HM Treasury

Public Service Pensions: Consultation on the discount rate methodology

Government response

March 2023

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Introduction

Summary

1.1 Public service pensions are a crucial part of the total remuneration package provided to public servants and continue to be among the very best available, providing generous guaranteed benefits in retirement. To ensure that public servants continue to benefit from these pensions in the long-term, it is important that pension promises are made on a sustainable basis and the cost of these promises are properly recognised. This is achieved through the setting of employer contribution rates at regular scheme valuations.

1.2 The current methodology for setting the discount rate used in actuarial valuations of unfunded public service schemes was adopted in 2011. In line with the government's previous intention to review the discount rate methodology after ten years, the government launched a public consultation in June 2021. The consultation closed on 19 August 2021.

1.3 The consultation asked respondents for views on the objectives for the discount rate, the advantages and disadvantages of different discount rate methodologies and their relative preferences. Respondents were also asked for any anticipated equalities impacts of changes to the methodology.

1.4 Following consultation, the government believes that the discount rate should have three objectives: to ensure employer contributions fairly reflect costs of providing these pensions, to reflect future risks to government income, and to support stability.

1.5 The government has concluded that the current methodology based on expected long-term GDP growth best meets the balance of these objectives. The government believes that this methodology will best provide intergenerational fairness by ensuring that pension promises are made in a way that is sustainable and affordable to future taxpayers, which will support the long-term stability of the public service pension system.

1.6 The government does not intend to make any modifications to this methodology. These decisions have been based on consideration of this methodology against all three objectives and the government's reasons for these conclusions are set out in this document.

1.7 As part of this assessment, the government acknowledges that its chosen methodology performs less well against the ‘stability’ objective. The government has therefore considered ways in which the ‘stability’ objective might be better met whilst retaining the current methodology.

1.8 Going forward the government will aim to review the level of the discount rate once per valuation cycle rather than every five years. The government believes this change will result in fewer reviews of the discount rate in practice than the current cycle and provide greater certainty to employers.

1.9 The Government Actuary has been consulted and his professional opinion is that, taken together, this approach meets the government’s objectives for the discount rate, noting the tensions that exist between these objectives.

1.10 The consultation on the discount rate methodology was held in parallel to a separate consultation on reforms to the cost control mechanism. The government’s response to that consultation was published on 4 October 2021.[1] All relevant points raised as a part of that consultation have been considered here.

Approach to the 2020 valuations

1.11 Valuations as at 31 March 2020 are currently underway and will result in new employer contribution rates which will be implemented from April 2024.

1.12 As part of the valuation cycle, the government will review the SCAPE discount rate in line with the discount rate methodology and approach set out in this consultation response.

1.13 The independent Office for Budget Responsibility (OBR) has recently published new long-term GDP projections in its July 2022 Fiscal Risks and Sustainability Report. These will be taken into account in order to ensure that the discount rate reflects the most recent assumptions. The government plans to announce the updated SCAPE rate alongside publication of this consultation response.

1.14 The government will look to ensure that departmental budgets set at Spending Review 2021 will not come under undue pressure because of a change in the contribution rates resulting from the updated SCAPE discount rate. For employers whose employment costs are centrally funded by departments, HM Treasury will exceptionally provide funding for any increases in employer contribution rates resulting from the 2020 valuations

[1] Public Service Pensions: cost control mechanism consultation – Government response to the consultation. October 2021. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1022938/CCM_RESPONSE.pdf

as a consequence of changes to the SCAPE discount rate. For devolved administrations, the Barnett formula will apply in the usual way. It is for the devolved administrations to decide how to allocate funding in devolved areas.

Background

1.15 Public service pension schemes provide generous pension benefits to public servants at retirement.

1.16 Most public service pension schemes are unfunded Defined Benefit (DB) pension schemes, where members' pension benefits are guaranteed by the government and there is no fund of assets from which pension benefits are paid. In these schemes, the pension benefits paid to pensioners are met by using the contributions paid by active members and their employers, with any difference between contributions received in a year and the pensions paid out that year being met by the Exchequer. This means that, apart from the contributions made by members, most public service pension costs are ultimately met through general taxation or government borrowing.

1.17 To ensure that the public sector provides pension benefits in a sustainable way, it is important that the expected long-term costs of pension promises are recognised and that these are taken into account when promises are being made. This is done at periodic actuarial valuations where employer contribution rates are set. In unfunded public service pension schemes employer contribution rates are determined using a process called 'Superannuation Contributions Adjusted for Past Experience' (SCAPE).[2]

1.18 As part of SCAPE, a discount rate is applied to each scheme's expected future pension payments, which extend decades into the future, so that the cost of pension promises being built up can be expressed as a present-day cost. This discount rate is called the SCAPE discount rate and is set by HM Treasury using a prescribed methodology.

Stakeholder engagement

1.19 Following publication of its consultation on the SCAPE discount rate methodology, HM Treasury ran a number of engagement sessions in July and August 2021 to ensure stakeholders were given the opportunity to express their views directly to the government.

[2] The only public service pension schemes which are not 'unfunded' are the Local Government Pension Schemes. Employer contribution rates in these schemes are set using a different valuation process to the SCAPE process used for unfunded public service schemes.

1.20 Meetings were held with members of Scheme Advisory Boards (SABs) from across the UK relating to each public service workforce, which are typically made up of member, employer, and scheme representatives.[3] These sessions also allowed stakeholders to seek clarification on any of the alternative methodology options. Most stakeholders followed up with formal written responses. The feedback received during the stakeholder sessions and in formal written responses has been considered in deciding the final policy proposals.

