives against which to monitor performance over time.[49] It is important that the Treasury clearly defines the objectives of any future changes and develops consensus around them, in order to promote a period of stability for public service pensions.

42 Qq 43-46, 54-57; Ev 21

43 Qq 5, 40

44 Qq 5, 15-17, 65; C&AG's Report, HC 662, para 3.14

45 Qq 143-151

46 Qq 111-114

47 Qq 101-108; Independent Public Service Pensions Commission, *Final Report*, 10 March 2011; HM Treasury, *Budget 2011*, HC 836, Session 2010-11, 23 March 2011, para 2.12

48 Qq 36, 101; C&AG's Report, HC 662, paras 6 and 12

49 Qq 73; C&AG's Report, HC 662, para 8

Formal Minutes

Wednesday 11 May 2011

Rt Hon Margaret Hodge, in the Chair

Mr Stephen Barclay
Dr. Stella Creasy
Matthew Hancock
Jo Johnson
Mrs Anne McGuire
Austin Mitchell
Nick Smith
Ian Swales

Draft Report (*The impact of the 2007-08 changes to public service pensions)* proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 15 read and agreed to.

Conclusions and recommendations 1 to 8 read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Thirty-eighth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for placing in the Library and Parliamentary Archives.

[Adjourned till Monday 23 May at 3.30pm

Witnesses

List of printed written evidence

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The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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Thirty-first Report	HM Treasury: The Asset Protection Scheme	HC 785
Thirty-second Report	Maintaining financial stability of UK banks: update on the support schemes	HC 973
Thirty-third Report	National Health Service Landscape Review	HC 764
Thirty-fourth Report	Immigration: the Points Based System – Work Routes	HC 913
Thirty-fifth Report	The procurement of consumables by National Health Service acute and Foundation Trusts	HC 875
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Thirty-eighth Report	The impact of the 2007-08 changes to public service pensions	HC 833

Oral evidence

Taken before the Committee of Public Accounts

on Wednesday 2 March 2011

Members present:

Rt Hon Margaret Hodge (Chair)

Mr Richard Bacon	Chris Heaton-Harris
Stephen Barclay	Joseph Johnson
Stella Creasy	Mrs Anne McGuire
Jackie Doyle-Price	Austin Mitchell
Matthew Hancock	Nick Smith

Amyas Morse, Comptroller and Auditor General, and **Keith Davis**, Director of Efficiency Practice, NAO, gave evidence. **Gabrielle Cohen**, Assistant Auditor General, NAO, and **Marius Gallaher**, Alternate Treasury Officer of Accounts, NAO, were in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

The impact of the 2007–08 changes to public service pensions (HC 662)

Examination of Witness

Witness: **Dr Ros Altmann**, Pensions Expert, gave evidence.

Q1 Chair: Hi, I am really sorry to have kept you waiting, and may I start by thanking you very much indeed? We have asked you to come and talk to us because you are a great expert on the sort of issues that we are looking at, and I know you have also contributed to the Hutton inquiry. I have seen that report and that is very interesting evidence that you have given to them. May I just ask you a completely general question? In preparing for this session, I tried to look a little bit at how other countries paid for their pensions. Again, you will probably know much more than I do about this, but the interesting thing is that, as I understand it, in EU and OECD countries, state pensions provide 80% of retirement income, and in the UK it is only 50%. What do you take from that? Before you start to answer, may I ask that you speak up a little bit, because the acoustics in this room are dreadful?
Dr Altmann: We do have a quite unique pension system in the UK, partly because of our history, and it is one that has been based for many decades on the idea that we have a very low state pension, but that is topped up by good private pensions. And that has grown up since the 1950s, or even before. The private pension system did rely quite heavily on final salary pension schemes, which were provided quite willingly by employers until not that long ago in the UK. The idea was that the UK pension model was held up as an example for others to follow, whereby Government can keep cutting the state pension payments by relying on private sector pension schemes invested in the stock market to deliver good pensions. That was really what our system was based on.
For a while it looked as if it worked, but unfortunately it ended up confusing the two elements of pensions. The word "pensions" actually relates to two very separate things. On the one hand, the original idea of pensions was basically social welfare. So if you were old and could not work, the state would give you some money so you would not be in destitution. Normally that would be a state role. However, the other way the word "pensions" applies is to your own private savings that you accumulate over your lifetime, and therefore you will have more to live on when can no longer work. What final salary schemes did, particularly in the UK, is mix up the two elements. What you found was, instead of the state doing all the social welfare and providing an adequate, basic minimum on which private savings could be built, you had employers being asked to take on a large part of the social welfare.

Q2 Chair: I am going to ask you to speed it up, because I think we understand that. So, what do you take from that now?
Dr Altmann: I take from that that we have put too much burden on employers to provide social welfare, which in other countries in Europe, as you say, is provided by the state. Companies are now pulling out, so the traditional final salary scheme, which is a form of social welfare, is dying out, and the system we have got was relying on stock market returns in private schemes to deliver good pensions, and it has not worked, partly because the assumptions on which they were based were flawed and partly because, as we obviously all know, people are living longer and markets did not work out in the way they could.

Q3 Chair: So what do you take from that when the state reviews its occupational pension schemes? What should be the principles that underpin that, whether it is a Government review or a Hutton review or whatever it is? We are in a mess on it really, so what do you take in terms of finding a way forward that enables people who are reliant on their pension for their income to have an appropriate income?

Dr Altmann: Yes, the bottom line for me is that the state should provide what it was originally intended to provide, which is some kind of adequate social welfare floor—a minimum amount—which is the Beveridge idea, really.

Q4 Chair: So, is it alright at the moment?
Dr Altmann: No, the state pension in the UK does not provide an adequate minimum floor. It has relied on employers topping that up via final salary pension schemes to add to that social minimum floor. But as employers pull out, it is no longer reliable. If we could get an adequate state pension floor, then we could start to sort out what private arrangements can add to it on top.

Q5 Chair: But again, if we are realistic—sorry, but we are tight on time—with the current state of public finances, that is not going to happen in the short to medium term. So we are then dependent on occupational pensions in some way or another, and here we are talking about a series of occupational pensions that are funded by the state. The state either funds the pension or it then funds pensioner credit, I suppose—it does either/ or—in a way that the onus comes back to the public purse. As we move forward in taking sensible, pragmatic decisions within affordability frameworks, what do you think we should be doing? What is wrong?
Dr Altmann: What is wrong is that taxpayer resources are in danger of being diverted to provide decent pensions for only one group in the workforce, which is public sector workers, who are one-fifth of the workforce. They are provided by taxpayer resources, while at the same time, the other four-fifths, the private sector labour force, which pays the taxes that provide those pensions to public sector workers, are not receiving an adequate state pension. If we reform the state pension system to make it fairer for everybody, you can start to have a discussion about how to move forward properly. I do not believe that where we are right now is actually a sustainable place to start from. I also am not entirely sure that an adequate state pension is unaffordable. Within the envelope of spending that we have on pensions, it is affordable if the political will is there to provide it. But so far, that has not been the case.

Q6 Chair: Even with the cuts?
Dr Altmann: Even with the cuts.

Q7 Chair: How much are you thinking of, in terms of that?
Dr Altmann: At the very least, some kind of slightly above pension credit level.

Q8 Chair: Have you worked out how much that is?
Dr Altmann: £140 a week would be a good start.

Q9 Chair: How much is that in additional public expenditure terms?
Dr Altmann: It depends on how you do it. You can do it from age 75, in which case, it wouldn't cost anything. As long as you get rid of contracting out, you will actually get more money in over the short term by doing it. There are ways to do this. They have been ducked, because they are complex and difficult, which is because we have a very complex and difficult pension system.

Q10 Stephen Barclay: You mentioned the issue of unfairness. With defined benefit schemes, is it not that part of the unfairness is that the better-off get a disproportionate share of the scheme? They are more likely to see their salary go up towards the later years of their career.
Dr Altmann: Yes, John Hutton encapsulated that very well, I think.
Stephen Barclay: Could you perhaps give us some numbers around that to bring that to life?
Dr Altmann: Well, what final salary schemes in particular do—and that is not necessarily defined benefit schemes—is that they reward the high flyers. So if you get a big pay rise through your career, and particularly at the end of your career, your whole pension is based on that higher salary, even if your original contributions were made on the basis of a much lower salary. You can have a career average arrangement, which is, if you like, more equal; in that case, your pension is related much more to the average pay that you have had throughout your career. But you do have situations where the vast bulk of the pension commitments from schemes go disproportionately to the very high earners, and the very low earners lose out, relatively. So there is an inherent unfairness in the structure of final salary pension schemes.

Q11 Chair: Can you just help us? On the average of the three schemes that we looked at, what is the average pension that comes out of that? I just cannot remember where it is in the book.
Dr Altmann: Teachers are about £9,000, and the rest are about £6,000.
Keith Davis: The NHS: £7,000; Civil Service: £6,000; the armed forces £7,500. That is the annual average pension payment.
Chair: And teachers?
Keith Davis: £9,000.
Chair: £9,000? Okay.

Q12 Mrs McGuire: I am just a little taken aback by the fact that, in many parts of the country, if people have to wait to the age of 75, they might not live long enough to get their state pension, given what you said earlier.
Dr Altmann: I am not recommending; I am just saying that there are ways of doing it.

Q13 Mrs McGuire: Right, okay then. That is a bit of a relief that you are not recommending 75. I sometimes think that in this conversation we confuse state pension with what we are really discussing today, which is the occupational pension for employees of the state—for public sector employees. Can I ask whether or not you think that public sector pensions for employees are over-inflated?
Dr Altmann: There is no doubt, in my mind, that public sector pension arrangements are more generous

than the private sector equivalent arrangements are. They did not necessarily used to be, but they are now.

Q14 Mrs McGuire: Are they over-inflated?
Dr Altmann: That is not a question that one can really answer, because you have to define what you are comparing it with.

Q15 Mrs McGuire: You are comparing it with private sector pensions.
Dr Altmann: Compared with private sector pensions, public sector pensions are significantly more generous now.

Q16 Mrs McGuire: Is that a problem for the public sector, given the levels of pension that we have heard about just a few moments ago, or is that an issue that the private sector needs to address, in terms of the provision for pensioners?
Dr Altmann: I think the issue for me is that the private sector has already recognised that the kind of pension promises we have been making in the UK are unaffordable, and have therefore voted with their feet and closed the schemes. What has not yet been recognised in the public sector is that same reality. I am not trying to say that public sector workers do not deserve decent pensions. Of course they do. The problem we have got is that the cost of providing the kind of pensions we have been promising is much higher than anybody ever realised or indeed budgeted for, because it has been based on assumptions that have turned out not to be correct. Time and again those assumptions have proven not to be correct, but somehow or other they were not sufficiently adjusted to recognise reality.

Q17 Mrs McGuire: But do you think the wider discussion on pensions should not totally rely on what I think is a somewhat spurious comparison between public sector pensions and private sector pensions? Rather than racing to the bottom, we should be looking to lift more people into a far more acceptable and sustainable pension regime. Rather than saying that public sector pensions are overgenerous, to use your words, we should be looking at how we deal with those who work in the private sector in terms of their pension provision.
Dr Altmann: I entirely agree with you that one has to look at how we can deliver decent pensions to everybody. That is absolutely correct. Where we started just a few minutes ago, though, was that I am told it is unaffordable to pay a decent state pension to everybody. Now, then you have the question of taxpayer resources. You cannot get away from it, because taxpayer resources are being used to fund public sector pensions. Whether we like it or not, no money has been put aside to pay for these.

Q18 Mrs McGuire: Could I just say that, I think, again, you are drawing a distinction that perhaps in unhelpful, which is that public sector workers, as well as being the recipients of public sector pay and public sector pensions, are also taxpayers as well. I think sometimes we seek to segment, when we should be looking for a solution that would actually help those who work across various sectors, whether that is in the private sector, the public sector or indeed the voluntary sector, which is now a significant part of our employment force.
Dr Altmann: I understand that whenever you are in a position that is reasonably comfortable, it is very uncomfortable to move away from it. I do understand that.

