Unpacking the Hutton report recommendations: what the future holds for public sector pensions

Last week Lord Hutton set out proposals for public sector pension reform, which were mostly slammed by unions and the media for proposing that public servants work longer and pay more to get less from their pensions. Looking beyond the hype and the headlines, **Leandro Carrera** *examines the key recommendations of the report and clears up the confusion about the future of public sector pensions.*

In June 2010 the government appointed John Hutton to chair an Independent Public Service Pensions Commission (IPSPC) to conduct a fundamental structural review of public service pension provision. The IPSPC published its final report on 10 March, ahead of the 2011 Budget announcement set for the 23rd .

In the UK, there are currently seven main pension schemes in the public sector with around 5 million active members. There are also a number of much smaller schemes for MPs, members of the Judiciary, and the Research Councils, with a combined active membership of 11,000, as well as 'quasi-public' sector pension schemes in which the government owns all or part of the sponsoring company (such as the BBC scheme). According to official figures, these schemes have a combined active membership of around 345,000 people.

The Hutton report makes a number of recommendations for the reform of public sector schemes, the most important of which are related to the design of the schemes. The Independent Commission recommends that public sector pensions should retain its defined benefit (DB) design. In schemes with defined benefit (DB) arrangements, the benefit paid depends upon a formula that considers a members' number of years of membership in the scheme and their salary levels. The current schemes in the public sector consider pre-retirement salary levels (which is why they are called final salary schemes). The report's most significant recommendation is that in the future public sector pensions should take into account *career average* salary levels rather than final salary ones.

How the career average revalued earnings (CARE) system works

In a career average revalued earnings (CARE) scheme, members earn an amount of pension each year based on their salary in that year and the scheme's accrual rate. The accrual rate is the rate at which workers accrue pension benefits for each year of membership into the scheme, usually expressed as a fraction of salary (i.e. 1/60th, 1/80th, etc.). The amount of pension earned every year is then revalued, usually according to prices or earnings growth. Upon retirement, the total pension paid will be equal to the sum of the revalued pension earned every year. The Hutton report recommends using average earnings growth. Post-retirement, it is recommended that pensions should be indexed in line with prices in order to maintain their purchasing power and adequacy.

The impact of the proposed CARE system

The report does not propose a specific accrual rate for the new career average scheme, nor does it recommend specific levels of employee contributions. This makes it difficult to predict how the new structure will affect the future value of public sector pensions compared to the ones under the current rules.

However, the report and independent research show that career average schemes tend to be fairer towards workers with low or average salary progression compared to "high flyers" with a fast salary progression. This is because the pension benefit in a career average scheme is based on the entire salary history of an employee rather than allowing the final salary to determine the value of the pension. In a CARE system, both the contributions paid and the pension accrued each year are directly based on the salary achieved in that year. This removes the unfairness in favour of high flyers who reach high salary levels towards the end of their career.

The Commission also recommends introducing tiered contributions levels. This means that contribution levels will be related to salary levels. This is to address the fact that high earners are likely to live longer and withdraw a benefit for a longer time than low earners.

The Commission highlights the need to increase the retirement age to address the fact that people are now living longer. In this sense, it recommends that the retirement age in public sector schemes should be linked to the State Pension Age (SPA), which is the age at which people are entitled to the Basic State Pension and other state age-related benefits. The current SPA for men is 65 years and for women it has been increasing since April 2010 to reach 65 by 2020. However, the Coalition Government has put provisions in the Pensions Bill 2011 to bring the SPA for both men and women to 65 by 2018.

The report acknowledges that exceptions should be made for the members of the uniformed forces – the armed forces, police and fire-fighters – for whom it recommends a retirement age of 60 years given the unique nature of their work.

Accrued rights

The Commission recommends that the Government should fully respect the pension promises accrued under the current rules. Therefore, it recommends maintaining the final salary link for past service. This means that once the reforms are put in place they will apply to all public sector workers but only from that point onwards. In this sense, older workers in the their 50s or early 60s will not be significantly affected by the changes as they will accrue most of their pension rights under the current rules and only a small portion under the new rules.

How future should reform be implemented

The Commission favours a centrally coordinated approach to implement the main design principles that is proposing. However, it also recommends a scheme by scheme consultation process on the specific details with scheme members to ensure that employees and their representatives have the chance to fully participate in the design of the new rules. This should allow the Government to implement all the changes before the end of this Parliament. Therefore, the new rules will be likely apply from the next Parliament.

The recommendations of this comprehensive and thoroughly researched report are likely to garner a lot of attention from stakeholders in the upcoming months. However, we will need to wait until the Government responds to see what recommendations will included in future legislation proposals.