CRESC Working Paper Series

Working Paper No. 100

In Defence of Public Sector Pensions: a Critique of the Independent Public Service Pensions Commission

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May 2011

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Abstract

This paper builds upon the analysis provided in an earlier CRESC Working Paper (No. 80) on public sector pensions. It provides a critique of the reports of the Independent Commission on Public Sector Pensions chaired by Lord Hutton. Our argument is that while the Commission recommends structural changes to public sector pensions it does not make a convincing case for such changes.

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Introduction

On 20th June 2010 the Conservative-Liberal Democrat Coalition announced that John Hutton, a Labour Peer and former Cabinet minister had accepted an invitation from the Chancellor of the Exchequer to chair an 'Independent Public Service Pension Commission'. The terms of reference of the Hutton commission on public sector pensions were 'to conduct a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the tax payer and consistent with the fiscal challenges ahead, while protecting accrued rights' (Hutton 2010: 133). An Interim Report (henceforth referred to as IR) was published on 7th October 2010 and its focus was on 'the landscape around public service pensions and …the case for reform'. The Final Report (henceforth referred to as FR) which recommended structural changes to public sector pensions was published on the 10th March 2011.

The FR and IR are organised around a series of 'principles'. These are 'affordability and sustainability' which refer to issues relating to the long term costs of public sector pensions (see Hutton 2010: Ch. 4). 'Adequacy and Fairness' which refers to the provision of a reasonable minimum income in retirement and various dimensions of 'fairness' in public sector pension schemes (see Ibid.: Ch. 5). 'Supporting Productivity' which examines ways in which public sector pension schemes impact on various dimensions of economic efficiency (see Ibid.: Ch. 6). The final key 'principle' is 'transparency and simplicity' relating to issues of clarity of data on and member understanding of public sector pensions schemes (Ibid.: Ch. 7). The analysis presented in this paper focuses on the first three sets of 'principles' which we believe are central to the case which the Commission advances for structural changes to public sector pensions.

In a previous Working Paper (Cutler and Waine, 2010) we analysed the weaknesses in contemporary criticisms of public sector pension provision and, unfortunately many of these analytic defects are replicated in the work of the Commission. The thesis advanced in *this* paper is that the Commission *fails* to advance a satisfactory case for the structural changes it proposes. The paper is divided into five sections. Section one considers Hutton's arguments on the affordability and sustainability of public sector pensions. Section two analyses Hutton's discussion of 'adequacy'; and Section three focuses on the various dimensions of 'fairness' in public sector pensions. While Hutton treats 'adequacy' and 'fairness' together we believe that the critical discussion is enhanced by separating out analysis of these issues Section four examines Hutton's argument that the current structure of public sector pensions represents a barrier to the development of a plurality of public sector service providers, a central plank of his argument on the implications of public sector pensions for 'productivity'. The brief final concluding section brings the main themes of the argument together.

1. ‘AFFORDABILITY’ AND ‘SUSTAINABILITY’

Summary

- The Commission does not present a formal definition of ‘affordability’ but it does provide a definition of ‘sustainability’ stating that ‘a sustainable pension scheme must be able to manage and share risks effectively *without dramatic increases in costs*’ (Hutton, 2011: 31, our emphasis)
- The Commission has a ‘preferred measure’ of the costs of public service pension provision which is the ‘level of benefit payments as a percentage of GDP’ (Ibid.: 28)
- Estimates of the long term costs of public pensions using this measure have been produced by the Government Actuary’s Department , the National Audit Office, the Office of Budget Responsibility and the Pensions Policy Institute. In *no case* was the estimated long term cost of public service pensions higher than *current* costs. Thus *on its own definition of sustainability and its own preferred cost measure* the Commission fails to make a case for structural reform of public sector pensions on the grounds that they are ‘unsustainable’.

The object of this section is to discuss the relationship between the principles of ‘affordability’ and ‘sustainability’ as outlined in the IR and FR and the case advanced by Hutton for structural changes in public sector pensions. The section is divided into four parts: the first discusses how the principles are defined and their implications; the second considers how the reports discuss the measures of the long term costs of public sector pension schemes: the third examines the trends in such costs using the preferred cost measure in the reports; and the final part critically analyses the grounds on which the reports reject the ‘cap and share’ arrangements introduced by Labour.

Defining ‘Affordability’ and’ Sustainability’

Discussing ‘affordability’ the IR states ‘what level of pension cost is affordable is a decision for the Government within the context of a wide range of priorities’ (Hutton 2010: 51): and the FR reiterates this view (Hutton 2011: 31). This suggests that while estimates of pension costs may *inform* pensions policy decisions they cannot *determine* them. However the principle of ‘sustainability’ has a much more direct connection to long term cost trends. The FR states that ‘in order to be sustainable, a scheme must be able to manage and share risks effectively, *without dramatic increases in costs*’ (Hutton 2011: 31, our emphasis). The issue of managing risk will be discussed in the final part of this section but there would appear to be guidance on an indicator of ‘sustainability’ given here. Thus a ‘sustainable’ public sector pension scheme is one which is able to operate ‘without dramatic increases in costs’. The definition of ‘sustainability’ includes no specific time reference but it is, arguably, implicit in the notion that *long term* costs should be controlled. Furthermore, the discussion of the sustainability principle in the IR is set in the context of estimates of public sector pension costs over a fifty year period (Hutton 2010: 64).

Measuring ‘Sustainability’

If a ‘sustainable’ public sector pension scheme is one which does not involve ‘dramatic increases in cost’ this raises the issue of how such costs should be measured. Public sector pension costs have been measured in a number of different ways (see for example NAO 2010a: 16). However most discussions have focused on *two* principal approaches. The first is to calculate the present value of the liabilities of public sector pension schemes (Cutler and Waine 2010: 25). The second is to estimate the expected annual cost of public sector pensions (usually expressed as a percentage of national income) (Ibid.).

As the term suggests 'present value' calculations are designed to express pension scheme liabilities in 'today's money' (NAO 2010b:36). All pension schemes have long term liabilities; thus an active member of a pension scheme at the beginning of his/her working life may not begin draw their pension until 40 years later; and may continue to draw this pension for a further 20-30 years. 'Present value' figures are designed to 'show how much would be required in current money to cover these liabilities' (Ibid.). However the present value figure is less than the total money value of these liabilities. The reason for this is that money *currently* set aside could be expected to grow over time through income and capital growth (Ibid.). Thus present value calculations use a *discount rate* which is designed to allow for the effects of income and capital growth.

One of the salient characteristics of the calculation of the present value of public sector pension liabilities is that they generate very large apparently 'frightening' figures. For example the Treasury's (HM Treasury 2008: 38) *Long-Term Public Finance Report* puts the present value of such liabilities at 31st March 2006 at around 50 per cent of UK gross domestic product (GDP); and subsequent estimates have generated even higher figures (for a discussion see Cutler and Waine,2010: 25). This cost level might seem to suggest a very strong prima facie case for major structural changes in public sector pensions leading to substantial cost reductions. However, it is necessary to realise that such figures encompass liabilities over very long periods. Thus, as the Treasury (2008: 38) points out, the above estimate 'represent the value of accrued pension payments…due over the next 60 or 70 years'.

Such measures are problematic because of their volatility. For example the Treasury estimate of the present value of public sector pension liabilities as at 31st March 2006 was 23 per cent higher than its estimate of such liabilities for 31st March 2005 (Cutler and Waine 2010: 25). These variations cannot be explained by changes in projected life expectancy. Thus the Government Actuary's Department (2007:9) estimate of the long term costs of unfunded public sector pension schemes anticipates only a slow increase in life expectancy. It projects an annual increase in male and female life expectancy at 65 in the NHS, Teachers', Civil Service and Armed Forces schemes (between 2005 and 2055) of 0.4 per cent a year for men and 0.3 per cent for women. Thus, as the Treasury Long-Term Public Finance Report (2008: 38) shows, changes in 'actuarial assumptions', principally related to projections of higher life expectancy accounted for only around 7 per cent of the difference between the 2005 and 2006 figures; while 'accounting effects' (related to the discount rate) accounted for over 80 per cent of the increase (calculated from Ibid.).

It is important to note that the IR is effectively sceptical of the value of such present value calculations in estimating the long term costs of public sector pensions. It argues that with such measures 'liability values are sensitive to the assumptions used and in particular the discount rate' (Hutton 2010: 59). In the UK Resource Accounts the discount rate is based on the yield on AA corporate bonds and as 'this yield is volatile, fluctuating with movements in the market ' which has the effect of 'rendering the liability also volatile'. The IR goes on to argue that as '…a change in bond yields has no implication for the actual cost of providing public service pensions so such estimates should be used with caution' (Ibid.: 60).