Q19 Chair: May I just ask you a question? In preparing for today's session, I discovered that the expenditure on public sector occupational pensions is 3% to 3.5%—this is a crude, back of the envelope calculation and might be out a little bit—of public spending. That, you say, is unfair and unaffordable. So what is fair and affordable?
Dr Altmann: The way I look at it, we have a system here where even on the Government's own figures the current service pension cost is £25.4 billion a year.

Q20 Chair: 3% to 3.5% of public spending.
Dr Altmann: The annual pension payments are £19.9 billion a year. The member contributions into these schemes is £4.4 billion a year.

Q21 Chair: I am just trying to get a feel. This is not trying to trick you out, but if we have to take a judgment on what is affordable and what the state should be paying as its contribution to the people who work for the state, you believe 3% to 3.5% is unaffordable, I assume. What is affordable? This is within a total package of income, and pensions is a part of your income package, so what is affordable? What should we be looking at?
Dr Altmann: We do not know. One of the big problems that I have with this discussion is that we do not actually know what these pensions are going to cost. The figure that you cite of 3% to 3.5% of GDP—

Q22 Chair: No, not GDP. 3% to 3.5% of public spending goes on the employer contribution to the pensions of those who work in the public sector.
Dr Altmann: But that only pays today's pensions; that does not actually cater for the commitments that we have made for the future.

Q23 Chair: If this Report is correct, the 2007/08 changes will keep that at a pretty level place. Am I right?
Dr Altmann: I am questioning those assumptions.
Keith Davies: Yes, as a proportion of GDP is how we have presented the figures. So, we are presenting them as levelling out at about 1% of GDP towards the end of the 50-year period.
Dr Altmann: If your GDP figures are not correct and if your inflation assumptions are not correct—and do not forget that these pensions are 100% inflation linked, whereas in the private sector they are not—then you have a significant overshoot of spending. Now, I would suggest that taxpayers need protecting from the unexpected when we are looking that far ahead, and there is not anything here that is actually protecting taxpayers from the unexpected, which has already happened. Spending on public sector pensions

has already been overshooting significantly from what was budgeted.

Q24 Chair: But that is why action was taken in 2007/08.
Dr Altmann: The actions in 2007/08 made some elements of the pensions less generous, but they were offset by other changes that have actually made some elements of the public sector pension deal more generous.

Q25 Chair: Yes, but it switched some of the cost. I am trying to get out that it switched some of the cost of public sector pensions from the employer, i.e. the state, to the individual. Right? Of course there were some things that came out of it that were better, but on the whole, it switched some of that cost. As we look forward to the Hutton Review and to whatever, I am trying to get a feel as to whether you are saying that employees have got to pay a greater contribution? Is that what you are saying?
Dr Altmann: I am not trying to recommend anything; I am trying to point out that there is an air of unreality in the debate and in the assumptions being made about the costs.

Q26 Chair: What is your answer to it?
Dr Altmann: Well, the first answer I have is transparency, and trying to explain to the workers themselves the true value of the pension that they are accruing. A £6,000 joint life index-linked pension would be worth about £250,000 if you bought it in the market—just for a £6,000 a year pension.

Q27 Chair: Okay, so we get transparency. I agree with you about that; I think it is really important.
Dr Altmann: It is fundamental; it is not just important.

Q28 Chair: No, but you've gone beyond that. You are saying at the moment there is an unfair advantage to people working in the public sector, and the taxpayer is paying too much towards the pension. What I am trying to draw out of you is some idea of how big that is or what we could do about it.
Dr Altmann: Let me try it another way. The average pay in the public sector now is at least as good as, if not better than, that in the private sector for equivalent work. That is the official statistics. The value of a public sector pension on top of that is at least 30% extra on salary. If you look at the Bank of England pension scheme, and if you look at companies that have outsourced public sector workers to within the private sector, they are finding that the costs of replicating the public sector pension scheme is 50% of salary. So, you are in a ballpark of public sector workers being paid between 30% and 50% more than private sector workers, but public sector workers themselves have no idea that actually that is how much they are getting, and they are not paying anything like that into their own pensions. Indeed, for taxpayers today, the employer contribution is far less than the value of those pensions accruing. Somewhere in the future, taxpayers will have to pick up the balance.

Q29 Mrs McGuire: How do you get those figures of 30% to 50%, because it doesn't actually sit with information that we have from the Pensions Policy Institute?
Dr Altmann: The Pensions Policy Institute used the Treasury's own discount rate, and the Government actuaries' own discount rates. If you look at the independent estimates, if you look at the rate the Government actually borrows at, and if you look at the security of public sector pension schemes, it is not reasonable to use a discount rate that would be applied to the private sector. Indeed, it is not a rate that was used in the Independent Public Sector Pensions Commission inquiry. If you use the appropriate discount rate, which would reflect the rate the Government is borrowing at, you would come much closer to the 50% than the 30%.

Q30 Austin Mitchell: Sorry, I am just struggling, as a pensioner, to understand this. Am I right in saying that the essence of your argument is that the state should pay out less to public sector pensioners, to spread that on a better state pension, to give the private sector pension payers an easier time?
Dr Altmann: No.

Q31 Austin Mitchell: Well, surely what you are saying is that there should be a higher state pension, however funded. How is it going to be funded?
Dr Altmann: It can be funded from within the envelope of current spending. Firstly, and in fact, solely, by removing contracting out. If you take away the contracting-out anomaly, you have enough money to pay a state pension of £140 a week.

Q32 Austin Mitchell: So you are not saying, "Take money from public sector pensioners to give us a better general pension?"
Dr Altmann: I absolutely am not saying that we should—

Q33 Chair: For the over-75s, just to make that clear.
Dr Altmann: No, that would be from 65 and whatever the state pension age becomes.

Q34 Austin Mitchell: Over 75, I'm grateful for anything. I still do not see how this higher state pension for everyone is going to be funded.
Dr Altmann: By taking away contracting out. If you want extra money, which you do not need immediately, you can also review the tax relief rules on pensions, which are also very generous to top-rate taxpayers.

Q35 Austin Mitchell: And with that we could bring it up to European levels?
Dr Altmann: Probably. But I actually think, having said that, we do not want to get to European levels. European state pensions are too expensive as well. We have the problem that we have got a public sector pension system that is diverting resources to just one group in the workforce. In Europe they are paying much higher pensions to everybody, and that is equally difficult to justify in affordability terms. I am not saying that people do not deserve good pensions,

and I am certainly not saying that we should take anything away from the past-accrued rights of public sector workers. I have never said that, and I do not support that. I am talking about how we have a sustainable, fair system going forward that is equally affordable and takes away some of the risks that future taxpayers are currently bearing.

Q36 Joseph Johnson: I just want to come back to the point you were making about the fact that recipients of public sector occupational pensions do not realise how generous the terms are that they are on. I guess, what I feel about it is that it is actually a very ineffective form of remuneration, in that sense, because I have traditionally thought of a pension as being deferred salary or deferred income. However, what you are saying, and what I believe to be the case, is that employees attach a very heavy discount to the pension that they are likely to get in the future, so it is actually a very wasteful way of encouraging or tax-advantaging saving, in a way, because employees attach a massive complexity discount to that. As Austin was just saying a second ago, as a pensioner he does not understand it, and I think that is absolutely typical. You were saying that is the case generally. So there is a high discount because of complexity, and then there is a second level of discount because of the extraordinary political risk that attaches to all likely future cash flows coming from HMT. So, would you agree that it is actually a very ineffective and inefficient form of encouraging saving?
Dr Altmann: Yes, I do not see it as a form of encouraging saving; I see it as a way of rewarding loyal public sector workers, and they indeed should be rewarded. Public sector workers do a really important job for the country, and deserve fair pay and fair pensions.

Q37 Joseph Johnson: But ineffective?
Dr Altmann: What I have argued for many years is that I would like to see the value of all pensions declared up front in your pay packet for everybody—both public and private sector workers. If you are being paid £10,000 a year and your pension contributions are worth another 30%, actually your pay is £13,000. If your employer in the private sector is only putting 5% of salary in for you, then your pay is actually just £10,500. Now that would be explicit, and that would at least get us towards this transparency that I think we really need, which is to say, "This is the real value of what you are being paid," which at the moment, we are not doing.

Q38 Matthew Hancock: Isn't part of the problem with transparency that it is quite confusing, and the discount rate that you choose matters. If that proposal were taken up to include the pension contributions in the pay statement, what discount rate would you apply?
Dr Altmann: If it is an unfunded pension scheme, then the discount rate you should apply is the discount rate that is appropriate for the money that is being borrowed that needs to be used to pay that.

Q39 Matthew Hancock: So you would use a gilt rate for the UK Government?
Dr Altmann: You would use the index-linked gilt rate, potentially. You can smooth that over time or you can look at an average over the last 10 years. You do not have to necessarily look at it for the last 10 minutes, but the idea would be that you would have an independent assessment. We still have not had an official independent inquiry into the discount rate that should be used. All the official inquiries that have taken place have used the GAD assumptions. I think there is a case to be made to use outside sources to reflect what the discount rate should be.
I am quite happy if you have a range of discount rates. Maybe this is one end of the estimate and that is another end of the estimate, and everybody can argue about assumptions. You get actuaries, or accountants or economists in a room and you will get two or three different answers. We all know that that is an issue, but it is not an insurmountable one. I think the main thing is: do we seriously want to tackle this and get to grips with how much it is going to cost, or do we want to keep pretending that it is going to cost something that it does not?

Q40 Stella Creasy: I just wanted to pick up on a couple of your comments, and just test your assumptions, because you talk there also about tax relief. When you talk about the pot of money we are spending on a particular group of citizens, it is not necessarily fair to just look at the public sector pension pay pot per se. If we are going to look at pensions and what we pay in the public sector to the broader cost of the taxpayer, we should include tax relief in that, shouldn't we? If we are going to start looking at some of the sums and some of the affordability of some of these proposals, we should also consider the way in which we apply tax relief.
Dr Altmann: There are lots of different elements of pension spending that I think it might be useful to tot up and just see if we are dividing it up in the fairest and best possible way.
Chair: Say that again?
Dr Altmann: Are we dividing it amongst our citizens in the fairest and best possible way? We have not actually looked at that explicitly, either. But I will come back to this issue of contracting out, particularly with unfunded pension schemes, where there is—

Q41 Stella Creasy: Sorry to interrupt, but tax relief is also 2.7% of GDP on average, isn't it? That is quite a chunk. If we are going to talk about the big sums of money that we are spending and start looking at public service pensions, then tax relief is also an issue for further inquiry as well, isn't it?
Dr Altmann: Yes, you are very welcome to look at any of the stuff on my website that has looked at alternatives to the system of tax reliefs that we have.

Q42 Stella Creasy: But obviously, that also applies to private sector pensions, so when we talk about who is benefiting from the public sector purse—
Dr Altmann: Yes, absolutely. I would not dream of it not applying to private sector pensions. It is not

necessarily the same debate, but it is definitely a related debate.

Q43 Stella Creasy: Obviously, there have been changes to the state second pension, and that has affected people within the public service as well. I wonder whether you had made any analysis. Obviously, in the last10 to 15 years, people have not been paying into second state pensions in the public sector because of the changes to national insurance contributions, so that does also affect the people that we are talking about now, who might be affected by the changes you are talking about.
Dr Altmann: Sorry, I am not sure I understood you. People in the public sector are not paying for their state second pensions?

