

5 March 2010

***Submission to the Public Sector Pensions Commission from
Terry Arthur, BSC FIA***

PREAMBLE

I notice that the submission from Toby Nangle of Baring Asset Management objects to the word “apartheid” in the first question. I see his point and also understand his suggestion that what matters is total compensation rather than a single element of it.

With certain qualifications, it must surely be an error to concentrate on only one element of a compensation package, albeit the second-largest one. The main justification for concentrating on the pension element would seem to relate to the issues of funding, accounting, and transparency, where the right description does indeed appear to be “apartheid”.

However, there is a second and inevitable form of apartheid between the public and private sectors in total compensation, arising out of the fact that tax-funded entities, per se, are not profit-seeking organisations.

Accordingly this submission tries to cover both (i) the ten questions asked (see Overleaf) and (ii) An Appendix on wider issues.

QUESTIONS AND ANSWERS

1. Do you believe there is a “pensions apartheid” between the public and private sectors, and why? If so, do you think this is economically and socially sustainable?

The basic issue concerns total remuneration (i.e. total compensation), including both salary and pension benefits. As explained in my Appendix, there is an inevitable apartheid in total compensation between the public and private sectors. The only real solution is to slash the size of the public sector.

Within pension schemes on their own, the apartheid lies in the different state regulations applied, including those regarding funding.

2. Do you think the reforms to public sector pensions that have been enacted over the last four years are sufficient to put them on a financially sustainable footing, and why?

I know of no reforms worthy of the name.

3. Do you have any views on whether some groups within the public sector benefit more from public sector pensions than others? Does it matter?

To the extent there are differences, it matters for the reasons given in Point 7 of my appendix.

4. Are the current “contracted out” arrangements for public sector pensions fair?

I am not sufficiently well informed re this matter to make a comment.

5. Do you believe it is reasonable for the taxpayer to continue to support DB in the public sector when the private sector has largely withdrawn from DB provision? If so, why?

As argued in my appendix, an immediate switch to defined contribution schemes is essential in the public sector (irrespective of the private sector) to ensure full and honest

funding. This is a sine qua non. If and when the public sector is able to demonstrate, with no ifs or buts, that benefits are, and continue to be, fully funded, then salary-based schemes (but not final salary schemes - see Q6) can return in respect of future service. My own view is that the no ifs or buts condition is impossible with a public sector of this size.

6. What would be the most radical change to public sector pensions that you would suggest, and why?

As an absolute minimum requirement, the lack of proper accounting in public sector schemes, at least some of which is inevitable, means that for future service they must switch immediately to a Defined Contribution scheme, whilst past service benefits must feature a (capped) price inflation link, *before* retirement as well as after.

7. What would be the most practical change to public sector pensions that you would suggest, and why?

See my answers to Q5 and Q6 above.

8. Thinking about the place of public sector pensions within the wider pensions system, what is the best way forward, given the enormous fiscal deficits currently being run, and why?

See my answer to Q5 and Q6 above.

9. Do you see merit in a ceiling on the level of public sector pensions? Would this be better as a limit on pensionable salary or on the pension?

Far better to pay realistic salaries in the first place, which would mean an overall cut of the order of 15-20%. Then proceed as per my answers to Q5 and Q6.

10. How can we best find a consensual way to reform public sector pensions, that avoids industrial action, and why?

Forget consensus; it is not possible. Industrial action is best avoided by changing the laws which condone it, for example the law that precludes companies from hiring temporary workers during stoppages. If that doesn't work, make industrial action illegal in the public sector, via a clear employment contract.