The second key measure is an estimate of the expected annual cost of public sector pensions as a percentage of national income. Arguably this measure has much greater relevance. UK public sector pension schemes (the major exception is the Local Government Scheme) are 'pay as you go' schemes which meet the current liability of having to pay pensions out of current income. Thus the second measure has the advantage that it reflects the demands on government to meet the liabilities of public sector pension schemes in a given fiscal year; and that their capacity to do this will naturally be related to national income. Equally such estimates are not subject to the volatility problem discussed above. In this respect it is important to note that both the IR and the FR treat public sector pension payments as a percentage of national income as a key measure of public sector pension costs. The IR argues,

'…the Commission's view is that the projected public service payments as a percentage of estimated GDP is *an effective measure* of the future cost of public Service pension provision…' (Hutton 2010: 63, our emphasis). The FR goes further stating that 'the Commission's *preferred* measure of the cost of public service pensions *is the level of benefit payments as a percentage of GDP*' (Hutton 2011: 28, our emphasis).

Long Term Trends in Public Sector Pension Costs

Given its status as the Commission's 'preferred measure' of the long run costs of public sector pensions it is necessary to review the major estimates of such costs. However, this discussion requires reference to a major change in the treatment of indexation of pensions introduced by the Coalition government. In his budget speech of 22nd June 2010 the Chancellor announced that from April 2011 the Consumer Price Index (CPI) would replace Retail Price Index (RPI) for the indexation of public sector pensions. (HM Treasury 2010a:17). While this change has a technical aspect relating to both the composition of the indices and the method of averaging (for a lucid account see Davies 2010) it is has major practical consequences because CPI is expected to rise more slowly than RPI hence indexing benefits (including public sector pensions) by CPI will result in lower benefits than if RPI were used (for discussion see Ibid. and the Pensions Policy Institute (PPI) 2011: 1) .

The first estimate considered is that produced by the Pensions Policy Institute (PPI) (Adams et al.2010). This is particularly useful because it compares the effects of using RPI and CPI inflation measures. Public sector pension payments as a percentage of Gross Domestic Product can be measured on a gross basis (i.e. without deducing employee contributions to public sector pension schemes) or a net basis (making such deductions), The PPI estimate (Table 1) is on a net expenditure basis; and they are for pay as you go public sector schemes and thus exclude the Local Government Scheme..

Table 1: Projected Future (Net) Annual Cost of Unfunded Public Sector Pensions as a Proportion of Gross Domestic Product

	2010	***2020***	***2030***	***2040***	***2050***
CPI indexation	1.2	1.2	1.1	1.1	1.0
RPI indexation	1.2	1.3	1.3	1.2	1.2

Source: *Adams et al. (2010)*

In the IR the Commission presents estimates from the National Audit Office (NAO) and the Office of Budget Responsibility (OBR), these estimates (Table 2) are presented on a gross expenditure basis thus accounting for the higher figures when contrasted to the PPI estimate given above.

Table 2: Projected Future (Gross) Annual Cost of Unfunded Public Sector Pensions as a Proportion of Gross Domestic Product

	2009/10	*2019/20*	*2029/30*	*2039/40*	*2049/50*	*2059/60*
NAO	1.7	1.9	1.9	1.8	1.7	1.7
OBR	1.8	1.9	1.9	1.8	1.7	N.A.

Source: *Hutton (2010)*

The IR also commissioned an estimate of long term public sector pension costs from the Government Actuary's Department (GAD). This was designed to update the NAO and OBR figures (Hutton 2010: 63-4). This estimate was that, on a gross basis total public service pension benefit payments would peak at 1.9% of GDP in 2011 falling to 1.4% by 2059-60; on a net basis the peak would also be in 2010/11 falling to 1.1% by 2059/60 (Ibid.: 64).

What is clear is how far all these estimates indicate a broad trend. In no case is the long term estimate of public sector service costs as share of national income higher than the current figure. In three cases (the PPI calculation based on RPI indexation; the NAO and OBR calculations the long term cost is at the same level as the current); in two other cases (the PPI calculation based on CPI indexation and the GAD updating for the Commission) the share of national income accounted for by public service pension costs is *lower* than the current level. Such trends hardly indicate 'a dramatic increase in costs'.

Managing Long Term Costs

The final aspect of 'affordability' and 'sustainability' to be considered concerns the Commission's view of the 'cap and share' arrangements introduced by Labour. The basic concept is that if, for example, pensioner longevity increases to an extent not anticipated in actuarial predictions, then costs will be 'shared' between employers and scheme members (Thurley, 2009: 8). The 'capping' aspect refers to a ceiling on employer contributions (Labour unsuccessfully sought to interest private sector employers in cost sharing and capping, (see Department for Work and Pensions (DWP) 2008)). Thus, if following periodic review of the actuarial assumptions, increased scheme costs are identified then the employer liability is linked to an agreed cap (the level of the caps for employer contributions can be found in Thurley 2009). Identified cost increases above the cap would thus have to be met by increased *employee* contributions, revisions to scheme benefits or a combination of both.

This issue is significant because Labour argued that these 'risk sharing' arrangements combined with other structural changes introduced under the post 2005 agreements provided the basis for 'affordable' and 'sustainable' public sector pensions.

At various points the Commission appears to accept at least some of this case. Thus the IR argues that Labour's 'cap and share' measures represented 'a major transfer of risk from employer to employee' (Hutton 2010: 40). However, the IR includes a section on what it terms (Ibid.: 47) 'the limitations of cap and share'. This begins in a particularly lame way. It is stated that 'many schemes are not yet covered by cap and share arrangements'; and that 'cap and share is an untried system'. With respect to the first issue these arrangements are in place for the larger schemes (such as the Civil Service, NHS and Teachers') and there would appear to be no obvious reasons why they could not be extended to other public sector schemes. With respect to the second the same argument would apply to the early implementation period of any long term structural changes including of course the proposals advanced in the FR by the Commission.

This section also includes the objection to 'cap and share' that increases in longevity are a long term process but that cap and share arrangements use a 'recent baseline' which is usually the 'preceding valuation'. The result is that such arrangements do not effectively claw back increased costs resulting from earlier improvements in life expectancy. The IR goes on to argue that 'cap and share…will not deliver…*significant reductions in current costs for taxpayers*' (Ibid.: 48, our emphasis). This is significant in two important respects. The first is that it involves a blatant change of criteria with respect to 'sustainability'; the latter requires a scheme to operate on a long term basis 'without dramatic increases in costs' not with 'significant reductions' in such costs. The second problem is that it contradicts the apparent political neutrality adopted with respect to 'affordability'. The latter, as was indicated above, was designed to leave 'affordability' decisions to governments. In contrast the criticism of 'cap and share' involves an apparent a priori commitment to a 'small state'.

2. THE GUARANTEE OF 'ADEQUACY'?

Summary

- The Commission adopts the Turner Commission replacement rates as its measure of 'adequacy' (Hutton, 2011: 38) and concludes that '*current schemes deliver*' the Turner adequacy levels when combined with a full state pension (Ibid.: 39, our emphasis) thus there is no case for structural changes to public sector pensions on 'adequacy' grounds.
- The Commission advocates an alternative form of public sector pension the Career Average (with) Revalued Earnings (CARE). Work undertaken for the Commission shows that two CARE scheme designs *could* deliver adequacy levels comparable to current public sector schemes (Ibid. : 73). However. the Commission does not recommend an accrual rate for the CARE scheme and hence proposes a break from current provision which *does* meet 'adequacy' criteria without specifying the conditions which would allow the preferred alternative to pass this test.
- The Coalition government has decided to introduce a 3 per cent average increase in employee contributions to public sector pension schemes while protecting lower paid workers. Even with such protection material (from a Government source) suggests that workers with earnings below the median could experience employee contribution increases of around 50 per cent over 4 years. The Commission argues that maintaining or improving coverage of public sector schemes is essential if they are to underpin 'adequate' pensions but it fails to explore the implications of these substantial increases for opting out from or refusal to join public sector schemes .
- The Commission recommends that the Normal Pension Age in public sector schemes should rise in line with increases in the State Pension Age (Hutton, 2011: 94). However it fails to investigate the potential problems stemming from the inadequate demand for the labour of older workers and their health status. Thus it fails to analyse whether workers, obliged by such measures to prolong their working life, will be capable of generating an 'adequate' income.