Q44 Stella Creasy: People weren't paying into the occupational pension schemes in the public sector, because of the changes that happened over the last 20 years.
Dr Altmann: The reality is that public sector workers are not paying for their S2P. That is what contracting out is all about. Public sector workers get a discount on their national insurance to reflect the fact that they are going to get their S2P replaced by their unfunded pension scheme. So they get S2P, under their scheme rules, from a different pension age from the rest of the country, and they haven't paid for it because of this system of contracting out.

Q45 Stella Creasy: No, what I am saying is, when we start looking at some of the changes that people are talking about, both of those facts need to be taken into account, don't they? Both the money we are paying into tax relief, but also the historical nature of the S2P system with public sector pay. Just to say, "Who is getting £6,000, and can we afford to give them £6,000?" doesn't really take into the round other factors that will affect their pensions and the income that they will have, when we are looking at what people from five, 10 years onwards would have.
Dr Altmann: I am not sure I understood your point. I am sorry. Can you try again?

Q46 Stella Creasy: Okay, I will try again. You are asking us to look at some quite radical ideas around how we might deal with the cost of public service pensions. I am saying that when we are looking at the issue of public service pensions, we also need to look at what people will be eligible for and some of the changes. We are not looking from ground zero, are we? We are not looking from year zero in terms of some of the schemes that people are currently members of. So, whether, for example, the change from Retail to Consumer Price Index will affect people who have also had other changes to their pensions in relatively recent terms, especially in terms of the second state pension, and whatever changes we might want to think about for tax relief on pensions. You have got to look at these things in the round when you are looking at the final amount that people would get. This is the point I am trying to make. To just look at one aspect of pensions policy is not to see it in the round.
Dr Altmann: Which aspect are you saying that I'm looking at on its own?
Stella Creasy: Because you are looking at rate at which employers make their contributions.
Chair: The employer contribution.
Dr Altmann: No, I am looking at everything. I am looking at the contributions made by the employees, and the employers, and the taxpayer. There are three parties here. You could argue that there are two and the employer contribution is just a taxpayer contribution by another name, but I am also looking at the employee contribution as well.

Q47 Nick Smith: Ms Altmann, I was interested in how you would pay for your suggested state pension of £140 a week. You said that two good ways of doing it would be to stop contracting out and the tax advantages to high rate taxpayers. How much do you think you could save, and who would be the chief losers?
Dr Altmann: The chief losers under a system of ending contracting out will be members of final salary schemes who are contracted out, who will have to move on to the right rate of national insurance that everyone else pays if they are not contracted out.

Q48 Chair: And the higher rate tax relief?
Dr Altmann: I think the higher rate tax relief is something that is part of a much wider debate on how we incentivise pension saving. At the moment it is a system to incentivise pensions savings, and what I would like to see, if possible—
Nick Smith: For people who have already got quite high pensions.
Dr Altmann:—is a redistribution of some of the very generous tax reliefs at the top to provide better incentives for basic rate taxpayers or lower earners, who, I think, one might argue, socially, need more incentive than they currently have. If you were trying to redistribute the costs of incentives for pensions, for me, it makes sense to look to increase the amount we incentivise low earners' pensions and take something down from those at the very top end, where you could argue, if you can afford to put £50,000 a year into a pension, you are not necessarily in need of a social incentive to save. But that is a somewhat separate argument. However, the cost of tax relief for pensions is around £35 billion per year. This is an enormous part of public spending. So the redistribution potential is significant. If we ended contracting out, one would save, perhaps £7 billion or £8 billion a year, which is still enough to pay a decent pension to our pensioners.

Q49 Nick Smith: So it would free up £42 billion?
Dr Altmann: If you got rid of them both, but I am not suggesting that. What I am suggesting is that we find a mechanism to give more incentives and better incentives to those at the lower end of the scale, who lose out a bit under the current system.

Q50 Stephen Barclay: This is really just to clarify something you said earlier. In terms of those getting better pension payments, am I correct in your figure that to go out in the market and buy a pension of £60,000—

Dr Altmann: £6,000.

Q51 Stephen Barclay: I know you said £6,000 for £250,000. So, in essence, £60,000 a year would be a £2.5 million pension pot, yes.
Dr Altmann: Yes, and I just don't think public sector workers understand the value.

Q52 Stephen Barclay: Sure, and so as part of these schemes where it has been reported that someone's cash equivalent value will deliver an annual pension of £60,000 a year, but they are reporting that as, say, a pot of £1 million, that is because of the Treasury—
Dr Altmann: It is not the reality.

Q53 Stephen Barclay: It is not the reality, and that is because of the discount that is being applied, which is not what you can get on the open market.
Dr Altmann: Correct, yes.
Chair: Okay, Thanks very much, indeed. Thank you for that.

Examination of Witnesses

Witnesses: **Sir Nicholas Macpherson** KCB, Permanent Secretary, **James Richardson**, Director, Public Spending, Public Services and Growth Directorate, HM Treasury and **Tim Sands**, NHS Pensions, Department of Health, gave evidence.

Q54 Chair: Can you just explain your system of contracting out, before we proceed? Do you know what people were contracted out of?
Sir Nicholas Macpherson: The concept of contracting out goes back to Barbara Castle's state earnings related pension scheme. You pay a lower rate of national insurance in exchange for not getting a pension through the earnings related pension scheme. So it has got a long history. So, for example, if you are in the public sector, you do not get a state second pension, you pay a slightly lower rate of national insurance, and you get all your pension through the pension scheme.

Q55 Chair: Right, and as a starter for 10, do you agree that if you stop people contracting out so they would have to pay more through their NI during their working life, you could raise the state pension to £140. Do you agree with those figures?
Sir Nicholas Macpherson: I do not immediately recognise them. My recollection is that if you abolish the contracting out rebate, that is worth something like £5 billion, isn't it, James? So that intuitively does not seem enough. There are about 10 million pensioners, so I do not think that £5 billion would go very far. Can you do the mental maths of what it would pay for, James?
James Richardson: I cannot work out whether it would be to £140, but I think it is useful to understand that the discount on national insurance is set actuarially to offset the value of the second pension forgone. So therefore, as it were, it would pay for the second pension for the people who are contracted out over time, but it would not pay for the whole population over time. It would pay for the people who are contracted out. Now, of course, you get the money immediately and the costs are downstream, so in the short term you are up on the calculation, as it were, and would be able to spread the money a bit more widely. But over time, that would unwind.
I think the other thing that may be of interest is that the reduced rate of national insurance is in two parts: the employee, themselves, pays a lower rate, but so does the employer, and that lower rate or wedge is slightly larger on the employer side than it is on the employee side. Of course, many of the employers are themselves public sector bodies, and so that cost would then fall on other parts of the public sector. Not all of it, of course, but quite a substantial element would fall on the health service, schools, and the Civil Service and so on. In that sense, it would be being made up from reduced budgets across the public sector.

Q56 Stella Creasy: Just out of interest, would it affect their national insurance entitlements to do that, because you would have a bunch of people who had not paid in contributions who were then being—
James Richardson: No, because it is a lower rate. It is not that you are in or out of the system; it is just that the rate is different.

Q57 Chair: What is your back of the envelope calculation?
Sir Nicholas Macpherson: I think it would buy you approximately £10 a week on the state pension, but don't hold me to that.

Q58 Chair: Right, thank you. That was a tidying up of the last one. If you want to drop us a note in the next week—we are getting very vigorous on our notes; we want them in a week—with a stronger analysis, that would be helpful when we think about that, if that is possible. But within a week please, so it does not hold us up. Okay, looking at the NAO Report along with the Report in March, it looks from the NAO Report that the 2007/08 changes are going to bring you in, over this 50-year stretch, £67 billion, or something like that, and a 14% reduction of the cost of what occupational pensions would otherwise have been and bring it down to a lower rate of GDP. Is that affordable? I am trying to get this idea of what is affordable, and how you think about affordability.
Sir Nicholas Macpherson: Well, I think there are two ways of approaching affordability. There is one approach that involves taking a whole stream of pension payments ever into the future, and then discounting them. You get some quite big sum, which always sounds quite scary, like £770 billion. That is quite useful and has a role, but the Treasury's preference is to look at pension payments as a

percentage of national income at any point in time. Certainly, if you look at the latest set of estimates, which I think are in the Hutton Review, you do get a sense that with regard to public sector pension payments—which I think are round about 1.9% of GDP—once you feed in the Government's subsequent decisions to link inflation uprating to the Consumer Price Index, once you take into account the current wages freeze and then take into account likely reductions in the public sector workforce, I think by 2060,the number is a figure of 1.4% compared with 1.9% now.

Q59 Mr Bacon: Sorry, 2000 and…?
Sir Nicholas Macpherson: 60.

Q60 Mr Bacon: Six zero?
Sir Nicholas Macpherson: Six zero.
Chair: It is always 50 years.

Q61 Mr Bacon: Hang on. This presumes you know what GDP is going to be in 2060, as well. I am really interested in knowing this, because I may still be alive then. I was born in 1962, so I will be waiting for my letter from the Queen, and I will only have 18 months to go. Can you tell us what the GDP will be, Sir Nick, in 2060? You must know because you have just told us an answer that relies on your knowing.
Sir Nicholas Macpherson: Yes, I have.
Mr Bacon: And I will be 18 months away from getting my letter from the King. It may still be the Queen, of course.
Sir Nicholas Macpherson: It is based on GDP going broadly in line, I think, with the Office for Budget Responsibility's current view of trend growth, which is somewhere in the region of 2.25%.

Q62 Mr Bacon: 2.5% per year?
Sir Nicholas Macpherson: 2.25%, I should think. Again, I can clarify that in the note.

Q63 Mr Bacon: For the next 51 years?
Sir Nicholas Macpherson: Yes.
Mr Bacon: This is terrific.
Sir Nicholas Macpherson: Actually, Mr Bacon, the Treasury occasionally gets a bit optimistic and convinces itself that the trend rate of growth is—
Mr Bacon: I have always thought of you as more of an Eeyore than a Tigger, Sir Nick.
Sir Nicholas Macpherson: I am. But interestingly, from time to time, Governments think that they have solved this issue of growth, and they raise their estimate of the trend rate of growth of GDP. Actually, if you go back to the war, you do not go far wrong if you assume GDP grows by 2.25% a year. There was a particularly bad period, I seem to remember, in the 1970s, but it generally averages out at 2.25%.

Q64 Chair: Can I just go back, because what you have said is, it goes down, right? We have taken all these measures and there are a few other measures that have been taken as well, and it goes down from 1.9% to 1.2%, I think you said.
Sir Nicholas Macpherson: 1.4%.

Q65 Chair: 1.4%. Now, why is that affordable? In what way do you judge affordability? I suppose I look at it as a percentage of public spending, really, rather than a percentage of GDP, because that makes more common sense to me. I am a bit kitchen-sinky about it, but it makes more sense to me. But why is that affordable?
Sir Nicholas Macpherson: That is a really good question. What, from first principles, is an affordable amount to spend on public service pensions? It is very difficult to answer. I suppose what you look at are two things. Is a trend moving away from you? I think that influenced some of the decisions taken by this Government and the previous Government on things like longevity.
And then there is another issue, which is about what society as a whole thinks is a reasonable amount to spend. I think that comes a bit back to something that Mr Johnson, I felt, was hinting at earlier, which is that there was a time when public service pensions were very much in line with good private sector practice. Over the last 15 years, there has been this extraordinary shift from final salary schemes, and employers in the private sector have basically taken the view that they can get a better return, in terms of recruitment and retention, by changing the balance a bit between pay now and pay later. The public sector stayed very much with the pay later model.
I guess the question is, if you are going to have reasonably generous pensions, there is an interesting issue about the balance between how much the employee should finance that pension, and how much the employer—or in the case of the public sector, effectively, the taxpayer—should foot the bill. Now, because of the change in longevity, when public sector pension schemes were originally set up, broadly, employees financed about half of the pension. Over the course of the last 30 years, there was this quite surprising increase in longevity, in the sense that it surprised the actuaries and it surprised pretty much everybody.
The most interesting fact that I have discovered in preparing for this Committee is that in 1841, if you reached the age of 60, you could expect to live to 74; by the early '70s, that figure had only increased to 78. The trick was to get to 60 in 1840, but once you got there, you lived to 74. By the early '70s it was 78, so there had only been a four-year increase. But since the early '70s, that figure has increased from 78 to 88. As a result of that, the employer has footed more and more of the cost of public service pensions—namely the taxpayer.
Coming back to your point of affordability, I think there is an issue that if the public sector is generally going to have more generous pensions, what is the right balance between the individual who is working in the public sector and the taxpayer? And that, in a sense, is one of the issues that the Hutton inquiry has looked into, and that, I think, successive Governments have wrestled with.