1.21 HM Treasury also sought views on the SCAPE discount rate methodology from the Government Actuary in January 2022. The Government Actuary reconfirmed that his views on the methodology remained the same in February 2023. These views have been published alongside this consultation.

Responses to the consultation

1.22 A total of seven questions were asked in the consultation. Responses to each question were considered in reaching the government's conclusions. Responses which did not necessarily address the specific questions posed in the consultation document have also been considered where appropriate.

1.23 The government has undertaken quantitative and qualitative analysis of the responses, and the common themes and views are summarised within this document. Any quantitative data has its limitations and has been handled with caution during the decision-making process. In particular, whilst trade unions and other representative bodies represent a large portion of public service workers, it should be noted that the government recognises that the number of responses received does not accurately represent all public service pension scheme members. Where we have supplied data in this document, it is to simplify and summarise responses and provide the reader with a sense of trends – the government did not treat respondents' answers in a binary way (agree or disagree) when reaching its conclusions.

1.24 HM Treasury received 51 responses from a broad range of respondents. These included individuals, trade unions and other member representative bodies, SABs, employers and employer representative bodies, actuarial and pensions specialists, and pensions administrators. The trade union and member representative bodies that responded included but were not limited to the Trades Union Congress (TUC), Prospect, Unison, the University and College Union (UCU), National Education Union

[3] Statutory bodies, created by the Public Service Pensions Act 2013, that advise responsible secretaries of state on potential changes to public service pension schemes and advise on the administration and management of the relevant schemes.

(NEU), the British Medical Association (BMA), and the Police Federations of England & Wales (PFEW) and Scotland (PFS).

1.25 In total, the 51 responses came from the following stakeholders:

- six SABs, representing the Teachers (England & Wales), Teachers (Scotland), NHS (England & Wales), NHS (Scotland), Firefighters (England), and the Police (England & Wales), Police (Scotland), and Police (Northern Ireland)[4] schemes
- sixteen trade unions and member representative bodies
    - of these, six predominantly represent members in schemes for teachers, two in schemes for police, two in schemes for firefighters, two in schemes for civil servants, one in the NHS schemes, and three across several schemes
- fourteen employers and employer associations
    - of these, eight predominantly employ members in schemes for teachers, four in schemes for police and firefighters, one in the scheme for local government employees, and one in the armed forces pension scheme
- six actuarial consulting and professional bodies
- three local government pensions administrators
- five individuals
- one think tank

1.26 Responses have been received from bodies in all the main public service pension schemes. The responses have informed the government assessment of the equalities impacts of the methodology options, and in line with the government's duty to have regard to the need to eliminate discrimination, advance equality of opportunity, and foster good relations in formulating its response.

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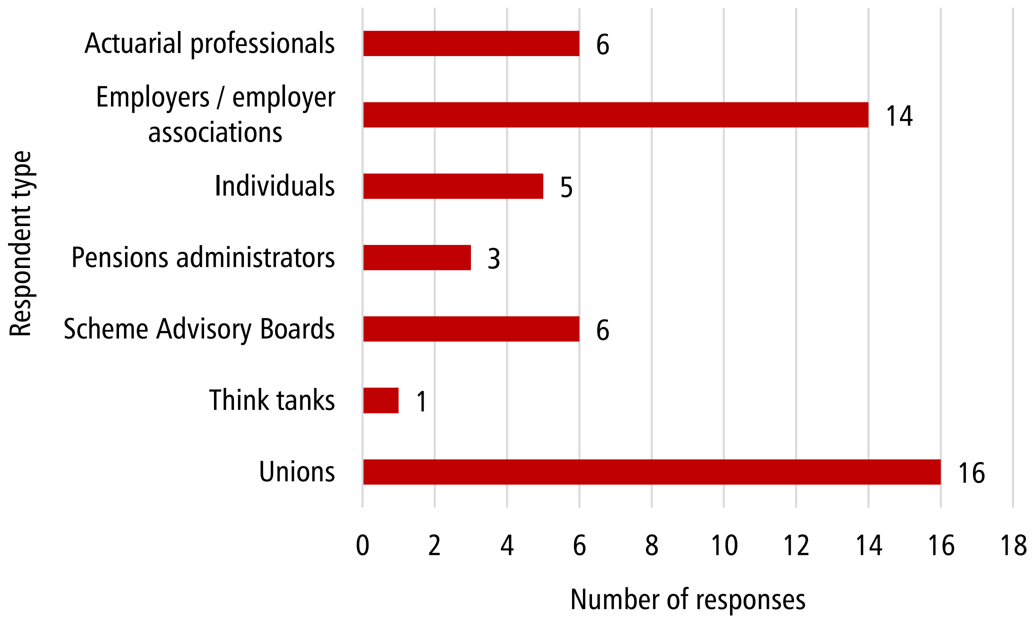
[4] The SABs representing the schemes for police in England, Wales, Scotland, and Northern Ireland provided a joint response.

Chart 1.A: Summary of responses received



Chapter 2

Objectives of the SCAPE discount rate

2.1 The consultation proposed three objectives for the SCAPE discount rate to evaluate the advantages and disadvantages of possible discount rate methodologies. It noted that tensions may exist between the objectives.