The aim in this section is to discuss how the IR and the FR discuss the principle of 'adequacy'. The section begins by examining how this term is defined in the reports and goes on to discuss a series of issues focused on whether there is a disjuncture between the advocacy of 'adequate' public sector pensions in the reports and the framework of structural change in public sector pensions proposed in those reports. Three key questions are analysed. The first concerns how far the specific recommendations in the FR are consistent with the recommendation that the Government should ensure that public sector pensions should provide an 'adequate' income in retirement. The 'adequacy' of public sector pensions presupposes that public sector workers are members of their occupational pension scheme and the overwhelming majority of public sector workers are members of such schemes. However, the Coalition government has indicated that it will impose a substantial rise in average employee contributions in public sector pension schemes. This raises the possibility, discussed in the second part of this section, that such contribution increases may significantly increase the number of workers opting out of public sector pension schemes and reduce the numbers of new employees deciding not to join them. The argument discusses how this issue is treated in the two reports.

The third and final question considered is the implication for 'adequacy' of the Commission's proposal to raise the normal pension age in public sector pension schemes in line with increases in the state pension age. A case could be made that this is not strictly a public sector pensions issue. However the implementation of this proposal presupposes that working lives are extended and that during such longer working lives income from employment is a crucial component of overall income. In turn this scenario assumes both that the relevant employment opportunities are available, and that such employment generates sufficient income to either provide or significantly contribute to an 'adequate' income. In the final part of the section the analysis focuses on how the reports approach this question of the viability of extending working lives.

Defining 'Adequacy'

Before addressing the three critical issues outlined above it is necessary to explore both how the IR and FR defined 'adequacy' and to undertake a preliminary exploration of the relation of the question of adequacy to the structural changes in pensions advocated by the Commission. It is clear that the Commission regards adequacy as a major issue. The FR states 'ensuring that public service pensions continue to provide at least an adequate level of income in retirement is, in the view of this Commission, a crucial result of any structural reforms of the scheme' (Hutton 2011: 38).

The Commission's discussion of 'adequacy' is first raised in the IR with reference to 'a set of benchmark replacement rates' set out by the 2004 Pensions Commission (henceforth referred to as the Turner Commission) , these are reproduced in Table 3.

Table 3: Turner Commission Benchmark Replacement Rates

Gross Income	*Benchmark Gross Replacement Rate*
Less than £9,500	80%
£9,500-17,499	70%
£17,500-24,999	67%
£25,000-49,999	60%
£50,000 and above	50%

Source: *Hutton (2010)*

In this approach an adequate pension is defined in terms of the proportion of income while in work replaced by the pension. As the IR notes (Hutton 2010: 86-7) replacement rates are set below 100 per cent for a number of reasons. These include lower taxation levels in retirement, the likelihood of lower housing costs (due to paying off or mortgages), that work expenses may no longer be incurred and that saving for retirement is not required. In the IR these benchmark rates were not accepted by the Commission which simply noted that they had been 'widely accepted' (Ibid.: 87). However in the call for evidence for the FR the Commission asked for responses on 'how the Commission should think about the issue of adequacy and whether a full state and public service pension should ensure people reach an adequate level of income' (Hutton 2011: 38). The FR summarised responses on this issue and gave its own view. It noted that there was a 'broad consensus that the benchmark replacement rates set out by the Turner Commission…were the appropriate way of thinking about adequacy' (Ibid.) a view which the Commission endorsed stating that 'the Commission agrees with this view' (Ibid.) There also appeared to be a similar consensus on the role of public sector pensions in underpinning 'adequate' retirement incomes. Thus the Commission reported that 'most respondents felt that a full public service pension, in conjunction with a full state pension, should deliver at least at income at these levels' (Ibid.). This view also had the imprimatur of the Commission and the FR states 'the Commission agrees with these views and believes that the Government should ensure future public service pensions schemes (in conjunction with a full state pension) deliver at least the minimum level in retirement recommended by the Turner Commission' (Ibid.).

Thus public sector pensions (combined with a full state pension) should, according to the Commission provide an 'adequate' income in retirement and the Turner 'benchmark' was the preferred means of defining 'adequacy'. However, it is important to note that the Commission does not argue that structural reforms to public sector pensions are required to reach such 'adequacy' objectives. Earlier we quoted the FR to the effect that it was essential that public sector pensions '*continue to provide* at least an adequate level of income in retirement' (Hutton 2011: 38, our emphasis). Naturally if the objective is that public sector pensions should 'continue' to play a crucial role in contributing to an adequate income in retirement it follows that they already do. Indeed the FR is quite explicit on this point referring to a chart on p. 39 it is said that it 'shows that *current schemes* deliver these adequacy levels when combined with a full state pension after a lump sum has been taken' (Ibid.: 39, our emphasis), and this view that current public sector pensions pass the 'adequacy' test was also reflected in the IR (see for example, Hutton 2010: 88-9). The FR recommends a structural change in public sector pensions replacing final salary schemes with a career average scheme. In 'final salary' schemes members receive an occupational pension which is a percentage of earnings at the end of their working life. Currently virtually all UK public sector pension schemes are final salary schemes where the scheme member's pension is a percentage of earnings at the end of their working life. They are also Defined Benefit (DB) schemes where the pension level (the 'benefit') is predictable. In a Career Average Scheme the pension is based on a percentage of 'salary earned in each year of working life' (Hutton, 2010: 159) it is thus also a form of DB scheme. In the next part of the argument the compatibility of such a scheme with 'adequacy' objectives is discussed.

Career Average Public Sector Pensions: How 'Adequate'?

The first critical issue to be analysed is how far the Commission's recommendations can be expected to deliver an 'adequate' public sector pension as defined above. Central to this discussion is the Commission's support for a career average revalued earnings (CARE) scheme (Hutton 2011: 50). To test how such a CARE scheme could meet the adequacy test the Commission, using work it commissioned from the Pensions Policy Institute (PPI), compared a range of scheme designs. These were analysed in detail in Annex C of the FR. The PPI analysis was designed to compare a 'proxy final salary scheme' intended to be ' a broadly typical public sector scheme' (Hutton 2011: 171) with a range of alternatives. The aim 'was to define the parameters for a set of alternative scheme structures in order that they would, on average, provide the same value [as the proxy scheme] to the scheme membership' (Ibid.) Note that comparable benefits are 'on average'; thus there is the potential that the schemes compared to the final salary proxy may *distribute* scheme benefits in a different way to the proxy comparator.

The proxy scheme used by the PPI 'broadly emulates current terms offered to *new entrants* to the NHS, Teachers' and Local Government schemes (Ibid.: 171-2, our emphasis). In addition to 'cap and share' Labour introduced changes to the Normal Pension Age (NPA) in public sector pension schemes. The latter refers to the age at which a member can retire without any actuarial reduction in their pension. The Local Government Pension Scheme operated (generally) with an NPA of 65. The three other largest schemes, the NHS, Teachers' and Civil Service schemes brought in an NPA of 65 for *new members* following the Public Service Forum (PSF) agreement of November 2005 (Thurley 2009: 8). This choice for the proxy means that it is 'not identical to any of the current public…pension schemes' where, for example, scheme members who joined before the changes introduced under Labour would have an NPA of 60 (Hutton 2011: 172).

The PPI analysis concluded that two CARE designs would 'be approximately equivalent in overall value' (Ibid.: 175) to the proxy scheme. The operation of career average schemes crucially depends on how earnings are revalued. The PPI's two CARE 'equivalent' schemes differ in that one revalues earnings by the CPI while the other revalues earnings by rises in average earnings. As earnings generally rise faster than prices the CARE scheme using CPI revaluation has to have a significantly better accrual rate to the CARE scheme using earnings revaluation. The 'accrual rate' refers to 'the proportion of earnings which a (DB) pension scheme pays as pension for each year of membership' (Hutton 2010: 159) in a scheme. The illustrative scheme using earnings revaluation operates with a 1/61st accrual rate as against 1/40th for the scheme where earnings are uprated by CPI (Hutton, 2011: 175). In this respect there are therefore two crucial aspects of the CARE scheme design, how earnings are revalued and the accrual rate.

In the FR (Hutton 2011: 73) a chart is used to show the 'adequacy' effects of a CARE scheme 'with indexation by average earnings' for employees with at least 20 years service in the public sector. As the earnings indexed CARE scheme analysed by the PPI operated with a 1/61st accrual rate we assume that this also applies to the scheme illustrated in the chart, though this is not specified. Under this CARE scheme 'adequacy targets [using the 'Turner definition' discussed earlier] are achieved for more than 90 per cent of those with annual earnings up to £24,999 and three quarters of those with earnings over £25,000 (Ibid.). The FR also argues that there was 'little variation' between this scheme, the final salary proxy and the CAREs scheme using CPI or earnings indexation, all three were seen as 'performing well' against adequacy criteria. The FR thus draws the more general conclusion that 'there is no reason for a move away from final salary pensions to result in inadequate retirement incomes' (Ibid.: 74).