Q66 Chair: Okay, so what I take from that answer is that affordability is really defined, in a way, as perception of fairness?

Sir Nicholas Macpherson: I think there are two elements. Looking at the percentage of GDP is a good backstop. There are a whole lot of programmes that I think this Committee would look at in a similar way. Is our health spending as a percentage of GDP at 8% or 6%? Similarly, defence.

Chair: Well you would look at Europe.

Sir Nicholas Macpherson: Exactly, you can look at that. As I say, it is a good check, and if it was running away from us and getting up to 3% or 4%, or even 2%, I think we should all be getting extremely concerned. As I say, because of measures taken by the last Government and this Government, actually that is reasonably under control. So the next question, I think, is one—

Chair: Of the balance?

Sir Nicholas Macpherson: Yes.

Q67 Chair: And that is fairness?

Sir Nicholas Macpherson: Yes.

Q68 Chair: Okay, can I just ask you something? Everybody is challenging some of the assumptions you have made on your calculations. So they challenge your discount factor. We had a little discussion about that with Ros Altmann before you came, and you may want to comment on that. You have challenged the GDP growth rate, and I would actually challenge your assumption that the public sector workforce stays static over time. Maybe you would like to respond, because clearly, all of your calculations are based on these broad assumptions?

Sir Nicholas Macpherson: Those are all really important, and although I said that I am fairly confident that a figure of 2.25% trend growth will generally produce a sensible answer, I quite agree with Mr Bacon that one would want to do quite a lot of sensitivity analysis on it—similarly on longevity, and similarly on the size of the public sector workforce. Actually, I think one of the many good points, as ever, coming out of the NAO Report is that we need to develop that sensitivity analysis, and the Hutton inquiry will help us do that.

I think there is a special issue about the discount rate, which is a notoriously complicated subject. It is tempting to say, "Well, the gilt market is currently saying this. Because the Government can borrow over 10 years at this time and costing that amount, that is what should inform assessments." But, there are a whole lot of things that influence the gilt market at any point in time. For example, at the moment inflation is at a reasonably elevated level and the real rate of return in the gilt market is quite low. But that is because the gilt market is anticipating that inflation is going to fall. The gilt market basically has confidence in the Bank of England.

Q69 Mr Bacon: And the Bank of England certainly has confidence in the gilt market, because they have bought a quarter of all the gilts, haven't they?

Sir Nicholas Macpherson: Well, indeed. Guaranteed by the Treasury, I hasten to add. But my point is that, at any point in time, the gilt market will reflect a whole lot of factors: supply, demand or regulatory requirements. The fact that pension funds are required to hold so many gilts and the fact that the Bank of England has been active in the market, I think, it is fair to say, has probably distorted the yield in the gilt market. So I do not think one should be tempted into just focusing on short-term returns. You can look at the gilt market, but you might want to look at equities. Returns on equities recently have been quite good.

So, in looking at the discount rate, you have really got to take a long view. Now, the last time the Treasury did a major review of the discount rate was round about the turn of the century, and we got an answer of 3.5% real. With the passage of time, I think it is fair to say that that is beginning to look a bit on the high side. Hutton noted that it was probably on the high side—not totally silly, but just on the high side. As a result of that, the Government has started a review of the discount rate. A very impressive but complex Treasury document has been published, and I think the consultation, James, is set to end?

James Richardson: Tomorrow.

Sir Nicholas Macpherson: Tomorrow. So if you want to make representations, you have still got time. But the serious point is that this is being reviewed and it is right to review it every so often, but you should not get transfixed by market rates in the short run.

Q70 Mrs McGuire: Could I ask whether or not you were surprised to find out that over the period projected you were making the savings that you had anticipated? Did it come as a shock to you?

Sir Nicholas Macpherson: That we are making savings?

Mrs McGuire: Yes, over the projected period.

Sir Nicholas Macpherson: No, I am not wholly surprised. I think both the cap and share arrangements and the Government's decision to index public service pensions by the Consumer Price Index rather than the Retail Prices Index are quite meaty measures, which I would have expected would reduce the cost of pensions to a reasonable degree.

Q71 Mrs McGuire: The reason I ask is that it appears that there was not any structured monitoring of the progress and there did not appear to be a set of objectives that you could assess progress on? So, was it just instinct that said, "Yes, this is going to work"?

Sir Nicholas Macpherson: No. Loyal as ever, I have agreed the Report. In its own terms, the NAO's point is right, but I think perhaps the spirit of the observation is wrong. Why? Because the way the Treasury has always monitored pension spending is by making projections into the long term and then calculating the likely level of pension spending in relation to GDP. We do that every year. There are long-term fiscal projections. Those long-term fiscal projections have even more creditability now, because they are carried out by the independent Office for Budget Responsibility, and it is that that we focused on.

The paper is very much focusing on the set of measures that were introduced through the cap and share agreement, which was agreed with the trade unions in late 2005 and implemented in 2007. At that time, our objective was simply to recoup the money that was lost by agreeing with the trade unions that existing members would not have their age of retirement changed. We calculated in 2005 that that was approximately worth £13.5 billion. We needed to get that money back. So it influenced the policy and the way the Treasury drove that policy, but it was not fundamental to the cost of pensions. What was fundamental for us, in terms of the long-term effect of the cost of pensions, was that annual calculation, which is now done by the Office for Budget Responsibility.

Q72 Mrs McGuire: So, are you telling the Committee that the NAO did not quite understand how the Treasury was doing things?
Sir Nicholas Macpherson: Well, the NAO can speak for themselves.

Q73 Mrs McGuire: Well, you have challenged the methodology of the NAO.
Sir Nicholas Macpherson: Yes, I am challenging it because if you want to know what the cost of pensions is, you want to do these long-term projections and continue to look at them, and see whether they are moving upwards or downwards in the right area.
Keith Davies: What we meant by that point was that there is a programme of reforms here. I think in most circumstances we would expect them to be clearly stated objectives for that programme of reforms, with some numbers attached to them so that everyone can see clearly what the ambition is. We would expect to see some monitoring over time of performance against those, and that is what we perceived was lacking and that is the bottom line.
Sir Nicholas Macpherson: I think that is a fair criticism. We would always argue you should evaluate policies, and one of the challenges for us in the future is that there are now a number of changes that have been made to public service pensions. I think this Committee needs assurance that we are monitoring spending on public service pensions. We will be, and so on.

Q74 Mrs McGuire: So you will be able to give us a definitive report on the outcome of your monitoring at future points?
Sir Nicholas Macpherson: Yes. The Office for Budget Responsibility will publish a report each July, and the Government has already announced some changes. Following the Hutton Review, no doubt there will be further changes, and I think we will want to give you proper and accurate information on how much pensions are costing.

Q75 Mrs McGuire: One final question on this. Mr Sands, how are you monitoring the impact of the last set of changes on the NHS pension scheme?
Tim Sands: Right, the pension scheme changes are based on the valuation of the scheme. So for instance, the point that you were questioning about there: when we started, we had a situation where, in the NHS, the proposal was that people would move to 65 in 2013, 10 years after. It would have delivered very small changes in the short term, and we were facing a situation where, because of pay modernisation in the NHS, particularly the GP pay improvements and also the agenda for change scheme, we had significant extra costs, which would not have been addressed at all by the original measures.
The way that we both planned and monitored the spending is through the actuarial valuation of the scheme. We had identified that there was a pressure of 1.3% of pay, which would have fallen to the employer under the old arrangements. At any time, obviously, there is real pressure on NHS spending, and we were looking not to spend that money on increased employer contributions. The negotiation that we had and the cap and share being introduced meant that those costs were not actually met by the employer but met half by an increase in employee contributions and half by benefits changes, which reduced the cost. We had a formal agreement with the trade unions, which we negotiated, which sets out exactly how any increases in costs will be shared, and so that is the way we monitor it.
We were in the middle of the 2008 valuation when the current Government's changes, i.e. Hutton, came along and so we are currently suspended. But the process we had in place was that we looked at what the cost of providing those benefits would be going forward and any past service costs like longevity. We had an agreement about how those costs would be distributed, which was broadly, in the NHS scheme, that the employees would pick up the costs of living longer and being paid more and so on, and that the employer, through the Treasury, would pick up the financial risk within the scheme.
That is basically how we monitor it, and we have a governance group in the NHS pension scheme, in which employers and trade unions sit alongside each other, which makes recommendations to the Secretary of State; and the Secretary of State obviously then decides how to implement the valuation.

Q76 Stephen Barclay: Thank you. I just really wanted to clarify on the issue of the discount, following on from Dr Altmann's evidence. As I understand it, the average annual pension for a retired civil servant is around £7,000. Is that correct?
Sir Nicholas Macpherson: That sounds correct to me, yes.

Q77 Stephen Barclay: Yes. So, I was just looking at the Cabinet Office resource accounts, because the person who is the accounting officer for that scheme is Sir Gus O'Donnell. It says here that he will have, retiring at the age of 60, a personal pension of £100,000 to £105,000 a year, plus a lump sump of £305,000 to £310,000 a year. Yet, that is reported as a cash equivalent transfer value of £2.3 million. But if one follows Dr Altmann's figures, it suggests the real value, if one was to buy that on the market, would be more than £4 million. I was just wondering if you could clarify the numbers in that?
Sir Nicholas Macpherson: The estimates in resource accounts are, as you imply, based on actuarial calculations, and my presumption is that the Government actuary is using a discount rate consistent with the discount rate that we have been discussing, which is 3.5 real. As you say, if you used a lower discount rate, that would place a higher value on that

pension. The one point I would make is, do bear in mind that for future generations there is now a cap on your amount of tax privileged pension. So, the glory days enjoyed by the Cabinet Secretary and his predecessors will not apply to the likes of myself and Mr Richardson, because we will come up against a cap much before you got a pension of that level.

Q78 Stephen Barclay: Okay. What I am really trying to get at is the sense of urgency and whether, on the issues of affordability, too much of the money is being taken by those at the top, which is having a big impact on those on more modest salaries. If one looks at your own pension, this is currently reported as a cash equivalent value of more than £1 million. I think that is probably less.
Sir Nicholas Macpherson: Just.

Q79 Stephen Barclay: Just?
Sir Nicholas Macpherson: Just.

Q80 Stephen Barclay: Paying £55,000 to £60,000 a year, plus a lump sum of £165,000 to £170,000 a year when you retire. But again, if one follows Dr Altmann, that would be worth more than £2 million. I am just concerned about how affordable those sort of schemes are.
Sir Nicholas Macpherson: The fact is, you have mentioned what the average pension in payment is, and it is £7,000. So, on average, pensions paid out by public sector schemes are not dramatically different from those paid out elsewhere. I think you are quite right to raise the issue of the higher paid. One of the anomalies with final salary schemes is that the people who get promoted late on, or at least get big pay increases late on, get massive pension benefits.
Now, the good news is that the Civil Service has now moved to an average salary scheme. I think the Treasury's ambition, probably, at the time was that that average salary scheme should affect, albeit after a transition, all employees. Unfortunately, I it is a matter of public record that the Treasury failed to achieve its objective there. So those currently in the scheme were protected. So, for example, I remain in a final salary scheme, even though people currently joining the Treasury are joining average salary schemes.
Now, to take your example, if Gus O'Donnell or myself were in an average salary scheme, you might get a bigger pension at the end of it, but that would purely be a function of your salary. The effective contribution required to generate that pension would be the same whether you were high paid or low paid—James will correct me if I am wrong—and I think that is desirable.