2.2 The objectives proposed by the consultation were:

- **Fair reflection of costs** – The SCAPE discount rate should ensure that contribution levels are set so that:
  - the value of benefits being earned today, as well as past over- or under-payments of contributions, is recognised and total contributions reflect this;
  - employers pay a charge that is appropriate for public service pension schemes, just as private sector employers must pay contributions that are appropriate for funded pension schemes; and
  - today's decisions by government and public service employers about how many people to employ, as opposed to other forms of expenditure, take into account the full cost of employing people today
- **Reflect future risks to government income** – The SCAPE discount rate should reflect that public service pensions are paid from future tax revenues, which may turn out to be different to what is expected. It may be appropriate for the discount rate to reflect this risk.
- **Stability** – The SCAPE discount rate should support government and employers to make long-term decisions on workforce expenditure (as compared to other types of expenditure) and minimise large fluctuations in employer contribution levels where these are not caused by changes in expected future expenditure on pensions.

2.3 Respondents were asked whether they agreed that these were the correct objectives and to specify any alternative objectives that they thought should be included.

Responses

2.4 Forty-seven responses to this question were received. A high majority of responses received to this question agreed with the consultation's proposed objectives for the SCAPE discount rate, and only a small minority of responses disagreed with one or more of the proposed objectives.

2.5 While expressing support for some or all the government's proposed objectives, a number of responses highlighted tensions between them. Some responses therefore explicitly argued that certain objectives should take precedence over others.

2.6 A number of responses also proposed additional or alternative objectives that could be considered.

Fair reflection of costs

2.7 A very high majority of responses supported inclusion of the 'fair reflection of costs' objective, with many responses noting that this objective was reasonable and fundamental. A small number of responses argued that 'fair reflection of costs' should be the primary aim.

2.8 However, this broad support encompassed different interpretations of 'fairness'. Most responses included at least two or more suggestions for how 'fairness' could be interpreted. The different possible interpretations of fairness led some responses to suggest this objective might be subjective or ill-defined.

2.9 A large number of responses suggested that fairness should be considered in intergenerational terms, for example allocating costs fairly between generations and ensuring that excessive costs are not passed to future taxpayers. A number of these responses suggested that the share of national income expected to be spent on public service pensions in the long-term was therefore a key indication of fairness. However, a small number of responses questioned whether it was necessary for employer contribution rates to reflect past over- or under-payments to achieve 'fairness', suggesting that central government could be better placed to absorb deficits.

2.10 Alternatively, some responses proposed that 'fairness' be understood as requiring consistency in the value placed on expenditure on pensions as other types of government expenditure or government liabilities. These responses suggested that the value placed on pension costs should facilitate comparisons between spending on workforce or capital.

"The TUC agrees that a discount rate that generates a 'fair' reflection of costs is of paramount importance. In assessing fairness, the following issues should be considered: it should be possible to make a fair comparison between spending on additional staff or other capital expenditure – which would imply consistency with the Green Book; it should mean that the value placed on pension benefits for example by Pay Review Bodies is consistent with the costs to government of providing the benefit; it should mean that costs are generated fairly across generations."

Trades Union Congress (TUC)

2.11 Notably, responses from unions and SABs suggested that 'fairness' should be assessed relative to the value of public service pension schemes to members. Some responses suggested this value should be based on employer and member perception, but others proposed that it could also be informed by the value ascribed to pension benefits by workforce pay review bodies.

2.12 In contrast, several pension administrators and professional actuarial bodies suggested that considerations of fairness should also take into account differences between the public and private sectors. For example, some such responses suggested that fairness should cast doubt on any approach which produced a cost for employers using public service schemes that differed significantly from the cost of providing similar benefits in the private sector.

"We note that the concept of a fair reflection of costs is rather ill defined, as there are many different groups of stakeholders involved, who may have inconsistent views on what constitutes fairness. We agree that employers should pay a charge that is appropriate for public service pension schemes, and suggest that approaches that produce charges that differ significantly from the charges borne by private sector schemes should provide explicit justification of the differences. In addition, we consider that the concept of fairness should embrace fairness between generations of taxpayers."

Institute and Faculty of Actuaries

2.13 Some other responses also made broader points about fairness. For example, one employer suggested that 'fairness' should include scheme-specific considerations, while another response linked this objective to the perceived independence of the SCAPE discount rate from government. A small number of responses suggested that 'fairness' implied more fundamental changes to the design of public service pension schemes which went beyond the scope of this consultation.

Reflect future risks to government income

2.14 A very high majority of responses to Question 1 supported inclusion of the 'reflect future risks to government income' objective.

2.15 Several responses noted that public service pension payments are met through future tax revenue and stressed the need to ensure that public service pensions remain affordable in this context by having regard to risks to the source of government income when determining the most appropriate discount rate methodology. A number of responses suggested that this risk could be addressed by aiming to maintain the expected expenditure on pension promises as a percentage of tax revenue constant over time.

> "Future pension payments come out of future tax revenue, so it is appropriate to consider the risks to future government income, as it is with all issues which involve future government commitments and therefore raise questions of fiscal sustainability."
>
> Alisdair Smith

2.16 However, a number of responses from unions, SABs and employers questioned the impact of this objective. Several such responses suggested the risk of the government failing to meet its pension commitments was low, noting the government's ability to raise revenue through tax and member contributions. A small number of responses also pointed out that the government could mitigate this risk by reforming pension benefits or raising the state pension age if required.

2.17 Some responses also argued that any risks to government income did not pertain specifically to public service pensions, as all spending commitments would equally be at risk if government income was lower than expected. The majority of these responses did not oppose the inclusion of this objective but suggested it should have minimal impact on the choice of methodology; only a small number suggested this objective should not be included.