However, if it is *feasible* for a CARE scheme to meet the adequacy objectives outlined in the FR this raises the question as to whether the FR is recommending a scheme with parameters consistent with such adequacy objectives. This might appear to be a straightforward issue. As was indicated above, the FR makes the achievement of 'adequacy' in public sector pensions a high priority. Further one of the FR's recommendations is that 'the Government should ensure that public…pension schemes deliver *adequate levels of income* (as defined by the Turner Commission benchmark replacement rates) for scheme members who work full careers in public services' (Hutton 2011: 40, emphasis in the original). No definition of 'full service' is given in connection with this recommendation but, as was indicated above, the suggestion is that adequacy objectives can be attained, in a suitably designed scheme, after 20 years service.

There are two crucial parameters in this respect; the approach to earnings revaluation and the accrual rate. The FR *does* recommend a form of indexation arguing that 'pension benefits should be uprated in line with *average earnings* during the accrual phase for active scheme members' (Hutton 2011: 71, emphasis in the original). However, the Commission does *not* recommend an accrual rate. The FR does contain a discussion (Ibid.: 66-70) of the trade off between accrual rates and indexation reiterating the point that more generous indexation (earnings rather than prices) allows broadly comparable benefits to be achieved with a lower accrual rate. However, there is no recommended accrual rate attached to this section and no recommended accrual rate appears at any point in the FR. Thus, as various commentators have noted (Cooke 2011; Emmerson 2011) it is impossible to envisage how the recommended CARE scheme could operate because key parameters such as the accrual rate are not specified. In this sense the recommendation for an 'adequate' CARE scheme is gestural since key conditions are not specified.

Adequacy and Participation Rates in Public Sector Pension Schemes

The second critical issue to be considered is the potential impact of the Coalition Government's policy of substantially increasing employee contributions in public sector pension schemes. This question is crucial to the issue of 'adequacy' naturally if participation rates in public sector schemes fall then they cease to be a vehicle for achieving an adequate income in retirement. Substantial increases in employee contributions pose a threat to adequacy since they may encourage public sector workers to opt out of the relevant scheme and new recruits not to join it.

The FR argues that 'there is little point in designing a pension scheme that delivers adequate income levels, if public service employees…decide not to remain…once they are enrolled…or decide not to join at all' (Hutton 2011: 39). The document goes on to argue that 'it is important that the future structure of public…pension schemes *maintains or improves* the participation rate of employees, especially below median income levels' (Ibid., our emphasis, see also Ibid.: 76).

However, in the IR, the Commission states that 'it is up to the Government to decide on changes to the structure and level of contributions' (Hutton 2010: 122) in public sector pension schemes. The IR does refer to the Commission's terms of reference which state that any case made for savings on the costs of public sector pensions 'should be consistent with the Government's commitment to protect those on low incomes' (Ibid.: 123). It goes on to argue that 'it is reasonable to assume that lower paid workers are more likely to opt out of a pension scheme if they face the same increase in pension contributions as a proportion of their salary' (Ibid.). It further suggests that 'to reduce the level of opt-out…the Government should consider staging any increase in contributions, especially in the context of the current pay freeze' (Ibid.).

It is now necessary to consider the Commission's position on this issue in the light of Coalition Government policy on employee contributions to public sector pension schemes. In the Coalition's Spending Review of 2010 it is stated that 'the Government *will* implement progressive changes to the level of employee contributions that lead to an additional saving of £1.8 bn a year by 2014-2015, equivalent to three percentage points on average to be phased in from 2012' (HM Treasury2010b: 37, our emphasis). The use of the term 'will' indicates that this is designed to be a firm commitment and Table 4 shows the anticipated 'savings' anticipated from this source in the Spending Review Policy Costings 2010 and the 2011 budget.

Table 4: Anticipated 'Savings' from Increased Employee Contributions to Public Sector Pension Schemes, £ million

	2011/12	*2012/13*	*2013/14*	*2014/15*	*2015/16*
Comprehensive Spending Review	0	200	1,400	1,990	
Budget 2011	0	160	1,270	1,760	1,850

Sources*: HM Treasury, DWP and HM Revenue and Customs (2010); HM Treasury (2011a)*

At the time of writing no firm policy had been adopted on the precise implications of these increases for contribution rates to public sector schemes. In addition to the average three per cent increase the Spending Review Policy Costings did suggest that any increases would 'provide protections for the low paid' (HM Treasury, DWP and HM Revenue and Customs 2010: 18). However, there are some indications on this issue from an illustration by the Department of Communities and Local Government of possible changes to contribution rates in the Local Government Pension Scheme, this is reproduced in Table 5.

Table 5: Illustrative Example Issued by the Department of Communities and Local Government on Possible Implications for Employee Contribution Rates in the Local Government Pension Scheme

Salary	*Current Contribution Rate*	*2012/13*	*2013/14*	*2014/15*
£12,600	5.5%	5.5%	5.5%	5.5%
£12,601-14,700	5.6%	5.6%	5.6%	5.6%
£14,701-18,000	5.9%	5.9%	5.9%	5.9%
£18.001-24,000	6.5%	6.5%	6.5%	6.5%
£24,001-31,500	6.5%	7.8%	9.1%	9.7%
£13,501-42,000	6.8%	8.5%	10.2%	11.0%
£42,001-75,000	7.2%	9.5%	11.8%	13.0%
£75.001-100,000	7.5%	10.1%	12.7%	14.0%
£100,000-150,00	7.5%	10.3%	13.1%	14.5%
£150,000+	7.5%	10.5%	13.5%	15.0%

Source*: Association of Teachers and Lecturers (2011)*

The illustration in Table 5 shows a scenario in which there is an attempt to protect lower paid groups by not increasing contribution rates for those earning under £24,000. However, the Commission suggested that it was particularly important to maintain and improve scheme participation rates 'especially below median income levels' (Hutton 2011: 39). In April 2010 median incomes for full-time employees were £25,948 per annum yet, in the illustrative example in the Table 6 workers earning below the median income level (from an annual earnings of £24,001) would experience a 49 per cent increase in their employee contribution rate over a four year period.

As the Local Government example indicates the overall increase in contributions envisaged is so large that it can be mean individuals with relatively modest incomes (including below the median) will experience dramatic increases in pension contributions. It is literally the case that the increases are 'staged' but the average annual increase is very high with, for example, increases of the range of 49-100 per cent over a four year period in the scenario produced by the Department of Communities and Local Government. It is also worth observing that this would appear to move public sector schemes way out of line with private sector DB schemes. In the latter the weighted average employee contribution rate in 2009 was 5.2 per cent. This means, on the Local Government illustration workers earnings below the April 2010 median could pay employee contributions nearly 90 per cent above the average in private sector DB schemes.

It is, of course, difficult to know what the possible implications for scheme participation rates of such large contribution increases will be. In the Spending Review Policy Costings the Treasury states 'it is possible that a small number of individuals will choose to leave their pension scheme as a result of these changes, though given the generosity of the schemes there is little economic rationale to do so' (HM Treasury, DWP and HM Revenue and Customs 2010: 18). It goes on to indicate that the costing for 'savings' from higher contributions 'assumes an increase in the opt-out rate equal to one per cent of total paybill' (Ibid.). There are a number of problems with this panglossian account. Clearly the schemes (via substantial increases in contributions and increases in NPA) are being rendered significantly less 'generous'. The 'economic rationale' also assumes that the long term attractiveness of the pension scheme is the decisive factor ignoring the attractions of opting out in the context of falling real incomes and radically higher pension contributions. Finally no evidentiary basis is provided for the one per cent of pay bill figure. A report in the *Financial Times* (Cohen 2011) gives a rather more sombre picture. The Manchester Pension Fund (part of the Local Government Scheme) reported a 56 per cent increase in workers opting out of the scheme between 2009 and 2010 (Ibid.) and while it is not yet clear how far such a pattern is likely to be replicated it is important to bear in mind that this fall is before any of the planned substantial contribution increases come into effect.

Again the Commission's analysis is deeply flawed. The Commission's stated concern with maintaining or improving participation rates should surely have led to a questioning of the viability of imposing very large overall increases in employee contribution rates.