Q81 Stephen Barclay: What I am really trying to get to the heart of is whether it has been accurately reported. We had evidence earlier that suggested that to purchase on the open market a pension paying over £100,000 a year, with the lump sum attached that applies to Sir Gus, would be over £4 million. You are reporting it as £2.3 million, which presumably then frees up money to spend on short-term things. I am trying to clarify whether your reporting is correct. Would you accept that to buy a pension of over £100,000 on the open market would cost in the region of £4 million?
Sir Nicholas Macpherson: On the basis of annuity rates at the present time, I think your estimate is probably broadly right.

Q82 Stephen Barclay: So that is a yes.
Sir Nicholas Macpherson: No it is not. It is not, because the Government takes all sorts of decisions using a rate of time preference, which is higher than that available in the market at the present time. I think yours is a perfectly good point, but the fact is that in making these assessments you do need to look beyond the current market rate, and the private sector would do exactly the same thing. If I was in a final salary at BP, they would be using the same sort of discount rate, and indeed the Inland Revenue rules that determine the taxation of pensions apply in the same way for the private sector as they do for the public sector.
James Richardson: I think it may also help to understand that it does not free up resources elsewhere in the public sector, because the public sector does not buy that pension pot. These are unfunded schemes.
Chair: No, it comes out of current spending.
James Richardson: What matters is the actual expenditure year on year of actual pensions.
Stephen Barclay: Sure, but you are reporting it.

Q83 Austin Mitchell: I appreciate in all this digging we are just trying to produce a headline for the *Daily Mail*. I wonder, in all the future projections you have been doing about costs, what the calculations are on the effect of reduced public sector pensions on the take-up of means-tested benefits. Have the calculations been made about that, and can you give us an estimate of the possible cost?
Sir Nicholas Macpherson: Well, it is certainly an important factor in determining pension policy, and James may want to comment on it.
James Richardson: Yes, I think two things here are relevant. One is that the changes that have been put through, both under the previous Government and under the current Government, do not change the value of the pension for most pensioners on the day they retire. The change to career average for the Civil Service does mean that those on lower earnings are likely to receive a somewhat higher pension and those on higher earnings a somewhat lower pension. So that will remove, potentially, some people from means-tested benefits who might otherwise have been in receipt of them. But the bulk of these changes in terms of increasing the pension age for new entrants, some changes to employee contributions whilst people are working, and the cap and share provisions affect either the money that you get when you are working or the age at which you retire, rather than having a big impact on the pension.

Q84 Chair: When you look at your pension changes, the impression one gets from the Report is that you do not necessarily look at the impact on means-tested benefits.
Sir Nicholas Macpherson: Yes, we do.

Chair: You do?
Sir Nicholas Macpherson: Yes. One of the objectives here is to give people a reasonable income in retirement, and I think most people would regard a reasonable income as floating you off means-tested benefits. A lot of the emphasis, both under the last Government and indeed in the Hutton Review, which the Government has endorsed, is actually trying to create a fairer pension system, although "fair" is always a difficult term, so that the so-called fat cats will pay a higher share—dealing with Mr Barclay's point about Gus O'Donnell.
Stephen Barclay: You can use that term for almost any civil servant.
Sir Nicholas Macpherson: And people on low incomes, if anything, will be levelled up slightly.

Q85 Austin Mitchell: So you are saying there will be no effect on the take-up of means-tested benefits?
James Richardson: I cannot guarantee there will be no effect. What I am saying is that the broad thrust of the policy, if anything, levels up the pensions for people on lower earnings, and therefore there is unlikely to be a significant negative effect. There may be a positive effect. We certainly take these factors into consideration. Obviously modelling all of these things perfectly for changes that take place 30, 40 years in the future is not an exact science.

Q86 Joseph Johnson: In some ways it seems to me that we have got the worst of all worlds for the taxpayer, because on the one hand we have got these public sector occupational pensions, which according to Ms Altmann's evidence, are 30% to 50% better than those on offer in the private sector. So, I am just parking that for a second. I know you said that you felt that they were comparable with those on offer elsewhere. Her evidence was very clearly that they were 30% to 50% better than those on offer elsewhere in the private sector. And then on the other hand, as I was also mentioning in our discussions with Ms Altmann, they are not appreciated by those who are receiving them to the extent that they should be, because of these twin discounts that are being applied to them that I mentioned: complexity and political risk. What changes would you like to make to our pension policy in this country so that it is more effective as a tool of recruitment and retention?
Sir Nicholas Macpherson: I am going to ask Tim to come in on the NHS in a minute, but, I recognise what you are saying. Just to clarify one thing, my understanding is that pensions paid to people in the public sector are broadly comparable with the pensions paid to those who get a pension in the private sector. Because a lot fewer people get a pension in the private sector, I think it is fair to say that the direction of Dr Altmann's estimates, although perhaps on the high side, is right. Public sector pension provision, on average, is more generous than the private sector.
One of the difficult things from a Treasury perspective over the years has been with regard to your earlier point. People are myopic and tend to value pay now versus pay later, so you do not get the same return in terms of retention. On the other hand, historically, the state had quite a paternalistic view of these things, and thought that it was in people's interest to have a reasonably generous pension, even though people did not really appreciate it, especially when they were young.
Getting the balance right is a challenge. The world has changed since the Civil Service I joined in the 1980s, partly because the private sector has recognised that people are myopic. Coming back to the fairness point, I think, probably, that the state should move a bit more in the direction of the private sector. But I think it would be a pity if it moved all the way to where the private sector is, simply because there is some benefit in pension provision and as Lord Hutton has said, and as the Government has therefore endorsed, we do not want to race to the bottom. Tim?
Tim Sands: The thing that I would add in relation to the NHS is that I think, in a sense, you are both right and wrong in looking at the NHS. We did a survey before we started the whole review as part of the review of the pensions that led to the agreement that was implemented in 2008. Recruitment and retention and the effect was a very, very strong element of what we were looking for in what we were proposing. We did a survey that showed that the vast majority of people who were members of the NHS pension scheme were very happy with it; however, I think it was four in 10 of them did not really understand what it was that they were going to get from it.
I think in public service pension schemes, and particularly with regard to the NHS scheme, we must hold our hands up that people were not getting annual benefit statements, so they had no idea of what the actual value of their pension on retirement was. That has actually reduced the cost of the pension in the NHS, because on average, people in the 60 scheme retire at 63, because their expectations of how much they would get in pension as they came close to retirement were not realised. They thought they were going to get a higher proportion.
What we have done as part of this is focus very hard on the recruitment and retention benefits for the NHS. In the NHS, there is quite a high turnover of staff in the first five years, but once they have got through the first five years, they do tend to stay. They emphasise that the pension scheme is a very important part of that. The employers side in the pension negotiations wanted to move to career average for the NHS for new starters; however, the trade unions very strongly argued that they did not want that, and because we had a financial envelope and we could deliver that financial envelope with the final salary pension, we kept that in the end.
What we are doing in the NHS at the moment is everyone is getting a choice as to whether they want to move to the 65 scheme, because for people who are working longer, it would be a better deal. Everyone will have got a pension statement by the end of this year, which sets out what the value of their benefits is. We going to build on that by giving annual benefits statements going straight on from there, and we are looking at whether we can make those into total reward statements, because we have the electronic staff record across NHS organisations, which provides pay information. So we are looking at whether we can give that, because I think it is absolutely vital that

people do understand the value of their benefit. In the review we were told things like people were moving for a couple of hundred pounds or so a year extra pay, when the value of their pension, obviously, was considerably more than that.

Q87 Chair: I am sorry I am pushing you on a bit; we have just got so much to go through. Can we ask you to look at the 12 March Report, which we have also got, at figure 10 on page 19? Have you got that one with you? It shows that the change in employer contribution to the NHS pension was a gobsmacking 436% in 10 years; miles different from all the other ones that were looked at, and perhaps you could give us an explanation of that?
Tim Sands: Sorry, this is the increase in the employer contribution?

Q88 Chair: Employer contribution, as a percentage increase, went up from £3 billion to £5 billion[1].
Tim Sands: There are two factors, I think, that are involved in that. One was that the NHS is the one area of the public services that had the biggest growth in numbers.

Q89 Chair: I do not believe that can explain that.
Tim Sands: No. I think the other factor, as I understand it, is the indexation changes to the contribution rate, which used to be paid direct by the Treasury; we had an increase in the contribution rate from 7% to 14%, so that doubled.
James Richardson: It's a change in assumptions essentially in the way the costs are split between the Treasury and the employer, both of whom, of course, ultimately are the taxpayer.
Sir Nicholas Macpherson: The column you should look at is total cost to the taxpayer, which is on the right hand side of the table, and it shows it going up from 2.04 to 2.9.

Q90 Chair: I see, so it was taking out of Treasury and putting it on to the NHS books?
Sir Nicholas Macpherson: Yes.

Q91 Chris Heaton-Harris: A quick one on the NHS, but then another one, if I may. Why does the NHS stick with the final salary scheme for most employees, and why are doctors and dentists treated differently?
Tim Sands: Right. It's general practitioners and dentists who are treated differently. They are in a career average scheme, and the reason is that they are self-employed people, and if you had them in a final salary scheme they could make up their own final salary, so you could not have self-employed people in a final salary scheme. Dentists and GPs have been in the NHS pension scheme since 1948 as self-employed people and they've always had that arrangement. I sort of alluded to why we ended up with final salary.
That was not the preferred choice of the management side; we were given a financial envelope and the requirement to move people to 65 for new entrants. Those were the requirements that we were given, and so within that we had the freedom to negotiate as to what sort of defined benefit pension we had. We put a strong proposal, for reasons of fairness mainly, because of the issues that Hutton subsequently raised about defined benefit pensions, that we should move to a career average scheme for the NHS for new starters.
The agreement has been that for the existing members we wouldn't be looking to change arrangements, and in the course of the discussions and negotiations we were unable to convince the trade union side that we should move to that arrangement. In return, they accepted that they would pick up the costs of that arrangement in terms of salary growth, and so on, which was obviously the big financial risk that we were concerned about, if that had gone ahead, and, of course, of people living longer. So, in effect, the agreement was that they would pay for the potential risk costs of a final salary pension over and above a career average pension.

Q92 Chris Heaton-Harris: The other question is, before we came to this meeting—I am playing with these Twitter things—I tweeted that we are talking about this subject today, and I think it is a nettle that needs to be grasped. People who are taxpayers who are not in the public sector do look at these pensions and think, crikey, they are gold-plated and out of line with private sector pensions. Some of the replies I got back are pretty unrepeatable, but are from people who would agree with that. So how do you change that perception, especially given the facts we have been given earlier about the cost of the public sector pensions?

Q93 Austin Mitchell: Change your audience.

Q94 Chris Heaton-Harris: They are my electors.
Sir Nicholas Macpherson: I think this is very difficult, because it's not so much that public sector pensions have become more generous; at least the terms do not look as if they have become more generous. The fact is they are more generous because of longevity. What has happened is that the private sector has seriously reduced provision. In the 1980s there were far more people in the private sector in final salary schemes.

Q95 Chris Heaton-Harris: But is that the private sector living within its means, and the public sector not?
Sir Nicholas Macpherson: It is motivated by a whole lot of things. I think with the benefit of hindsight Governments imposed too much regulation on private sector schemes, for very good reasons post-Maxwell—a lot more regulation. In the days of high inflation, you could always paper over the cracks by the fact that all your worker's salaries were going up a huge amount. And the Government also imposed requirements like uprating pensions in payment, and trying to change the balance between early leavers and stayers, whereas in the private sector actually the only people you care about, quite rightly in economic terms, are the stayers.