> "The risk that the government will be unable to meet its commitments on public service pensions must be seen as very low, given the government's ability to levy taxation. The risk that at some point in the future the government would be unable to discharge its obligations would be shared equally across all its commitments. The Unions therefore does not believe that this minimal risk applies in any greater way to public sector pensions than any other area covered by our members' contracts of employment."
>
> National Education Union, Irish National Teachers' Organisation, & Ulster Teachers' Union

2.18 Alternatively, some responses suggested that this objective would be better described with reference to consistency with approaches taken to managing similar long-term expenditure commitments. For example, the Fire Leaders Association suggested rephrasing this objective as to 'maintain consistency with financial risk management approaches taken across government.'

Stability

2.19 A very high majority of responses supported inclusion of the 'stability' objective. The value of this objective was particularly emphasised by unions and employers, with a small number of responses suggesting that recent instability in employer contribution rates meant this should be the primary objective.

2.20 Several responses echoed the view set out in the consultation that instability in employer contribution rates caused uncertainty and made it difficult for employers to make long-term workforce plans. Several responses highlighted that the change to the SCAPE discount rate in 2018 had led to particular challenges, as it was unexpected and occurred shortly before the introduction of new employer contribution rates in April 2019. Many employers explained that this had disrupted budgets and reduced confidence in the valuation process.

2.21 Some stakeholders noted that instability could also cause disruption for government and greater stability could result in fewer calls for central funding, noting that in 2019 the government had provided immediate funding to ensure that the changes in employer contribution rates did not impact public services. Other employers, most notably in the health and education sectors, noted that if funding was not provided it could put significant pressure on Departments' and employers' budgets.

2.22 In addition, several responses from sectors which did not receive additional funding to meet increased employer contribution rates from April 2019 explained that the increase in contribution rates had impacted service delivery. For example, responses on behalf of independent schools and the higher education sector stated that increased costs had required them to reduce staff numbers and, in the case of independent schools, reassess their membership in the scheme. Some responses from this group argued that this had made it harder for the independent education sector to offer competitive packages to recruit and retain staff.

> “There is the need for stability, with the SCAPE discount rate supporting government and employers in making long-term decisions on workforce expenditure, whilst minimising unwelcome fluctuations in employer contribution levels. Lack of said stability has led to three changes in the discount rate in the last ten years leaving employers facing pension contributions almost 10% higher. This has had a negative effect of that on their ability to plan-ahead and impacted on some independent schools’ ability to remain in the Teachers’ Pension Scheme (TPS).”
>
> Association of School and College Leaders

2.23 A number of responses expressed the view that the ‘stability’ objective conflicted or existed in tension with the ‘fair reflection of costs’ and ‘future risks to government income’ objectives, for example where a change to the SCAPE discount rate is considered appropriate to reflect changes in the expected future cost of pensions but will cause a fluctuation in employer contribution rates. In this scenario, achievement of the stability objective could inhibit the aim of fairly reflecting costs. The majority of responses agreed that ‘stability’ should still be considered as an objective despite this tension, but a small number of responses argued that this was a fundamental inconsistency and that a ‘stability’ objective was therefore inappropriate.

> “However, we believe the proposed "Stability" objective is not appropriate for the derivation of the SCAPE discount rate. Our concern is that this objective may act in direct opposition to the objective to fairly reflect the costs (and possibly also the objective relating to future risks to government income). By way of example, if there is change in economic conditions which fundamentally changes what is a fair reflection of costs it will not be possible to

reconcile a change to SCAPE rate resulting from this and the stability objective."

Aon

2.24 A few responses also noted a potential tension between stability in contribution rates in the short-term and longer-term stability in the wider public service pensions system if pension promises were made without a link to government's expected ability to pay them.

Other proposed objectives

2.25 A number of responses suggested additional or alternative objectives alongside the objectives proposed in the consultation.

2.26 Several responses from unions and SABs proposed an additional objective related to supporting the provision of generous public service pensions. These responses highlighted the importance of public service pensions to both members, as part of their overall reward package, and to employers, as tools for recruitment and retention. They suggested that increasing uptake was made more difficult by lower discount rates, which increase the cost to employers. One response suggested that this consideration should expressly be considered in relation to the 'fair reflection of costs.'

2.27 A number of responses also argued for retention of an objective related to 'transparency and simplicity' which had been included in the government's consultation on the discount rate methodology in 2011. Several employers and unions indicated that not including this objective would further reduce the confidence of employers and members following the government's decision to conduct an 'out of cycle' review of the SCAPE discount rate in 2018. A number of actuarial professionals also supported consideration of 'transparency and simplicity', emphasising the importance of ensuring the cost of public service pensions, and how that is calculated, is communicated clearly to stakeholders and taxpayers in a way that instils confidence.

2.28 Finally, a small number of responses emphasised a general requirement that the valuation process work in the interests of employers, members, and government. One response expressed this as a need for 'balance' between identifying costs and enabling employers to provide high-quality pensions, while another response suggested a 'fourth' objective of 'manageability' of the valuation process, including the practical implementation of contribution rate changes on employers.

Government's response

2.29 Following consideration of the views expressed as part of this consultation process, the government believes that the three objectives proposed in the consultation – 'fair reflection of costs', 'reflect future risks to government income' and 'stability' – are the appropriate objectives for the SCAPE discount rate. The government notes that responses to the consultation displayed a high level of support for the inclusion of these three objectives.