Adequacy and the Raising of Normal Pension Ages

The third issue related to 'adequacy' to be considered concerns the Commission's recommendations on the Normal Pension Age in public sector schemes. In the FR one of the Commission's recommendations is that 'the Government should increase *the member's Normal Pension Age (NPA) in most schemes so that it is in line with their State Pension Age (SPA)*' (Hutton 2011: 94, emphasis in the original). The recommendation is qualified by the caveat that 'the link between the SPA and the NPA should be regularly reviewed to make sure it is still appropriate' (Ibid.). However, in line with the overall recommendation the Commission wants any review of the SPA-NPA link to be undertaken 'with a preference for keeping the two pension ages linked' (Ibid.).

In the context of Coalition government policy on the SPA if such a recommendation were to be adopted there would be a significant increase in the NPA in public sector schemes. In the Pensions Bill, introduced by the Coalition in January 2011, it is proposed to raise the SPA for men and women from 65 to 66 by April 2020. The previous Labour government had proposed to raise the SPA but the Pensions Act 2007 provided for SPA to rise to 66 between 2024 and 2026.

The ‘adequacy’ issue raised by this recommendation refers to the related assumptions regarding employment. If the NPA in public sector schemes rises in line with an increasing SPA it follows that scheme members will be expected to work longer and that they will either be completely dependent on their income from work during this extended working life, or that, if they do have an income from an occupational pension, this will, necessarily, fall short of a *full* occupational pension. This, in turn, assumes that the relevant employment opportunities for older workers will be forthcoming.

In effect the Commission treats the employment implications of such longer working lives as unproblematic. A clue to the underlying assumptions behind this sanguine treatment of the issue can be found in Table 4A of the FR. In that Table the Commission outlines its ‘assessment of longevity management’ options against the ‘principles’ which inform the structure of the Commission’s reports. The FR discusses the option of setting the NPA in public sector schemes at 65 and thus, in the light of plans to raise SPA discussed above, allowing NPA to remain below SPA. It comments that this would have the effect of creating ‘no cultural expectation for continued working beyond NPA even though SPA would be increasing’ (Hutton 2011: 93). Conversely the course recommended by the Commission (linking NPA and SPA subject to review) is treated positively because it ‘should assist in creating a cultural expectation of changes in working life in response to changes in longevity’ (Ibid.).

In an important article Macnicol (2008) has explored the thinking underlying such a view of extending working lives. The FR’s reference to ‘cultural’ expectations is consistent with the approach taken by New Labour (see DWP 2006: 66). Thus Macnicol (2008: 587) points to the emphasis placed on ‘achieving ‘cultural change’ on the part of employers and employees by addressing the ‘personal factors’ that allegedly prevent economically inactive people from working and by ‘incentivising’ work’.

However this approach effectively ignores potential problems arising from the demand for the labour of older workers (Ibid.) Macnicol points out that optimism regarding the employment of older workers stems from employment patterns between the early 1990s and the onset of the 2008 economic crisis. Currently economic activity rates are highest for those aged 25-34 (85.1 per cent) and 35-49 (85.8 per cent) (Office for National Statistics (ONS)2011a). Between the Spring of 1994 and the second quarter of 2007 employment rates for those aged between 50 and the SPA increased from 62.4 per cent to 71.7 per cent (Macnicol, 2008: 582). An examination of the long term historical experience suggests that relatively buoyant economic conditions are crucial to such patterns (Ibid.). However, it has now become a virtual commonplace of post 2008 economic crisis discourse to question whether the economic conditions applying from the early 90s to the onset of the 2008 crisis are sustainable (see the discussion in Ibid.: 582). This approach also presupposes that it can be implemented across the national economy. However this fails to appreciate the significance of marked regional differences in employment rates for older people (Ibid.: 587). Thus, in the second quarter of 2010, employment rates for those between the ages of 50 and 64 varied from 58.3 per cent in Wales, 59.7 per cent in North East England to 70.2 per cent in South East England (DWP 2010).

A further reason for concern over this pattern relates to analysis of patterns of job creation in the public and private sectors from the late 1990s. As Buchanan et al (2009: 22) have demonstrated areas with lower employment rates for older workers were heavily dependent on direct state and ‘para-state’ employment, the latter referring to employment financed by the state but outsourced to primarily private sector providers. In the North of England such state and para state employment accounted for 64 per cent of new job creation between 1998 and 2007 and in Wales for 55 per cent of such job creation (Ibid.). However, current Coalition policy is designed to undercut the sources of such job creation by substantial cuts in public expenditure. The Coalition claims that this should not damage long term employment prospects because it is part of a process of 'rebalancing' the economy away from what it perceives as excessive reliance on public sector employment (e.g. H.M. Treasury 2010a). However, the experience of areas where significant deindustrialisation has occurred suggests that there are severe doubts on the viability of such 'rebalancing' and, if so this also suggests the need for scepticism with respect to prospects for employment of older workers.

Two additional problems in respect of employment for older workers can be identified. Firstly there is a substantially higher incidence of part-time working amongst older workers and this raises the question of whether such employment could generate an 'adequate' income (Macnicol, 2008: 588). Secondly there are problems relating to the health status of older workers and the extent to which it constitutes a barrier to employment (Macnicol 2008: 584). Thus 47.4 per cent of those economically inactive between the ages of 50 and 64 in 2004 cited long term sickness as the reason for their economic inactivity (Whiting 2005: 292).

3. THE QUESTION OF 'FAIRNESS'

Summary

- The Commission's discussion of 'fairness between public and private sectors' provides no criteria of such 'fairness'. Nearly two thirds of private sector workers have no occupational pension coverage. but Lord Hutton (2010: 4) rejects the view that the public sector should follow the private sector in a 'race to the bottom'. The Commission points out (Ibid.: 93) that, where private sector firms provide final salary pensions structurally similar to the majority of public sector schemes, benefits are similar thus it is not clear that the Commission establishes that there is 'unfairness' in pension provision between sectors.
- The Commission argues that a CARE scheme would produce greater 'fairness between scheme members' because it avoids the problem that final salary schemes give advantages for members who obtain promotions/ increases in salary late in their career (Hutton, 2010: 94). The Commission implies that there is no solution to these equity issues within final salary schemes but does not consider introducing more progressive tiered contributions to public sector schemes. There is also no discussion of the private sector. The very high pension entitlements for executive directors in private large firms suggest that the 'high flyer' problem may be much more marked in the private sector but the Commission is silent on this issue.
- The Commission suggests that public sector pension schemes raise issues of 'inter-generational' fairness. However, it eschews, for sound reasons (Hutton, 2010: 126), the radical right option of switching to DC provision in the public sector as a means of avoiding inter-generational redistributive effects.
- The Commission fails to specify how fairness between 'taxpayer and employee' should be defined or measured. It arbitrarily treats situations where employee and employer contributions to public sector schemes were at or close to parity as a norm (Hutton, 2010: 99) but it is not clear why such parity or near parity should operate as a standard and evidence on current practice shows that, in private sector DB schemes, employer contributions are a larger multiple of employee contributions than in their public sector counterparts.

In this section the aim is to discuss how the Commission's reports discuss 'fairness' in public sector pensions schemes and to link this discussion to the case it attempts to make for structural changes in public sector pensions. The principal discussion of this question is to be found in the IR with some of the arguments developed in the FR. The question of 'fairness' is discussed under four broad headings: 'between the public and private sectors' (Hutton 2010: 92-3); ''between public service pension scheme members' (Ibid. 94-5); 'between generations' (Ibid: 96-7); and 'between the employee and the taxpayer' (Ibid.: 98-9). The argument considers each of these in turn.

'Fairness' between the Public and Private Sectors

The discussion of 'fairness' between the public and private sectors is hampered because no definition is given as to what would constitute such 'fairness' In the IR (Hutton 2010: 92) the Commission presents a chart which shows the 'mean value of total [pension] benefits as a percentage of pay both overall and between public and private sectors. This shows a wide and increasing gap. In 2001 the mean value of such benefits in the public sector was 23.7 per cent as against 8.7 per cent in the private sector and the respective figures for 2005 were, respectively 25.1 per cent and 8.2 per cent.

The presentation of this contrast could lead to the view that the Commission's implicit view of 'inter-sectoral' fairness was equality of such rates across sectors. However, such a conclusion would be highly problematic given other positions taken in the IR. In its discussion of the inter-sectoral data the Commission (Hutton 2010: 92-3) points out that 'The fall in the private sector is entirely due to a composition effect, rather than a reduction in generosity of particular schemes in the private sector. This composition effect is as a result of falling membership of more generous DB schemes in the private sector; and increase in membership amongst less generous DC schemes; and an overall fall in membership of pension schemes in the private sector'. In this respect it is worth noting that while nearly 85 per cent of public sector employees are occupational pension scheme members in the private sector coverage is only just over a third of workers (ONS 2011b). The Commission concludes that where the comparison is *between DB* provision across sectors it is broadly similar. The Commission argues that 'where DB schemes are still open in the private sector they provide similar levels of benefit to the reformed public sector schemes' (Ibid.: 93). This conclusion is broadly consistent with a more detailed analysis produced by the Pensions Policy Institute (PPI) (Steventon 2008 ;for a summary of their argument see Cutler and Waine 2010: 16-17).