[1] The correct figure for employer contributins to the NHS pension sheme in 1999–2000 is £0.9 billion rather than £3 billion.

So there were a lot of reasons which made it less advantageous to the employer to provide pensions, and, again, with the benefit of hindsight—and I am one of the guilty men, because I was working on pensions in the 1980s—the Government got it slightly wrong. So the private sector has moved on, the public sector has broadly stayed where it is. I think the gold-plating is particularly obvious in relation to the high paid; I think there is someone in the public sector who has got a pension pot of £5 million, or at least a notional pension pot of £5 million. That appears, to some people, to be excessive.

Q96 Stephen Barclay: Could you provide us with a name of those in these schemes with pensions above £2 million?
Sir Nicholas Macpherson: I can provide you with name: I suspect the list would be very small in relation to these schemes. I was thinking of the wider public sector.

Q97 Mr Bacon: In the senior Civil Service can you easily get at separate figures for the pension costs of the senior Civil Service?
Sir Nicholas Macpherson: Well, consistent with the principle of transparency, they are published in our accounts and Mr Barclay read out my pension. Being a sensible person, I checked it this morning.

Q98 Mr Bacon: That is Department-by-Department, I am talking about across the piece for the 3,000 or so people in the senior Civil Service. Do you have a handle on the total pension cost for that tranche of people?
Sir Nicholas Macpherson: We do have a handle, because the Senior Salary Review Body is continually looking at these issues. Do I have a spreadsheet in the Treasury on which I can tick off Mr X, or Ms Y? I do not, but fortunately there are very good organisations like the Taxpayer's Alliance who go through everybody's resource accounts and then go out and denounces us regularly once a year for being idle fat cats.

Q99 Stephen Barclay: There is a serious point within this Sir Nicholas, particularly with, say, the NHS, because I was quite struck by the fact that management salary costs in PCTs went up by more than 25% in two years, between 2007 and 2009, which is a massive increase. Even in my own county of Cambridgeshire, last year certain executives in Cambridgeshire mental health trust got salary increases of 18% or 19%. Now, that has a material impact on the pensions that they are taking. I think it fuels the debate of gold-plated pensions, when many of those on modest incomes are not getting particularly favourable pensions.
Sir Nicholas Macpherson: I think this is an interesting point, and speaking as a civil servant I have some sympathy, because it is very striking that salaries in the wider public sector, for example local government, have gone up a lot more than those of civil servants. If you went and looked at what the Permanent Secretary of the Treasury was paid in the 1890s, he would have been paid a lot more than I am today, and I am paid less than my predecessor was paid six years ago.
I think you are right to focus on the dynamics of pay, and all of us will remember—I think it was in the 1980s—the Chief Executive or Chairman of British Telecom doubling his salary, for he was a he, in his final year of employment. It rather relates to your point about doctors; the people who benefit from final salary schemes should not be able to set their own pay, because if they do, you can rake off very large sums of money indeed.
I totally agree with you: you need to look at senior pay across the public sector, you need to look at how much it is moving, and if it is rising, what the pensions implications are. That is why one of the things the Treasury has been trying to do over the last 20 years is to factor pension costs in to budgets. For example, in National Health Service, as part of its Departmental expenditure limit, the employer's contribution is factored into that. So you cannot just pass the cost effectively on to the Treasury, but I think there is more we need to do on this.
Interestingly, Lord Hutton is doing this review on pensions. Will Hutton, I believe, is shortly going to publish a Government paper, a report to the Government on senior pay and how it relates to low pay, because I think it is a really important issue. I have got no brief at all for the high paid in the public sector on that point.

Q100 Matthew Hancock: On this point, I just want to push on the discount rate again. I understand the point that you made about needing to look through short-term fluctuations even in long-term bond prices, but Mr Richardson said that the change in the discount rate does not really have an impact, because it is an internal accounting measure. I do not want to misquote you, but you said something about an internal accounting measurement, but it does have an impact on how much a public sector employer is paying, relative to how much the Treasury is picking up, does it not? If the discount rate is wrong and the contribution therefore does not reflect the appropriate discount rate, then effectively a Department gets a higher or lower spending settlement.
James Richardson: It does indeed affect that, and that is why it is important, because it gets the incentives right, as Nick was saying, for Departments to take the full costs of employing people into account, and not simply pass those on to future taxpayers. So it is very important that we get the discount rate right, and that is why we are reviewing it at the moment, and, as we said earlier, there is a consultation that closes tomorrow. What we have said, in terms of the consultation and any change that follows from it, is that this would not be an excuse for the Treasury to then raid Departmental budgets on the back of a change in the discount rate. If that were to follow from the consultation, we would make adjustments, but it would make sure that the incentives were as good as we can get them, obviously, because this is an unfunded scheme. There is no precise, unarguable answer to the question of what the discount rate is, but getting it as good as we can will get those

incentives as good as we can, and that will make for better decision making.

Q101 Matthew Hancock: Yes, but it is not right to say that the discount rate does not have an impact. It does have an impact in terms of getting those incentives straight.
James Richardson: Exactly. But it does not have an impact on public expenditure.
Matthew Hancock: Right.
James Richardson: I mean, there are some at the margin, to be absolutely precise, because there are some private sector people who are in public sector schemes, most obviously GPs, but there are teachers in independent schools often in the teachers' pension scheme, and, of course, they make real contributions into the public sector. So there is some marginal kind of fiscal impact of it, but it is predominantly internalised within the public sector.
Amyas Morse: I just wanted to look ahead a little, please. As we were writing these Reports, we noticed there had really been no change in the pension regime since the 1970s, and now we have had quite a lot of change. Is it a bit optimistic to assume we have finished, would you say? As I look at it, the Chair referred earlier to the various key assumptions, and you acknowledged, Nick, that there are these key assumptions that drive a lot of things. It is good to hear the discount rate is being thought about. Looking at all of them, when you look at them you say, "Are they, in combination particularly conservatively positioned?"
I wonder whether we are not likely to see more tightening in all of the settings over the next while and therefore should we be looking at a further set of changes? Are we in the middle of this flow of change really, and we should be looking for more change over the next two or three years? It is a little difficult for me to believe we have arrived at the terminus already, but I would be curious to just get your steer on it, so we can be thinking about a forward work programme, and so forth.
Sir Nicholas Macpherson: Well, we have had quite a lot of change, and you have produced some very good reports on where we are. The Hutton Review is about to complete. I would hope that Government generally, and Departmental employers in particular, will then take some decisions for the long-term. There is a cost in continually changing pension schemes. Going back to transparency, it is important people understand what their pension is. One of the reasons there is a problem with the state second pension is that it has been reformed so many times, no one has got the first clue what they are entitled to.
So that is a factor, and so I would hope in the next two to three years, things will stabilise. Obviously, thereafter, if facts change like longevity, you would expect it to be reflected in contributions, but I hope we can achieve a reasonable stability in pension schemes, because there is a massive benefit in terms of certainty to the employee in having quite a simple message about what your pension is.
Amyas Morse: So that stability would be evidenced by a set of assumptions and bases for the scheme that you would regard as stable and able to stand the test of time, is that right?
Sir Nicholas Macpherson: Yes. Critical I think is ensuring that there are schemes across the public sector that are sustainable and fair.

Q102 Chair: And it is going to take you two or three years to get there?
Sir Nicholas Macpherson: James is in charge of this, what was your estimate?
James Richardson: Yes, I think the immediate point, of course, is that we have set up the Hutton Commission to have an absolutely comprehensive look at all of these questions, and we are awaiting the final report.

Q103 Chair: And he is reporting when?
James Richardson: We would expect it before the Budget, so pretty soon now.
Sir Nicholas Macpherson: A week or two; two weeks.

Q104 Chair: So there will be announcements then in the Budget of direction of travel?
James Richardson: We have to see what is in the report before we decide.

Q105 Chair: But one assumes you will work towards announcements in the Budget for direction of travel? Yes or no?
James Richardson: I am not going to pre-commit what the Chancellor is going to say in the Budget. We have not seen Will Hutton's final report. This is, if I might put it this way, at the independent end of independent reports.

Q106 Chair: I love civil servants; there will be announcements in the Budget.
James Richardson: However, the Government will obviously respond to the Hutton Report once we have it. What I would say is that, if there is to be major structural change, implementing that will no doubt take a number of years. There will need to be negotiation schemes, we will need to bring forward change, and it would probably be sensible to have some kind of transition period so that, for example, people who are currently close to retirement are not having to deal with a sudden change for the last year or so of their employment. So you would expect major structural changes, if that is what comes out of Will Hutton's final report, to take a number of years to come into effect.

Q107 Chair: Two to three years?
James Richardson: I have not seen what the report says.

Q108 Chair: Oh God!
James Richardson: But that is probably a reasonable timetable. You will probably need legislation for some of these changes as well.
Chair: This is because you have not seen it, we will need legislation.

Q109 Matthew Hancock: We were discussing, whilst you were sitting at the back, the need for transparency, but you're a big employer, so what do you think about the idea of making the contributions that are made towards pensions very transparent so that people who benefit from them actually understand that. I was once in an extremely generous public sector final salary scheme.
Sir Nicholas Macpherson: Very generous one, particularly for certain people in it.

Q110 Matthew Hancock: It was always made clear to us that this was extremely valuable, but if it had been on the payslip every month it would have been even more clear.
Sir Nicholas Macpherson: I will ask Tim to comment. The Treasury is a very small institution, but I totally agree with you. The Treasury does have a problem of retaining people. I know it is always asserted that the public sector is generously paid, but the sort of people who work in the Treasury generally can go and work in the City, and one of the things which we try and sell, in terms of being a good employer, is, first, the pension, secondly, being family friendly people who will have alternative working patterns, and so on. We do regularly tell people how much they are getting, and I think it is an important sell.
Tim Sands: I mentioned total reward statements and annual benefit statements. At the moment, for instance, the Civil Service annual benefit statements just say what pension you have earned, and what it will be in the future. We are looking for the NHS scheme to give some sort of idea of the capital value of it, whatever basis we would use for that, because it does have an important retentive effect if people can see just how much they are getting from their NHS employment.

Q111 Mrs McGuire: We are currently redefining, to a greater extent, what we mean by the public sector. I think part of Government policy is moving that way. We are now looking at NHS commissioning practices that will effectively be medical businesses. I do not mean that in a pejorative sense, but there will be free-standing, independent businesses run by general practitioners, and their staff will be employed by those new practices. Obviously, we have got the situation with free schools, and, again, independent organisations, and certainly that was the indication that we got from Oliver Letwin when he was in front of the Committee a few weeks ago. So these organisations, to a certain extent, I think will be almost hybrid; they will be delivering public services, but they will not necessarily be staffed by public servants in the traditional and understood way that perhaps we have grown up with. Can I ask specifically on the NHS whether or not any consideration has been given to what is going to happen to those people who work in those commissioning practices? I do know that prior to 1997 NHS staff, or staff in general practice, were not entitled to be part of the NHS scheme. Is there maybe a read across on to some of the other elements where the public services are being deconstructed, let me put it that way?
Tim Sands: Obviously the Bill is going through at the moment, and so anything I say is subject to legislation, but the position with regard to GP commissioning consortia is they are completely separate from the GP practices. They will be spending quite large sums of public money, they have a choice as to how many staff they employ, or whether they buy in services from elsewhere, but they will be statutory bodies. They have to be, to be accountable for public money, and they will have access to the NHS pension scheme. So the staff who work for GP commissioning consortia will be the same as PCT staff now in that sense, although they will be quite different organisations, I entirely accept. They have that statutory basis.