Fair reflection of costs

2.30 Consultation responses displayed a high level of consensus that the discount rate should ensure that contributions paid towards pensions are a 'fair reflection of costs,' but demonstrated that there are different ways to view fairness. The government believes that in the public service pension context, fairness should be interpreted with reference to the long-term nature of pension promises. Fairness therefore implies striking a fair balance between the charge paid by employers for making pension promises and the costs that will be passed to future taxpayers to meet those promises to achieve intergenerational fairness.

2.31 Public service pensions are a key part of the remuneration offer that participating employers provide to their employees. In unfunded public service schemes, the liabilities associated with providing this benefit will mostly be met by future taxpayers. The liabilities passed to future taxpayers should therefore be reflected in workforce decisions taken by current employers (such as hiring more employees or increasing pay) by requiring them to pay contributions that fairly reflect the cost of the associated long-term pension payments that will have to be made in the future as a result of these decisions. This charge should also reflect any changes in the expected cost of pension promises previously made to employees. By allowing for the expected cost of pension benefits, this should ensure that the pension promises being built up are not unaffordable and support intergenerational fairness.

2.32 Public service pensions are of course also a benefit to the member who will receive them. However, the primary use of the SCAPE discount rate is to determine the contribution rate paid by employers. There is a separate process, the cost control mechanism, that is carried out as part of valuations to determine whether changes to member benefits will occur based on the need to ensure a fair balance of risk regarding the cost of providing public service pension schemes between members of those schemes and employers. Therefore, the government does not believe that, in the context of the SCAPE discount rate methodology, fairness should be assessed relative to the value of schemes to members. The current design of public service pension schemes goes beyond the scope of this consultation.

2.33 The government agrees that, as applies to employers in other sectors who offer defined benefit pension schemes, employers using public service schemes should pay an appropriate charge for providing defined benefit pension benefits. However, the government does not believe that unfunded public service schemes should apply the same approach to discounting as used in funded schemes when setting contribution rates, where the amount of assets in a scheme's fund relative to its liabilities as well as specific circumstances of the scheme and its participating employers are taken into account. Rather, determining an appropriate charge should reflect the particular context of unfunded public service pension schemes, where the promises are met by the state, which is permanent and has tax raising powers. In contrast, and in line with the 'consistency' principle for Treasury Directions, fairness entails a consistent approach to discounting across public service schemes.

2.34 Several responses suggested 'fairness' should incorporate consistency with how government approaches the assessment of other types of public spending to allow for comparisons to be made between different uses for budgets. The government believes consistency is best achieved by ensuring that workforce decisions reflect a complete rather than partial assessment of employment costs. In other words, the marginal cost of workforce decisions should fairly reflect the typical expected cost of additional pension promises.[5] It should also be noted that while public service pensions share similar features to other types of public spending decisions, by involving the deferral of current consumption for future benefit, they are also distinct because they involve guaranteed promises to individuals.

Reflect future risks to government income

2.35 The government agrees that the primary way to manage the long-term costs of public service pension schemes is through the design of the schemes, as well as ensuring long-term trends in public sector pay are sustainable. However, the government also believes that it is important that pension promises are made in a way that is affordable and sustainable to government (and so future taxpayers) to ensure that future generations are not unduly burdened. In assessing this, regard should be given to the risk that the income from which government will pay out pensions may turn out to be different to what has been expected. The discount rate should therefore 'reflect future risks to government income.'

5 While the cost of paying out pension promises made in the course of a potential Government project, programme or policy should also be considered in the economic appraisal of that project, the purpose of such an assessment is to determine whether to proceed with that specific project based on its net present social value. However, within any given project, marginal decisions regarding expenditure are made based on the true cost of the additional expenditure, not the net present social value.

2.36 While the government agrees that this risk may also be true for other long-term spending commitments, the government believes it is appropriate for specific consideration of this risk to be made in the public service pensions context given the guaranteed nature of public service pension promises set out above. The government does not think it would be appropriate to comment on the level of that risk in setting the objectives. However, the government believes that in determining how that risk should be reflected in the discount rate, this objective should be considered alongside the other objectives as well as the wider context of unfunded public service pensions, to ensure the charge paid by employers is appropriate. For instance, due consideration should also be given to not unduly burdening current employers using public service schemes (the majority of which are funded through current taxation), as well as the general ability of government to raise revenue and reallocate spending.

2.37 The government also agrees that risks related to public service pension liabilities should be accounted for and monitored in a way that is consistent with international standards. However, the government believes it is important to distinguish the scope of the current consultation, on the methodology for setting the discount rate used to determine employer contributions, from broader mechanisms and governance arrangements in place for public service pensions at scheme and whole of government levels. The government therefore disagrees that this objective should be framed with regard to wider financial management practices.

Stability

2.38 The government agrees that there are benefits to both government and employers from relative stability in employer contribution rates. These benefits include the ability to set budgets, make workforce plans over the medium and long-term and to minimise uncertainty surrounding the introduction of new employer contribution rates. More generally, as public service pensions are long-term liabilities, it is preferable for the cost of providing pensions to not fluctuate dramatically over short periods.

2.39 In particular, the government appreciates that changes to the discount rate shortly before the introduction of new employer contribution rates, which can have a significant impact on the outcome of scheme valuations, are difficult for employers to handle. This is especially so if plans for the period when new contribution rates come into effect are already set.