It is also important to set this conclusion on the overall comparability of private and public sector DB schemes in the context of planned changes to contribution rates in the public sector discussed earlier. The Commission states that 'on contributions to DB schemes, there is no consistent difference between the public and private sectors' (Hutton 2010: 93)). A higher proportion of private sector employees in DB schemes pay no contributions or contributions under 5 per cent of pay; but a higher proportion of private sector employees in DB schemes pay in excess of 7 per cent of salary as an employee contribution (Ibid.). However, this comparison is made in terms of current schemes without any discussion of the implications of the changes to contributions to public sector pension schemes as a result of the planned 3 per cent overall increase in member pension contributions outlined in the Spending Review 2010. While at the time of writing it is not possible to have a view on the overall effects of this change the illustrative figures presented by the Department of Communities and Local Government suggest that the numbers of public sector scheme members subject to very high employee contribution rates could increase substantially. Thus as the data presented in the adequacy section showed, the scenario envisaged by the Department would mean that workers on below median incomes would be paying a member contribution rate of 9.7 per cent.

While one possible view of 'inter-sectoral' fairness is that pension benefits as a percentage of pay should be equalised across sectors the Commission does not advocate this course. The reason is that such an approach would be inconsistent with a number of key positions taken in the IR and FR. It would endorse a 'race to the bottom' in pension provision particularly bearing in mind that the de facto private sector 'norm' is absence of occupational provision.

In his foreword to the IR Lord Hutton explicitly rejects such an approach: 'The downward drift in pension provision in the private sector does not…provide sufficient support or justification in my view for the argument that pensions in the public sector must automatically follow the same course. *I regard this as a counsel of despair*.' (Hutton 2010: 4, our emphasis). Furthermore the logic of the 'race to the bottom' would effectively be to wind up occupational pension provision in the public sector while protecting accrued rights. This would have a number of paradoxical effects. Winding up such schemes would, of course, end the income stream to government from employee contributions thus increasing the net cost of public sector pensions as pensions to retired staff would have to be paid by virtue of the guarantee to accrued rights. Furthermore it would provide a disincentive to pension saving contrary to the Commission's desire to at least maintain if not increase the coverage of occupational pension provision in the public sector.

'Fairness' between Public Sector Scheme Members

The second dimension of 'fairness' considered is that 'between public service pension scheme members' (Hutton 2010: 94). In this instance the Commission *does* present a formal definition of 'fairness' suggesting that 'a benchmark for fairness within a scheme could be that effective benefits from scheme membership, net of employee contributions, are roughly equal as a proportion of salary (at least over someone's career – since effective benefit rates will vary with age' (Ibid.). In this respect the 'problem' is that 'final salary schemes are often criticised on the basis that high flyers (those people who receive late promotions or large increases in salaries) receive far higher effective pension benefits than those who have few or no salary increases' (Ibid. : 94), the latter are referred to as 'low flyers' in the IR. It should be noted at this point that the 'high flyer' advantage discussed here relates to 'final salary schemes' per se not to final salary scheme in the public sector alone. The significance of this point will be developed below.

In the IR the Commission does not present a wealth of systematic evidence on advantages to 'high flyers'. It presents data from the Local Government Pension Scheme indicating that (presumably) average pension benefits per £100 of contributions are around 25 per cent higher for those earning over £20,000 than those earning under £14,000 (Ibid: 95). In the NHS scheme it is estimated that 'high flyers' (operationally defined as group with a salary progression 1% per year higher than 'standard' members) achieve an effective employee [pension] benefit rate of 25 per cent while their 'standard' counterparts receive 20 per cent. (Ibid.) These differences assume comparable longevity whereas, as the Commission points out '…there is evidence that people with higher pensions live longer' (Ibid.). The argument is further developed in the FR. This presents analysis of the Local Government scheme which shows that median annual pension payouts for employees retiring on a salary in the highest quintile are 'almost 30 per cent higher than the pension payout' for employees retiring with a salary in the lowest quintile (Hutton 2011: 23). Furthermore the analysis undertaken by the PPI comparing the proxy final salary with the two CARE options discussed in the adequacy section showed that whereas effective employee benefit rates were similar for individual with different patterns of career progression in various CARE schemes, in the proxy final salary scheme there were clear inequalities favouring those with a more rapid earnings growth (Ibid.: 179); and that such proxy schemes also gave 'high flyers' (operationally defined as above) a much higher ratio of benefits received to contributions paid (Ibid. : 180).

The Commission argues that such effects constitute part of a 'fairness' case against retaining final salary schemes in the public sector. However, this claim is problematic in various respects. Tiered contributions, where employees with higher pensionable incur a higher employee contribution rate apply in the Local Government and NHS pension schemes (ONS 2010: 28). In the IR (Hutton 2010: 95) makes the point that the effect of such tiered contributions in the NHS scheme has been to narrow the effective employee benefit rate gap between 'high flyers' and workers who do not experience substantial increases in their pensionable pay later in their career. This suggests that issues of 'fairness between members' might be addressed by making tiered contributions more progressive than they currently are. This course is, of course, made more difficult by the Commission's de facto acceptance of the overall 3 per cent contribution increase outlined in the Comprehensive Spending Review since the scenario from the Department of Communities and Local Government suggests that this would push employee contributions on higher incomes into the 13-15 per cent range. However it is indicative of the rigidity of the Commission's approach to public sector final salary schemes that there was no suggestion of commissioning an analysis of the possible effects of more progressive tiered contributions as a means of combating the regressive effects of public sector final salary schemes.

There are also peculiar effects stemming from the focus purely on the *public sector* final salary schemes. The IR (Hutton 2010: 94) indicates that final salary schemes per se magnify the pension advantages for scheme members who experience significant promotion/salary increases later in their careers. However, as this is the case there is a paradox since naturally such characteristics will naturally be a feature in private sector schemes. Indeed there are two reasons to suggest that such effects are more marked in private sector schemes. The first is that, as the Commission, indicates the regressive effects identified can be and are modified by the operation of tiered contributions. However, tiered contributions would appear to be currently confined to the Local Government and NHS schemes. Thus in their most recent annual survey of occupational pensions the ONS does refer to the tiered contributions in these schemes (ONS, 2010: 28) but makes no reference to tiered contributions applying at all in private sector schemes (Ibid.: 24). Thus this mechanism for mitigating the regressive effects of final salary schemes are present in certain public sector schemes but do not appear to be present in private sector DB schemes.

The second issue which is relevant in this respect is the much discussed feature of very large increases in pay and pensionable earnings for senior corporate executives. We discussed this issue in a previous CRESC Working Paper (Cutler and Waine 2010: 17-25). A broadly reasonable 'benchmark' for 'top' pension entitlement in the UK public sector is the accrued pension benefit of the Cabinet Secretary and Head of the Home Civil Service, Sir Gus O'Donnell. As of 31st March 2009 his accrued pension entitlement (what he could have expected if he had retired at that point was £95-100,000, for the lower accrued pension benefits of other Permanent Secretaries including to the Treasury see Ibid.: 18). This benchmark was used to compare accrued pension entitlements for executive directors in FTSE 100 Companies offering DB pensions to executive board members. The analysis used data from the relevant company accounts in 2008 and referred to various months according to the reporting period used by the company. The analysis found that 81 per cent of these executive directors had accrued pensions over double the benchmark (i.e. £200,000 per year) (Ibid.: 20). Nearly a third had accrued pension benefits at least five times the benchmark (£500,000 per year) (Ibid.). Thus, reflecting the much more rapid increase in the pay of senior corporate executives when compared with senior public sector managers and officials it would appear that the regressive effects are much more marked in private sector as against public sector pension schemes. In this respect there is a quixotic element to the critique of final salary schemes in the public sector as creating inequities between scheme members. In the case of the public sector this issue calls for structural changes in provision. In the case of the private sector where it is likely that the problem is vastly worse the Commission is completely silent.