Q112 Chair: And foundation trusts?
Tim Sands: Foundation Trusts have access to the pension scheme. At the moment the rules in the NHS are that you have to be an employing authority to have full access to the pension scheme, which is PCTs, Foundation Trusts, Trusts, Special Health Authorities, and so on. GP practices also have that status; they have to be organised in a particular way in order to have access, only GPs can be partners, they cannot bring in private sector partners or anything. We also give access to voluntary organisations; hospices have access to the NHS pension scheme, and where staff are transferred, for instance, to a social enterprise, the transferring staff—if it's a voluntary organisation, not for profit—have access to the pension scheme. The big issue that is raised with us continually is that private sector organisations currently have to give comparable pensions when staff are transferred out of the public sector, but they cannot have access to the NHS pension scheme under the current policy, and so they have to provide it. I think that is what Dr Altmann was referring to when she was talking about the expense of providing pensions, and her 30% to 50% figure.

Q113 Mrs McGuire: Is the situation being looked at in terms of education, and the fact that we are now on the road to establishing free schools which will be free-standing in terms of the wider education authority?
Sir Nicholas Macpherson: I think we would be looking at pensions in all these reform cases. The Government has also announced that it is launching a consultation on the fair deal policy, which Lord Hutton noted can create a barrier to the plurality of public service provision. You will recall the fair deal policy was agreed with the trade unions early in the century.

Q114 Mrs McGuire: This century or early last century? Some time in the last 50 years, right?
Sir Nicholas Macpherson: Yes, some time—I try to remember when it was—and, as a result of that consultation, I think there will be a report on the way forward in the summer of this year, because there is this issue; if you do contract out something in an innovative way, if you saddle the provider with public sector style pensions, they have to carry quite a bit risk, and so there is a balance to be struck in that area.

Q115 Mrs McGuire: I notice the word you used was "saddle" there, which perhaps is a value-laden word.
Sir Nicholas Macpherson: I make no value judgments in these cases, I am just an official.

Q116 Nick Smith: There is great variation in employee contributions at the moment. Teachers put in most, the armed services, some would say for good reason, do not pay anything. Do you expect employee contributions to converge over time, or do you think, given changes in public sector structures that we are hinting at at the moment, that the variations will continue?
Sir Nicholas Macpherson: Some of these things reflect history; for example, when I joined the Civil Service I was told the reason I was not paying a contribution was that all Civil Service salaries were reduced across the board to allow for notional contributions. I do not think the Civil Service, as an employer, makes that point quite so much these days, but that was the history of why civil servants historically did not pay very much. I would expect to see a bit more convergence, because fairness, both within schemes and across schemes, is something that people tend to regard as a priority. The Government has been clear on the armed forces that it is going to follow Lord Hutton's recommendation not to introduce contributions, so you could see increasing divergence between the armed forces and other schemes, which could have quite interesting effects in terms of the choice of who you employ in the Ministry of Defence, but I am not close to it.

Q117 Chair: Is it the MoD as well?
Sir Nicholas Macpherson: No, it is just the armed forces, but I do not know what happens, James, if you are a member of the armed forces who fills a Civil Service post in MoD.
James Richardson: You would still be in the armed forces scheme if you were in the armed forces.
Chair: Lucky you.
James Richardson: If you were the Head of Procurement, or whatever, but you were a General, you would be in the armed forces scheme.
Sir Nicholas Macpherson: We need to be careful about perverse incentives, but the Government is very clear that soldiers are not going to pay contributions. Everywhere else I would expect to see more convergence.

Q118 Nick Smith: We did talk about a change to pensions per week for the population. I think the Government has got an ambition of £120 a week at the moment, which seems quite ambitious, and we heard earlier on evidence from Ms Altmann that you would have to do some quite chunky things to pay for that. Given this Government's ambition—I think it is £120, it might be £130 per week—do you think that is achievable very easily?
Sir Nicholas Macpherson: James, as well as being in charge of pensions, is in charge of public spending, so he is best placed to comment on this.
James Richardson: It is very clear that at the moment the public finances are under a great deal of pressure, so finding additional funding for anything is quite difficult, but within the Spending Review Settlement we have made the basic state pension a priority. The Government has introduced the triple guarantee and that does mean that expenditure on the basis state pension is one of a few items that is rising at the moment. I am afraid I do not have the figures that you have provided in my head, so I do not want to comment precisely on those, but this is a priority area in public expenditure, and that is very clear from the spending review settlement. Additional generosity above and beyond what has already been announced would have to be funded from somewhere else, and that is obviously going to be quite difficult at the moment.

Q119 Austin Mitchell: I just wondered, did the calculation of pensions, benefits and payments play any part in Sir Nicholas's calculations when he left Peat Marwick Mitchell and came to join the true faith?
Sir Nicholas Macpherson: I took a wage cut, I can remember that. I think I was 26 years old at the time, so I was as myopic as most of the workforce, and pensions played no role at all. Indeed, in my first year in the Treasury I was not even in the pension scheme, so I've always been a bit resentful that I have not got as many years as I should have.

Q120 Mr Bacon: Is that because you did not fill the form in in time?
Sir Nicholas Macpherson: No, it is because I was employed as what was known as a casual employee; you were allowed to be employed for a year as a casual employee, which meant I did not have to go through any process, but it meant I got no pension.

Q121 Mr Bacon: Did you ever go through a process afterwards?
Sir Nicholas Macpherson: You will be relieved to hear I did.

Q122 Austin Mitchell: This balance has become such a political football between the private sector and the public sector pensions; the Daily Mail has made a career of hyping up public sector pensions. A lot of the problem is surely caused by the fact that the private sector pensions buggered themselves by taking long pension holidays and shoving the money into profit? Is that not the cause of a lot the difference?
Sir Nicholas Macpherson: As I said earlier, I think private sector employees have seen it as quite a good way of cutting costs without upsetting their workforce too much, because their workforce do not attach a very high weight to it. Successive Governments—and this goes back way back—have not done themselves any favours either by encouraging, for example, pension schemes to run down their surpluses, and also by changing rules which just make it more burdensome to run a pension scheme. I think there are a number of factors at work.

Q123 Chair: I just wanted to cover one area which I think we haven't covered, and then we are almost at the end. One of your key savings is your cost sharing and capping scheme? Nothing has happened, no

actuarial assessments since '06, '07, '08. Why? When are you starting with all that lot?
James Richardson: The assumption was that cap and share savings would start to come in from 2012/13 and that valuations would be taking place now.

Q124 Chair: But you should be doing a valuation every couple of years. That is what most people do. Every three years.
James Richardson: We would routinely do them every three to four years. Because there are so many changes going on at the moment and we are still reviewing, for example, the discount rate, which is a critical factor in all of this, we have put some of those valuations on hold at the moment because it would not be good value for money to spend money on doing them and then have to redo them in a few months' time if the Government changes the discount rate or if things that come out of the Hutton Report require further changes. So there has been a bit of a delay in those valuations, but I think there is a good reason why we have put them on hold.

Q125 Chair: Are you going to wait now until post-Hutton and post-legislation to do evaluation to bring in the cap and share?
James Richardson: I think it would be sensible to wait until there is a change of view on the discount rate.

Q126 Chair: Which is by when?
James Richardson: The consultation closes tomorrow, so we will obviously have to see what we get in, but I would expect the Government to respond pretty shortly thereafter. It is certainly not going to take a number of years. You then probably do want to do those valuations. I do not know precisely what Lord Hutton will recommend, but I imagine that that is a more long-term structural set of changes that probably would not justify waiting until all that had happened before doing a valuation.

Q127 Chair: So your intent is to have a valuation and to implement the sharing and capping in 11/12? 12/13?
James Richardson: As I say, the assumption is that most of this will take place in 12/13. I think that is probably still a perfectly sensible assumption. It also overlaps, of course, with the change in the employee contributions that starts in 12/13.

Q128 Chair: The only thing I would say is in this Report, somewhere—I have not picked it up—it says if everything goes wrong and the valuation demonstrates this, and you put it all on the employee contribution, it could be a 70% increase in employee contribution. That is gobsmackingly huge.
James Richardson: Sorry, where is that figure?
Chair: You tell me, Keith.
Keith Davis: It is figure 12, page 29.
James Richardson: Of which of the two Reports?
Keith Davis: The most recent.
James Richardson: Yes, now I understand the figure that you are looking at. That, as it were, assumes that employees chose to take the increase.

Q129 Chair: No, I understand all that. Actually, it is worse. If you are an employee, what that suggests is if you want to retain your same pension benefit—Let me start this again. What worries me is you have not done a valuation since—when was the last valuation?
James Richardson: They vary in the different schemes. Tim can probably tell us when the last one was in the health scheme.

Q130 Chair: When was it?
Tim Sands: I can tell you in our scheme.
Chair: No, I know you have obviously from the evidence given more.
Tim Sands: 04 was implemented in 08 and we were in the process of doing the 08 valuation.

Q131 Chair: And the rest?
James Richardson: It is similar timing, but I do not have the precise dates.

Q132 Chair: So 04 might have been the last one?
James Richardson: Around those times, yes.

Q133 Chair: So by the time you are implementing this, you are eight years on and if you want to retain the same pension benefit, it could well be that you are going to be looking at 70% increases in employee contribution. That is gobsmacking.
James Richardson: Other changes, of course, will also have taken place in that. As we have said, the CPI change, for example, is relevant here.

Q134 Chair: But the CPI knocks your occupational pension by 15%.
Stella Creasy: Yes, does that not mean you might end up paying more?
James Richardson: But that will be taken into account in the valuations. That affects the size of the valuation. So all I am saying is not all the changes across the valuation are in one direction. It is not automatically the case that valuations push up the costs and as the NAO report says a number of times, there is a great uncertainty about these longevity projections that drive all these curves. This has been the great issue in pensions over the last 30 years—longevity predictions have been very, very hard to get right. Systematically they have been wrong and therefore, assessing what changes will happen in the future is very difficult in this area. What cap and share does is insulate the taxpayer against those shocks.

Q135 Chair: We understand what it does. Rather than having that sort of an answer, the observation I would make to you is that in a period when there are a whole lot of changes that make it tougher for the average person working in the public sector—let's forget about the top ones—who gets on average £7,000, they have the CPI; they have all the things going against them and your failure to do an evaluation and therefore implement the cap and share for such a long period of time could have a very bad effect on those individuals, either in terms of their contribution or in terms of their pension. It seems to me that that is not a good thing to do.

James Richardson: I am sorry, but I do not think that is right. The change in the end is the same change, whether you do it in two valuations or one valuation. Cap and share does provide—and the graph essentially shows this—a mechanism that allows the people affected to decide whether to take that, which is in fact the impact of a greater value to the pension. It is not a loss; it is a gain that they then pay for in terms of longer life expectancy.

Q136 Chair: Hang on a minute. But if they have got to pay more or take less because the valuation shows the cost to the public purse is greater than it would otherwise have been, it is better that they do that gradually than in one lump.
James Richardson: That was exactly the point that I was coming to, that cap and share precisely provides people with the ability to take that as a choice between costs now and costs in the future. What this does is represent the extremes of that choice and indeed a position in the middle.

Q137 Stella Creasy: You are asking them to make a pretty stark choice, aren't you, between a substantial increase now or a substantial loss later? It is not gradual increase now. You might know that you have got a choice in front of you, but it is not a great choice to be faced with, is it?
Chair: Quite. And it is better you face that every three years rather than every eight or nine.
James Richardson: It is a consequence of a real increase in the value of the pension. It is a consequence of the fact that you are living longer and getting more pension.

Q138 Chair: That is not the point. I do not think you get the point. If things have changed for me as an individual because of longevity and therefore the cost to the public purse and therefore either I have got to pay more to get the same or I have got to decide I am going to get less, I want to know that every two or three years. I do not want, because you have failed to do it, to be told that every eight or nine years, because the impact of the decision after eight years is going to be greater than the impact every two or three. I think it is an irresponsible way to treat public servants.
James Richardson: As I say, had we gone ahead and done the valuations at a time when a number of factors were changing, we would simply have had to have redone them immediately afterwards anyway.