2.40 However, the government disagrees with suggestions that stability should be the most important objective for the discount rate. Likewise, it would not be feasible to set an objective for the discount rate of achieving *total* stability of employer contribution rates. Regardless of the discount rate, employer contributions rates are expected to change between valuations as the result of changes in assumptions such as members' retirement behaviour, their life expectancy, and their expected earnings. Furthermore, achieving *total* stability would conflict with the other two objectives because it would mean that the cost to employers cannot reflect changes in the expected cost of paying out pensions, whether caused by changes in the discount rate or other assumptions. As noted by some responses, a failure to consider the expected costs of pension promises being built up when making workforce decisions could make the public service pension system unstable in the long-term.

2.41 Furthermore, the government does not believe that 'stability' in employer contributions should be viewed as replacing the fiscal process for shaping the size of the public sector. The purpose of scheme valuations is to assess the scale of pension promises that have been made and when they will fall due, and so determine the charge that employers should pay when making pension promises to employees. In turn, decisions about the appropriate size of the public sector should be made by the government in the round at fiscal events based on the most recent assessment of costs.

2.42 For these reasons, the government supports the inclusion of a 'stability' objective, while acknowledging that there are tensions between the three objectives and that it may not be possible for a single methodology to fully achieve all objectives.

Other objectives

2.43 In the 2010/2011 consultation on the discount rate methodology, the government included an objective for the discount rate to be transparent and simple to assist wider understanding of the budgeting mechanism for public service pensions. The government does not believe that retaining an explicit objective of this nature would be effective within the approach described above of three equally weighted objectives which may require trade-offs when choosing a methodology. Indeed, transparency is already an established feature of the wider valuation process regardless of discount rate methodology, including consultation with the Government Actuary when making changes to the SCAPE discount rate and issuing Treasury directions.

2.44 The government has carefully considered other objectives that were proposed. The government recognises the important role public service pensions play as part of the public sector remuneration package and in recruiting and retaining skills and expertise and agrees that the wider public service pension system should serve the interests of members, employers, and taxpayers fairly. However, the government disagrees that targeting the number of individuals receiving public service pensions or a 'manageable' cost for employers would be appropriate for the SCAPE discount rate. It would not be responsible for the government to set the SCAPE discount rate in a way that artificially reduced the cost to employers of providing these pensions; such an objective would be fundamentally inconsistent with the 'fair reflection of costs' objective.

Chapter 3

Discount rate methodologies for consideration

3.1 The consultation proposed that two possible approaches to setting the SCAPE discount rate were considered on the basis that these were most likely to meet some or all the government's proposed objectives:

- a methodology based on expected long-term GDP growth; and
- a methodology based on the Social Time Preference Rate (STPR)

3.2 Respondents were asked whether they agreed that these were the two most appropriate methodologies for consideration and were invited to suggest alternative methodologies that they thought should be considered.

Responses

3.3 Fourty-seven responses to this question were received. The vast majority of responses agreed that a methodology based on expected long-term GDP growth and a methodology based on STPR were the most appropriate methodologies for consideration. A number of responses added that they were not aware of any other suitable methodologies.

3.4 Some actuarial professionals and actuarial consultants recommended that proper consideration should be given to alternative approaches to discounting as part of the consultation. For example, some responses suggested that an argument could be made that pension payments should be discounted by index-linked gilt yields, as both public service pensions and index-linked gilts represent commitments by the government to make index-linked payments in the future. According to this argument, index-linked gilt yields therefore provide a reasonable proxy for the cost of making an unfunded pension promises by representing the cost that would have attached to a similar promise.

> "By definition, the economic cost of new public sector Defined Benefit pension promises made in any year is the opportunity cost of the pension promise. The opportunity cost of the pension promise is another government promise to make payments, with an identical start date, size, annual inflation increases and end date."
>
> John Ralfe

3.5 Alternatively, some responses suggested an argument could be made that pension promises represent an accounting liability to the employer and therefore the discount rate used to calculate pension liabilities for accounting purposes should be used when setting employer contribution rates. In line with international accounting standards, the calculation of pension liabilities for accounting purposes applies a discount rate based on corporate bond yields.

3.6 However, the majority of these responses did not argue for these methodologies to be taken forward. In particular, a number of responses pointed out that government is a monopoly issuer, rather than purchaser, of gilts. Yields on gilts therefore reflect the value of gilts to purchasers rather than to government. Some employers and unions welcomed government's suggestion to not consider methodologies based on index-linked gilt yields or processes for setting discount rates for funded schemes at this consultation. Likewise, most responses which presented the argument for applying accounting standards noted that accounting measures are not generally used to set employer contribution rates in funded defined benefit schemes.

3.7 Finally, some responses suggested that broader changes to the design of public service pensions were needed to ensure sustainability of the system, including to make the indexation and revaluation of pension benefits earned by members in the past conditional on certain economic conditions.

Government response

3.8 The government has considered the alternative methodologies proposed for setting the SCAPE discount rate, such as based on index-linked gilt yields or in line with accounting standards. The government maintains that these would not be appropriate in light of the purpose of the SCAPE discount rate and the government's objectives.

3.9 Public service pension schemes will continue to disclose pension liabilities for accounting purposes in line with international accounting standards. However, as noted by some responses, accounting measures are not generally used for setting employer contribution rates, even in funded schemes. And further, as noted in Chapter 2, the government does not believe that it is appropriate for unfunded public service schemes to apply the same approach for setting contribution rates as applied to funded defined benefit pension schemes in any case.

3.10 The government does not believe a discount rate based on index-linked gilt yields or corporate bond yields would represent a fair reflection of the cost of providing public service pensions. Although they are affected by assessments of the government's likelihood to default on payments, the government agrees that index-linked gilt yields primarily reflect the value of gilts to purchasers rather than the cost of index-linked payments to the government. Furthermore, the majority of government's income is raised through taxation and not the issuing of gilts, and so it does not seem evident that gilts are the most appropriate method for reflecting risks to future government income for the purpose of making pension promises.