'Fairness' between Generations

This putative dimension of 'fairness' elicits a relatively weak response from the Commission. At the end of the section of the IR devoted to inter-generational 'fairness' it is stated 'it may not always be possible to avoid inter-generational unfairness' (Hutton 2010: 97) although it should be 'minimised wherever possible'. In this section we seek to account for this sotto voce approach by situating the argument with respect to a series of dilemmas for the

Commission. One claimed example of unfairness between generations is the impact of the structural changes introduced under Labour which introduced distinct terms for new members of public sector schemes. Thus the IR argues ‘Another inter-generational impact is caused by reforms to scheme rules. A fire-fighter who joined the service before 6 April 2006 is a member of a much more generous pension scheme than one joining after that date’ (Ibid.: 96). There are a number of respects in which this statement is bizarre. Firstly it is difficult to see how this can be conceptualised as an ‘inter-generational’ issue as what is relevant is not the age cohort of the person but when that person joined the scheme. Secondly, this perceived inequity followed a pattern broadly common to both private and public sectors. The dominant pattern of DB scheme closure in the private sector has been to *new* members so existing members continue to earn pension benefits in more generous DB schemes (Pensions Regulator 2010: Ch. 3) . If this is inter-generational inequity then it applies across sectors.

A more serious candidate for ‘inter-generational’ inequity is increases in longevity not reflected in particular in employee contributions to public sector pension schemes. The IR argues this applied to public sector pension schemes before the structural changes introduced under Labour. Thus the IR argues that ‘in pre-reform schemes longevity increases raised employer contributions but employee contributions remained relatively unchanged’ (Hutton 2010: 96) though ‘the introduction of cap and share arrangements’ means that ‘future risks of changing life expectancy’ are shared between employers and employees’ (Ibid.)

As Piachaud et al (2009: 56) point out the debate on intergenerational equity and its fiscal implications arose in the USA in the 1980s in the context of unfunded social security pensions. A key response (particularly advocated by the extreme right) was the proposal that social security pensions should be privatised and provided on an individualised basis. This had implications for the form of pension provision. It was suggested that inter-generational equity would be promoted by a move from pay as you go schemes to Defined Contribution (DC) schemes. In such schemes what is predictable is the *contribution level* (employer, employee or combined). Unlike DB schemes there is no predictable *pension* level. The eventual pension level is governed by four features: the contribution level; administrative costs which effectively reduce the share of contributions which can be invested; investment returns; and annuity rates which govern the size of the pension income stream which can be derived from a given volume of accumulated pension saving. While the Commission rejects switching public sector pensions to a DC form (see Hutton 2010: 126) proposals to change provision in public sector pensions to such a form have been made (for a critical discussion see Cutler and Waine 2010: 30-35). DC forms of provision also figure in debates on ‘inter-generational’ equity which is an issue discussed by the Commission as a dimension of ‘fairness’ in pension provision.

DC schemes would involve minimal levels of redistribution on class, gender and age lines. The apparent absence of any distributional effects between age cohorts could be seen as promoting intergenerational equity (Ibid.: 57). However, as we have seen, the Commission does not favour moving public sector pensions to a DC basis preferring to retain a DB form of provision based on career average earnings.

As Piachaud et al (2009: 57-8) there are a number of telling objections to DC provision. These include the problem that as benefits depend on contributions it is likely that low paid workers or people with interrupted working lives (particularly women) will only qualify for very low pensions. In addition, however, there is an important structural problem. A shift to DC provision creates in the context of current public sector pension provision creates a ‘double payment’ problem. As was pointed out in the first section public sector occupational schemes are predominantly ‘pay as you go’, namely current employee contributions effectively serve to reduce the net cost to public funds of paying current public sector occupational pensions. A progressive shift to DC provision would, however, necessarily reduce the share of public sector pension contributions which could be used for this purpose.

This is because contributions to new DC entrants would be invested to accumulate their individual pensions saving. Thus this shift would, at least for some time, operate to increase public spending and the public sector financial deficit.(for an earlier discussion of this issue see Sheehy 1993: 137).

'Fairness' between Taxpayer and Employee

In its discussion of this dimension of 'fairness' the IR (Hutton 2010: 99) points out that public sector schemes in the past exhibited either equality or relatively small differences (when contrasted with current practice) between employer and employee contributions. Thus for example (Ibid.) whereas, in 1925, employer and employee contributions in the Teachers' Pension Scheme were equal at 5 per cent, in the current scheme employee contributions are 6.4 per cent and employer contributions at 14.1 per cent; in the NHS scheme in 1948 employee contributions were 5 per cent and employer contributions varied from 6 to 8 per cent according to different categories of worker, in contrast in 2008 employee contributions varied from 5 to 8.5 per cent whereas employer contributions were 14 per cent (Ibid.). However, as there is no criterion suggested for what would constitute a 'fair' distribution between employee and taxpayer it is not clear what such historical data is supposed to prove.

There is also a repetition of the failure to contextualise the discussion by reference to the private sector. As was discussed above the historical reference appears to suggest a norm of a ratio of under two to one between employer and employee contribution rates in pension schemes. Table 6 shows weighted average employer and employee contributions to private sector DB schemes over the period in which the Office for National Statistics has conducted an annual survey of occupational schemes (earlier studies were undertaken in a different format by the Government Actuary's Department).

Table 6: Weighted Average Employer and Employee Contributions to Private Sector Defined Benefit Schemes 2006-2009

	Employer Contribution (% of salary) (1)	*Employee Contribution (% of salary) (2)*	*Ratio 1: 2*
2009	16.5	5.2	3.2
2008	16.6	4.9	3.4
2007	15.6	4.9	3.2
2006	14.6	4.7	3.1

Source: *Office for National Statistics (2007); (2008); (2009); (2010)*

There are two clear implications of the data in the Table. The notion that a norm of employer and employee contributions operating with a ratio of under two to one is spurious. In the private sector employer contributions to DB schemes have been consistently in excess of three times employee contributions. Secondly this makes the example cited by the Commission even more anomalous. The discussion of the NHS scheme cited above suggested that employer contributions were effectively excessive relative to employee contributions. However in the example given employer contributions to the NHS scheme were 2.8 times employee contributions in the case of the lowest contributory rate (14 per cent as against 5 per cent) and 1.6 times in the case of the highest rate (14 per cent as against 8.5 per cent).

4. PUBLIC SECTOR PENSIONS AND 'PRODUCTIVITY' IN THE PUBLIC SECTOR

Summary

- The Commission suggests (Hutton, 2010: 109) that differences in public and private sector pension provision could constitute an obstacle to greater plurality of provision in public sector services. However, there is no attempt to discuss this 'obstacle' in the light of the documented substantial growth in outsourcing of public sector services since the mid 1990s.
- There is a major tension with the desire to avoid a 'race to the bottom'. If increasingly the private sector norm is an absence of occupational pension provision then any obligation to provide very minimal levels of pension provision for transferred workers will be portrayed as an 'obstacle' to plurality of service provision.
- While plurality of provision is regarded as implicitly desirable by the Commission it makes no attempt to justify this view by reference to the literature (much of it highly critical) on outsourcing of public services to private and 'third sector' organisations.

The terms of reference of the Commission required it to 'have regard to…the growing disparity between public service and private sector pension provision' (Hutton 2010: 133) and to examine the extent to which this disparity acted 'as a barrier to greater plurality of public services'. The latter is an objective of the Coalition Government (H.M. Government 2010: 29-30). This issue is addressed in the IR in the chapter entitled 'Supporting Productivity' and the object in this section is to produce a critical analysis of the discussion of relationship between 'plurality of service provision' and the structural changes in public sector pensions advocated by the Commission. The section is divided into four parts: the first gives an exposition of the Commission's views of the links between perceived barriers to plurality of provision and structural changes in public sector pensions; the second considers the argument that inter-sectoral differences in pensions constitute such an obstacle to plurality of provision by considering evidence of the growth of outsourcing in the UK public sector; the third examines the tension between the Commission's proposals and its repudiation of a 'race to the bottom' with respect to public sector pension provision; and the final part considers the evidence (or as we shall see lack of it) presented in the Commission's reports for the desirability of plurality of provision in public services.