Q139 Chair: I do not think you get the point on the impact on individuals.
James Richardson: I do understand the point.
Sir Nicholas Macpherson: I would make two points. The delay has not been seven or eight years; as a result of what is going on, the valuation might may be delayed by, say, a couple of years. But the other point is that the whole point about actuarial valuations is to spread the cost, or indeed the benefit, over a long period. Things with pensions move very slowly, so although you can come up with quite dramatic charts, I do not think it will feel quite as terrible as you set out.
Chair: Wait and see.

Q140 Matthew Hancock: I do not understand the cap and share, so can I ask in figure 12, when people make the choice, they do not make the binary choice between the dark green line and the brown line, do they? Do they have the option to have a range somewhere in between?
James Richardson: Exactly. The green line represents the previous Government's estimate of the choice that people would make.
Matthew Hancock: On average?
James Richardson: Yes.

Q141 Matthew Hancock: But some people could go higher than that; some people lower than that?
James Richardson: The decisions are taken scheme by scheme, so they are not taken individual by individual.

Q142 Matthew Hancock: And that means that if there is a longer delay in between the valuations and therefore the jump in future cost is bigger, an employee could choose to go somewhere else on this chart in order to mitigate the size of the change that is being made.
James Richardson: Yes. That was the point I was trying to make; you have made it must better than I. I am afraid I was completely failing, but that was the point I was trying to make.
Amyas Morse: I think those comments are quite fair. On the other hand—not to be critical, because I do not intend to be—it is quite reasonable to point out that if you are an individual who is told, "You are getting more for your pension", you say, "Why". "Because your actuarial life expectancy has gone up a couple of years". You say, "Okay, great. It still does not mean that my income goes up; what it just means is I might be around a bit longer to collect it". So it is not going to feel all that comfortable, is it? You can understand that.
James Richardson: It beats dying.
Tim Sands: We made that argument very clearly in the last round and it was accepted by the trade unions. I think you are probably right that individual employees do not understand that, but we actually had a delay with the last round, because it was going to be implemented earlier and then there was the Public Service Forum agreement and it took longer. The way it worked the last time round was that we were picking up longevity and paying modernisation costs and we had to pick up an extra year or so compared with when we would have done it and they then spread forward over 15 years. So everyone is paying for those, but the 15-year spreading means that the impact of delaying the valuation by a year or two is not quite as big a hit and that has worked okay. We were in quite an advanced stage of the valuation, so the moment when all these other assumptions that James has been referring to are clear, then we will be able to move fairly quickly.

Q143 Jackie Doyle-Price: This actually follows on quite nicely. We are talking about an overall shift towards employees meeting the costs of their pension provision and although we get excited about the very high salaries at the top, ultimately a lot of public sector workers are not people enjoying high salaries. So if we are moving towards a system where they are going to be expected to cough up 10% of their salary, which is not unreasonable given the longevity risk, to what extent have you made an assessment as to whether people will just vote with their feet and opt out?

James Richardson: We have looked at this in terms of the specific measure that the Government has announced in terms of increasing the employee contributions. It is a difficult thing to assess, because there is not a huge evidence base out there, but the assessment that we have made is that there would be some element of opt-out and we have estimated that at about one percentage point of workforce costs within the schemes. That has been scrutinised by the independent Office for Budget Responsibility and they have accepted that. Now in fairness, they point to the uncertainty around that and I would highlight it to the Committee; this is a difficult thing to assess. But I would say several things that I think are relevant here. One is that for everybody in the public sector schemes, the employer contributions are a very substantial increase in their basic salary; roughly speaking 15% of salary on the current discount rate. If you think the discount rate should be different, you get these larger numbers, as you heard earlier. But on the current discount rate, you are getting about 15% of salary on top of what you get by being in the pension scheme. So that is what you give up if you opt out. That is over and above the value that you get from your own contributions. So you are giving up a lot, which is not a tremendously rational thing to do if you can afford it. Now I fully accept that some people will be cash constrained at the point when you put in the increase and those are the people that we worry about most. Of course, some of those people have already opted out and a lot of people who are on low pay or are only going to be in the scheme for a year or two may already have opted out. They cannot opt out twice. We are planning to bring those increases in over time so they are introduced in three stages and to make them progressive by income, because clearly it is the people on the lowest incomes who are most at risk of being cash constrained and therefore opting out. I think all of those things will quite heavily mitigate those risks. We cannot, unfortunately, completely eliminate them, but we are doing what we can and we are discussing these issues as well with the relevant trade unions, who are very focused on this. In terms of the loss to the financial position, it is the case that most of the contributions come from people higher up the income scale, because the opt-out that we have at the moment is lower down and because they are paid more and so the contributions are worth more. But obviously we do not want people to opt out so we will try to minimise that.

Q144 Jackie Doyle-Price: We can all completely understand that it is in their best interests to stay in there, but we have all agreed that people are very myopic and we are talking about monitoring people's behaviour. By your own answer just then, people have already opted out at the lower end of the income scale, given the less generous levels of contribution. At the same time, you have got the state in here with means-tested benefits, so people will take an element of risk, particularly if they have got other lifestyle issues, and ultimately the taxpayer is going to pick it up one way or the other. So to what extent are you offsetting that calculation with the fact that the taxpayer is going to pay one way or another? Is it a more efficient way to maintain that level of contribution?

James Richardson: Because the change in contributions does not affect the pension that you get when you retire, the calculation about whether the state is going to pick it up anyway through means-tested benefit is not affected by that. So if I think it is not worth me being in this pension scheme because I can get the Pension Credit, I think that today and I will already have opted out. The change in employer contributions does not change that calculation for anybody. So although it is an important point in policy making more generally and one that we do take a lot of account of, because we have not changed the pension through these changes, it is not relevant to this particular issue.

Q145 Chair: It is relevant in the round, because you must look at these things in the round.

James Richardson: Indeed it is important and we do look at it. What I am saying is that your point that if we put up contributions, people will opt out because they can get the Pension Credit anyway, has been made to us by a lot of people. What I am saying is if they can get the Pension Credit anyway and they are smart enough to work that out as their reason for opting out, they have already opted out. They cannot opt out twice.

Q146 Stella Creasy: So what is the saving to the public purse?

James Richardson: If they have already opted out, they are not in our calculations.

Q147 Stella Creasy: But if this increases the numbers of people opting out, we know that half of households are already struggling to make it to the end of the month on what they are being paid at the moment and then you ask them to pay an increase in their pension contribution and they go, "We just simply cannot afford it right now so we will opt out now and worry about it later", what is the saving to the public purse of this scheme?

James Richardson: The savings have been calculated on the assumption that we do lose some of the benefits.

Q148 Stella Creasy: 1%?

James Richardson: 1% of workforce cost through opt-out.

Q149 Stella Creasy: So just 1% of the workforce that is currently in the pension scheme at the moment you think would then opt out on your model?

James Richardson: 1% of the cost, as I say. There is a really important consideration here, which is because some people have already opted out and because inevitably the people who are paid more contribute more, most of the money that is paid in employee contributions is paid in by people further up the income scale and therefore, from a purely fiscal perspective—I am not discussing the social policy implications here—there is relatively little risk from those people impacting on the fiscal numbers. From a social perspective obviously it is really important that we make these changes progressive so as to avoid those kinds of issues.

Q150 Stella Creasy: From a Treasury perspective, you are still going to have to find the money to pay the Pension Credit if people are not paying into a pension scheme that they can then realise when they are older, aren't you?
James Richardson: As I said, the calculation of whether you opt out for that reason is not affected by the rise in the employee contribution. If I am going to opt out because I am better off on the pension credit, I am going to do it anyway.

Q151 Chris Heaton-Harris: If it is 1% of the costs, what percentage of the workforce is it?
James Richardson: Well we have not made an estimate on that, because we have not worked out the precise progressivity of the scheme, which is one of the things that, as I say, we are discussing at the moment with the trade unions. Once we have that, we will then have to make a new and more detailed estimate of opt out. Hopefully that will be a lower figure, because if we can protect the people who are most at risk of opting out, then the opt out will fall.
Chair: Thank you. I am going to draw it to a close, because I think people have got to go to other things, but thank you very much for very full and helpful evidence.

Written evidence from HM Treasury

PAC Hearing on 2 March 2011

At the PAC hearing on Wednesday 2 March on Public Service Pensions, I promised to provide you with notes explaining the following:

(i) Contracting out, and increasing the basic state pension;

(ii) Senior civil service pensions; and

(iii) Long-term GDP growth projections.

(i) *Contracting out, and increasing the basic state pension*

The State Pension has two components:

- The basic State Pension is a contributory pension—the amount an individual receives depends on the number of qualifying National Insurance years they have. A full basic State Pension is currently £97.65; and
- The State Second Pension is the earnings-related State Pension paid on top of the basic State Pension.

Individuals can choose to "contract out" of the State Second Pension. In return for not accruing rights to the State Second Pension in later life, an individual and their employer both receive a National Insurance rebate. From April 2012, those in defined contribution pension schemes will no longer be able to contract out. This change has already been included in the public finance forecasts.

The Committee discussed by how much the basic State Pension could increase if contracting out were to be abolished and the money recycled into the basic State Pension. The following analysis is based on the published cost of the contracting out rebate calculated using the current rebate levels.[1]

The contracting out rebate (given current rebate levels) is forecast to cost £6.8 billion in 2012–13. And 12.7 million individuals are forecast to receive a basic State Pension in 2012–13. This implies that ending contracting out could fund circa £10 a week rise for each basic State Pension recipient.

However, not all basic State Pension recipients receive a full basic State Pension. Further, the increase in basic State Pension could reduce the amount of income-related benefits some pensioners receive. If these effects were taken into account, ending contracting out in 2012–13 could increase a full basic State Pension by circa £15 a week.

While this change would be funded in 2012–13, there would be a net Exchequer cost over time:

- The number of basic State Pension recipients is increasing, and this additional basic State Pension would increase by the triple guarantee (as the basic State Pension rises by the highest of earnings, prices, or 2.5%). However, the cost of the rebate in cash terms rises more slowly. This could lead to an unfunded cost of circa £1 billion in 2016; and

[1] In February 2011, the Government announced that the rebate on earnings will be reduced from April 2012. This change has not yet been included in the published public finance forecast.

— Those individuals who are no longer contracted out will now accrue rights to the State Second Pension. Although these costs build more slowly (for example circa £100 million in 2018–19), there would be a significant increase in spending in the long term. Abolishing contracting out and increasing the basic State Pension represents an intergenerational transfer from working age people today to current pensioners.

(ii) *Senior civil service pensions*

Individual employers' Remuneration Reports (in Departmental Resource Accounts) include details of the pension benefits and Cash Equivalent Transfer Values (CETVs) of each of the members of the department's senior management team. These are available online on an employer by employer basis, but are not collated centrally.

However as an example, the following central departments had scheme members with CETVs near or above £2 million as of 31 March 2010:

Department	*Name*	*£ million*
Cabinet Office	Sir Gus O'Donnell	2.322
	Stephen Laws	2.401
Foreign and Commonwealth Office	Peter Ricketts	1.812
Home Office	Sir David Normington	1.988
	Peter Makeham	1.916
Ministry of Justice	Phil Wheatley	1.891
HMRC and Treasury	None	

Background to CETVs

The Cash Equivalent Transfer Value (CETV) is the capital value of an individual's pension and is calculated using guidance from the Scheme Actuary. It is an assessment of what it costs the scheme to provide the pension benefits. MyCSP, who are the Civil Service scheme's administrator, provide CETVs as of 31 March each year.

(iii) *Long-term GDP growth projections*

The OBR published its Economic and Fiscal Outlook in November 2010, in which it projected real economic growth of 2.2% per year on average, between 2016 and 2050. This was based on assumptions about growth in productivity (output per head), the population and employment.

Longer term growth rates will be updated annually in the fiscal sustainability report due to be published in the summer.

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