3.11 The government also notes that both index-linked and corporate bond-yields fluctuate frequently and are often impacted by short-term events. The government does not believe these methodologies could sufficiently meet the 'stability' objective.

3.12 The government has noted the views set out in some responses regarding further changes to the public service pension system but believes they go beyond the scope of the present consultation

Chapter 4

Methodology for setting the SCAPE discount rate

4.1 The consultation sought views from respondents on the advantages and disadvantages on the two possible SCAPE discount rate methodologies proposed in the consultation.

4.2 For each methodology option, the consultation also sought views on the merits of two possible modifications to each methodology that could be applied. In relation to a GDP-based methodology, these were:

- to allow for term-dependent GDP growth by discounting expected pension expenditure in each year using forecast GDP growth in that specific year
- to calculate over- or under-payments for past service using actual GDP experience

4.3 In relation to a STPR-based methodology, these were:

- to disapply the 'catastrophic risk' element of the STPR when setting the SCAPE discount rate
- to use reduced rates to discount expected pension expenditure occurring further away in time, in line with HM Treasury guidance

4.4 Finally, respondents were asked to state their preferred methodology for setting the SCAPE discount rate.

Expected long-term GDP growth

Responses

4.5 Approximately 45 responses to Question 3 were received. Several responses expressed the view that a discount rate methodology based on expected long-term GDP growth best met the 'fair reflection of costs' and 'reflect risks to future government income' objectives.

4.6 Some responses suggested that a GDP-based methodology provided a 'fair' cost for pensions because unfunded public service pensions are paid from the tax base, which therefore represents schemes' notional investments, and GDP growth is a proxy for the rate of return on these investments. These responses therefore argued that discounting pension costs by expected long-term GDP growth could be justifiable and consistent with the principles applied when setting contribution rates in funded defined benefit schemes.

4.7 Alternatively, some responses highlighted that using a SCAPE discount rate based on expected long-term GDP growth, which is a proxy for the size of the future tax base, establishes a link between employer contribution rates and the revenue from which government, and so taxpayers, will have to pay public service pensions in the future. These responses argued that this link provides a 'fair reflection of costs' by determining those costs relative to the government's ability to pay out pensions in the future. Some responses further remarked that an effect of this link is that the proportion of current GDP spent on employer contributions is equal to the expected share of GDP needed to pay out pensions in the future, helping to prevent pension promises from encompassing a disproportionate share of future income.

> "The associations acknowledge the advantages of using a SCAPE discount rate methodology based on long-term expected GDP growth, as it maintains stability of pension cost as a proportion of taxation revenues, as referenced in the consultation. It also reflects the return achieved by investing 'deferred pay' into the economy."
>
> Police Federation of England and Wales, Police Superintendents' Association, and Chief Police Officers' Association

4.8 Several responses noted that a further advantage of a methodology based on expected long-term GDP growth is that it utilises independent GDP forecasts to set the discount rate. Responses suggested that this made the setting of the discount rate more transparent and less liable to government interference.

4.9 A small number of responses noted that use of a methodology based on long-term GDP growth for setting the SCAPE discount rate would ensure consistency between how the government assessed a fair reflection of the cost of pensions for employers and when assessing the long-term economic outlook as part of an 'economic check' in the cost control mechanism.[1] However,

[1] Since publication of the discount rate methodology consultation, the Government has confirmed its plans to introduce an economic check to the cost control mechanism which will be designed with reference to either expected long-term GDP growth directly, or to the SCAPE discount rate if a methodology based on expected long-term GDP growth is retained.

responses from some unions recorded their opposition to the economic check or argued that this should not be a relevant consideration.

4.10 Nearly all responses stated that a disadvantage of a methodology based on expected long-term GDP growth is that it can lead to frequent changes to the SCAPE discount rate, which can lead to significant fluctuations in employer contribution rates between scheme valuations. Some responses argued that this methodology therefore inherently fails to meet the 'stability' objective. In support of this view, several responses noted that the SCAPE discount rate had changed twice since 2011. Several responses also noted that the timing of revisions to long-term GDP projections are uncertain and not conducted to coincide with scheme valuations.

4.11 As set out in Chapter 2, several responses emphasised challenges they had faced as a result of uncertainty regarding new employer contribution rates and the need to adapt budgets and workforce plans following cost changes. Some responses argued that this had had a direct impact on their abilities to deliver public services, for example where increased costs had necessitated unforeseen reductions in employee numbers or other costs. Individual responses highlighted particular challenges they or other stakeholders faced in responding to changes in pension costs, for example constraints on raising revenue. Furthermore, some responses suggested that these cost changes were unfair, as employers could have to pay significantly different costs for providing pension benefits despite no difference in the value of the benefits to the member.

4.12 In addition to general volatility, several employers, employer associations and SABs noted that the downward trend in the discount rate since 2011 had increased contribution rates, while the most recent long-term GDP growth projections implied that if a methodology based on expected long-term GDP growth was retained, the SCAPE discount rate could be reduced again when it is next reviewed. Several employers argued that any further reductions in the SCAPE discount rate could result in unsustainable and unmanageable pension costs for employers and suggested that additional funding would be required to ensure that further increases in pension costs did not negatively impact the provision of public services.