Appendix on wider issues

1. Economic and profit-loss calculations are crucial for all business entities. Double-entry book-keeping (according to Goethe, one of the finest inventions of the human mind) allows the fast pinpointing of all aspects of any entity, however large. Amazingly, it is not used in the European Community, and the last time I checked, it wasn't universal in the UK Government either.
2. In private enterprise, businesses profit or loss is meaningful but, double entry or not, that is not so in government. Correctly totted up expenses in the public sector cannot be confronted by income equivalents; there are no sales proceeds and the only income comes from donations in one form or another. (A "budget" is an arbitrary and meaningless figure.)
3. Without sales proceeds from *voluntary purchases*, there can be no economic testing and that means chaos. That is why Nikita Khrushchev allegedly said "When all the world is Communist, Switzerland will have to remain capitalist so that it can tell us the price of everything". Thus NHS hospitals can estimate the true cost of major operations (say) only by examining those of private hospitals – and the same goes for other aspects such as the relative costs of single-sex wards versus proper hygiene, etc. Market prices are the NHS "Switzerland". But the greater the presence of the public sector, the greater is the loss of market prices which alone can provide the economic calculation which we all take for

granted. Without market prices, it is impossible to prioritise. There is no means of getting an answer to the question whether projects are those best fitted to satisfy the most urgent needs; success and failure remain unrecognized in the dark.

4. How great is the role of the UK public sector? The number of employees relative to the private sector is a poor measure because many companies are involved significantly in providing goods and services for the public sector. A better estimate is probably expenditure (including that from borrowing) which takes us above 50% of GDP, to which we need to add the effects of regulation – at least another 20%. So the UK Government's reach removes or distorts a very substantial part of market prices.
5. In particular the effect on the employment market for both public and private sectors is highly distorted. It is well known that over the past decade *each* of the two main remuneration elements (salary and pensions) have moved substantially in favour of public sector employees, in parallel with the number of the latter. This situation is unrecognisable compared to fifty years ago when salary-based occupational schemes in the private sector were growing fast – and catching up on those for civil servants, which I understand had begun more than a century earlier. Since then, the size, membership, and costs of public sector schemes have grown beyond all recognition, like government itself, whilst its attitudes to public service have turned right on their heads (to the point where politicians do not balk at luring executives into public sector services as potential voters). The same goes for the enormous role of State regulation of occupation pension schemes, at the same time as standards in the public sector have been relaxed.
6. Thus as the need for genuine attempts at accounting in the public sector has grown, the will to do so has shrunk. Whilst I sympathise with Toby Nangle's suggestion that the main issue is recognition of liabilities, it is impossible to take seriously his claim that the WGA (Whole Government Accounts) initiative will make anything more than a minor contribution – if and when it comes about. It is astounding to read Mr Nangle's praise of the Brown Treasury in taking steps to rectify this problem whilst at

the same time changing adversely the rules of Advance Corporation Tax on *assets already accrued to cover liabilities similarly accrued*. (The WGA project, now more than ten years old, was ostensibly concerned particularly with a proper accruals-based accounting system!) An estimate by the actuary Nick Silver* (and my figures agree) suggests that whilst Public Sector occupational schemes are around £1200 bn in debt, the State Pension schemes are in debt to the tune of £2200 bn. These numbers dwarf the conventionally stated National Debt. Quite simply, “accrual” is absent from the language of the vast majority of politicians – and indeed many others who should know better when discussing issues like increasing the State Pension Age.

7. The above distortions mean that comparisons of total compensation for the private and public sectors are flawed and thus *some* separate consideration of pension arrangements are valid when all else fails.

8. On pension scheme design, the old model of “final salary schemes” has not stood the test of time. The problem is not the salary-based element; it is the *final* salary element – again, as I understand it, appearing first in the Civil Service schemes. In the 1980s, when I was heavily involved as a pension scheme consultant, it was by no means unheard of for directors of a company to ensure that they themselves received decent salary rises towards the end of their careers. I didn’t hear too much about public sector schemes, but it has got to the point where any self-respecting public sector executive would have his eye firmly on this particular ball.

9. As an absolute minimum requirement, the lack of proper accounting in public sector schemes, at least some of which is inevitable, means that for future service they must switch immediately to a Defined Contribution scheme, whilst past service benefits must feature a (capped) price inflation link, *before* retirement as well as after.

*A Bankruptcy Foretold, by Nick Silver

<http://www.iea.org.uk/record.jsp?ID=151&type=release>