Public Pensions and Plurality of Provision

In the context of increasing plurality of public sector service provision it is important to stress that pension provision becomes a significant issue predominantly with respect to staff who are *transferred* from a public sector provider to a private and/or 'third' sector provider. Currently staff compulsorily transferred to a non-public sector employer have their pensions protected either by the Transfer of Undertakings Protection of Employment Regulations (TUPE) or by the Fair Deal policy. The original TUPE arrangements applied only to employment contracts, not pensions. This was amended by the Pensions Act 2004 and, since 2005, for employees transferred within TUPE regulations, employers are required to match employee contributions of up to 6 per cent of salary in either a stakeholder pension or an alternative occupational pension. Fair Deal is a non-statutory arrangement which builds on TUPE and aims to provide a higher level of pension protection. The new employer must provide a 'broadly comparable pension scheme' to that of the public sector for transferred staff and bulk transfer arrangements for those staff who wish to transfer their accrued benefits (HM Treasury 2011b: 8) The IR (Hutton 2010:109) argues that this arrangement has 'maintained the level of pension provision for those compulsorily transferred out of the public sector'. However this policy can '… make it harder for private and third sector organisations to provide public service pensions because providing a 'broadly comparable' defined benefit pension scheme can be more expensive and risky'(Ibid.) for the private sector than the public sector (See also the submissions to Hutton by the CBI (2010:9-11) and Serco (2010: no page number). The IR (Hutton 2010: 110) argues that the enhanced expense and risk is due to two principal reasons. Firstly, the public and private sectors use different bases for calculating pension liabilities and contributions. In the private sector liabilities are calculated on a 'prudent basis' monitored by the Pensions Regulator and must be regularly assessed to take account of the risk of under performing investments. Thus the employer contributions required by private sector employers are generally higher than public sector employers who are protected by an 'ultimate government guarantee' (Ibid.).

Secondly, when private or 'third' sector organisations take on employees with DB rights they expose themselves to risks of increased longevity and poor investment returns (Ibid.). The IR argues that though this could be manageable for larger organisations it is likely to be very difficult for smaller ones (Ibid.). The issue of the desire to include smaller organisations within the ambit of pluralism of service provision will be discussed below.

A way to deal with the perceived disadvantages to non-state providers faced as a result of Fair Deal would be to extend the current policy of allowing access to public service pension schemes by non-public service employees (See Hutton 2011:116-118 for a discussion of these arrangements). The FR (Hutton 2011:118-119) perceives a number of virtues in this approach. Enabling access would help remove the barriers for external contractors when bidding against in-house providers, and it would facilitate the transfer of staff and maintain the cash flow into the public sector pension schemes. It also '…can enable more transparent contract prices, *as bids can focus on the costs of service delivery rather than pension provision*' (Ibid. 119, our emphasis), thus effectively taking pensions out of the outsourcing equation for transferred staff. This mechanism is also of major significance in one of the largest public sector schemes. As the GMB, in its evidence to the Commission points out the majority of employers participating in the Local Government Scheme are 'private or third sector' organisations (GMB 2010: 11). The FR also points out that such 'additional' organisations account for nearly a quarter of membership of the Local Government scheme (Hutton 2011: 117). The GMB considers that such arrangements have 'worked well' in the Local Government Scheme and suggests comparable arrangements should be developed in the unfunded public sector schemes (GMB 2010: 11) The FR, however, rejects this course. The fundamental objection is that it would increased risk for the government as it would take on liabilities it cannot control e.g. if an organisation failed, or if it awarded excessive pay rises thus increasing pension liabilities (Hutton 2011:119).

Public Pensions: an obstacle to outsourcing?

The attention given to public sector pensions with respect to 'pluralism' in public service provision relates, as has been indicated, to the conception of inter-sectoral differences in pension provision as an obstacle to such pluralism. This might seem to suggest that outsourcing of public services in the UK was stagnant or falling. This issue was investigated by Oxford Economics in their research for the DeJulius review which is discussed below. They investigated trends in the size of the 'Public Services Industry' (PSI) in the UK economy. This industry was defined as including 'those private and 'third sector' enterprises that provide services to the public on behalf of Government or to the Government itself. These enterprises depend in whole or in part on revenues contracted through Government and deriving from taxes' (Department for Business, Enterprise and Regulatory Reform 2008a: 3). The study estimated that the PSI in the UK grew in real terms by 5.4 per cent per annum between 1995/6 and 2007/8 (Ibid.: 10). This strong growth rate meant that the PSI share of UK gross domestic product rose from 4.2 per cent in 1995/6 to 5.7 per cent 2007/8. It is thus rather difficult to reconcile the putative obstacle posed by inter-sectoral pension differences with the Oxford Economics estimate the PSI was over a third larger as a share of national income in 2007/8 as against 1995/6.

Plurality of Provision and the 'Race to the Bottom'

The rejection of allowing private or 'third' sector providers to join public sector schemes raises the second major problem with the Commission's analysis. The Commission wants to ensure that the design of public service pension schemes does not prevent outsourcing and a plurality of provision but also that this should not engender 'a race to the bottom'(Hutton 2010:4) in pension provision. Submissions to Hutton (by for example the CBI and Serco) argue that some private sector defined contribution schemes are generous and of high quality. However, as was indicated in the section on fairness, the Commission takes the view that it is a trend to deterioration in private sector provision which is crucial to the widening inter-sectoral gap in pension provision. The FR (Hutton 2011:119) argues that a 'redefined public service pension scheme framework…should overtime also help to remove some of the barriers to plurality of service provision'. As was indicated in the section of adequacy the failure to recommend an accrual rate means that it is not clear how generous the CARE scheme advocated by the Commission will be. However, it is worth bearing in mind that the dominant pattern in the private sector is for enterprises not to offer occupational provision at all, with roughly two thirds of private sector employees not having any occupational pension provision. It is also important to bear in mind the Commission's emphasis on giving smaller organisations more opportunity to compete for public sector contracts. As was noted above, one of the objections to the status quo with 'Fair Deal' and current public pension structures was that while larger organisations might be capable of managing the associated risks smaller organisations could not. However, this increases the tension with the 'race to the bottom'. A consistent trend in pension provision is that occupational pension coverage is inversely related to organisation size. Thus 62.5 per cent of employees in organisations employing over 1,000 people are members of occupational pension schemes whereas only 12.1 per cent are members in organisations employing between 1 and 12 people (ONS, 2011b). Fair Deal is now subject to a Government consultation (HM Treasury 2011b) and one of the options put forward in the consultation document (Ibid.: 15) is that it could be abolished. Whatever policy is adopted in this respect the Commission's desire to embrace pluralism in public service delivery would appear to invite the very 'race to the bottom' which it repudiates.

The Absence of a Case for Outsourcing

In the IR the Commission states 'In the last few decades there has been a drive towards moving services that were traditionally delivered by public service in-house providers to outside ones as a way to improve the efficiency and quality of services' (Hutton 2010: 109). The could be interpreted as assuming that pluralism in the delivery of public services is necessary and desirable . This is the view of business pressure groups that thus the CBI (2010: 9) states '…diversity of providers is essential to achieving efficient, innovative and responsive public services'. In a similar vein Serco (2010 no page number) claims that he introduction of more competition into public services '…delivers better value for money and quality both for government and the taxpayer'(Serco 2010:no page number). However, one of the bizarre aspects of both the IR and the FR is that neither contain any discussion of whether the available evidence supports such claims.

When he was Secretary of State for Business, John Hutton commissioned DeAnne Julius to review the Public Services Industry. Her report concluded that the benefits flow from competition and the contractual process though the review argues that the private sector does not have 'innate efficiency advantages' (Department for Business, Enterprise and Regulatory Reform 2008b: 28). However there is a substantial academic literature questioning the desirability of the 'pluralism' in service provision apparently taken as a given by the Commission. Increased costs of service provision have been identified relative to initial contract estimates in Private Finance Initiative (PFI) hospitals (Shaoul et al 2008: 102-3). Schools built under PFI had higher cleaning and catering costs than 'traditional' public sector counterparts (Audit Commission 2003: 20). Value for Money provided by Independent Sector

Treatment Centres has been questioned because of their higher unit costs relative to the public sector (Ruane 2006). Private firms used to outsource educational services have failed to meet performance targets (Farnsworth 2005: 835 and 2006: 486; West and Currie 2006: 198-9). Quality of school building under PFI has been judged inferior to those built under 'traditional' procurement (Audit Commission 2003: 13-14). The Public Administration Select Committee (2008: paras. 65-88) reporting on claims that the Third Sector provided more user focused, flexible and innovative services, argued that the evidence for such claims for this sector were 'inconclusive'. The contractual framework involved in pluralism in service delivery has been criticised for imposing rigidities on service provision in education, health and the Information Technology services (Grimshaw et al 2002.: 492; Shaoul and Stafford 2010: 753).

5. CONCLUSION

The overall thesis of this is paper is that the Commission's two reports *fail* to make a tenable case for the structural reforms to public sector pensions which the Commission advocates. The argument has sought to show such a case has not been established on affordability and sustainability grounds, in terms of providing an adequate income in retirement, on grounds of fairness nor on grounds of contributing to increased efficiency in the provision of public services via outsourcing.

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