"Bitter experience since 2010, and especially around the 2016 valuation, has highlighted the risks associated with a discount rate that is volatile and leaves employers at risk of regular significant changes in costs. Three changes in the discount rate in the last ten years has left TPS employers facing pension contributions that are nearly 10% higher than the start of the period, and the negative effect of that on their ability to plan-ahead was magnified many times by the bulk of the increase coming about because of a late and out of cycle change. That has been made particularly hard to bear for employers, and indeed all stakeholders, by the methodology in place meaning the rate is based on assumptions that come with a high degree of uncertainty."

Teachers' Pension Scheme (England and Wales) Advisory Board

4.13 Stakeholders from the education sector, where independent schools participate in public service pension schemes on a voluntary basis, suggested that independent schools may leave the Teachers' Pension Scheme (TPS), with possible negative impacts on members, remaining employers in the scheme, and the wider scheme. For instance, they highlighted that this could impact mobility of teachers between independent and maintained schools.

4.14 A small number of responses also questioned whether it was necessary for contribution rates to reflect the ability of government to pay out pensions to represent a 'fair reflection of costs.' Some responses noted that overall expenditure on public service pensions was determined by the design of schemes and their demographic profile, rather than contribution rates, and that the sustainability of public service pension schemes was monitored through the projection of future cash flows. In contrast, they argued that the primary purpose of contribution rates in public service schemes was to place a charge on public sector employers for making pension promises and that this charge did not need to be set in relation to expected government income. Instead, they argued that political discretion could be exercised in how it is set. In addition, a number of responses highlighted that long-term GDP projections are inherently uncertain, creating a risk that any assessment of ability to pay is inaccurate.

Modifications

4.15 A small number of responses highlighted that, as expected GDP growth for some periods can differ significantly from the long-term average, the application of short-term GDP expectations when discounting pension liabilities could ensure that contribution rates more accurately reflect government's expected ability to pay for pensions. However, several other responses suggested this could add complexity to valuations with minimal benefit in accuracy, noting the inherent uncertainty of GDP forecasts.

4.16 A small number of responses argued that the failure to account for actual changes in the size of the economy, as measured by GDP experience, in determining contribution rates meant that the contribution rates did not fully 'reflect risks to future government income.' They argued that this results in hidden costs being passed to future taxpayers. However, some other stakeholders suggested it was not appropriate for employers to bear the risk of the economy underperforming expectations, and that the government is better suited to manage these costs.

4.17 Several responses which emphasised the importance of the 'stability' objective argued that both changes could make employer contribution rates less stable. Some responses noted that short-term GDP forecasts, as well as measures of GDP experience, can be affected by short-term economic events and are subject to frequent revisions.

4.18 Other modifications were also proposed. For instance, some actuarial professionals suggested that when setting the SCAPE discount rate, a reduction could be applied to expected long-term GDP growth (a 'prudence margin') to reflect the fact that members' pension benefits are guaranteed even if the size of the tax base turns out to be smaller than expected, as well as the inherent 'estimation risk' of long-term GDP projections.

4.19 Alternatively, one group of responses suggested revising the SCAPE discount rate less frequently but reflecting changes in the actual size of the tax base when determining whether any over- or under-payments have been made. They suggested that under this model, costs would more accurately reflect the government's expected income from which pensions will be paid but would not fluctuate dramatically as under- or over-payments could be spread over a longer time period.

4.20 Several unions, employers and SABs also argued that consideration should be given to align schemes' notional assets with changes in schemes' liabilities caused by changes in the discount rate at each valuation. This would mean that a scheme could not face a notional deficit due to changes in the discount rate, but deficits could still arise if liabilities increased by more than schemes' notional assets for other reasons. These responses argued that this change would support stability by reducing the impact of changes in the discount rates on employer contribution rates. Some further argued that this would be fair, as it is not appropriate for employers to face the cost risk of the value of previous pension promises changing due to changes in the expected performance of the economy, and also suggested this would not increase the risk to future government spending, as the benefits in question had already been earned.

"Previous increases to the value of past service liabilities arising from falls in the discount rate have led to the creation of notional deficits, which has contributed significantly to the volatility of contribution rates. Rebasing the assets to allow for changes in the discount rate would reduce this effect. In the private sector, pension schemes can use "matching" assets to hedge liability movements arising from interest rates changes – rebasing the notional assets in public service pension schemes when the discount rate changes would replicate this immunisation."

Police Pension Scheme (England and Wales), Police Pension Scheme (Northern Ireland), and Police Pension Scheme (Scotland) Advisory Boards

4.21 Alternatively, some responses suggested that rather than modifying the process for setting employer contribution rates, the government should intervene to ensure that changes in contribution rates do not negatively impact employers. They proposed that this could include government absorbing a share of costs or smoothing a change in costs over a period of time. They indicated that this would ensure costs remained 'fair' but better allocate risks between different parts of the public service pension landscape.

Social Time Preference Rate

Responses

4.22 The most widely cited advantage of a discount rate methodology based on STPR was its performance against the 'stability' objective. Nearly all responses noted that the STPR has historically been very stable, with the level unchanged since 2003, and that use of this methodology for setting the discount rate could therefore reduce the likelihood of significant changes in employer contribution rates. Several responses argued that this methodology would provide reassurance to employers, who had been required to manage considerable changes in pension costs in recent years, and consequently allow employers to budget with greater confidence and certainty. Indeed, some responses which favoured a GDP-based methodology acknowledged that it was sensible to reassess the merits of a more stable methodology given the volatility of long-term GDP projections and proposed change to the discount rate objectives.

"A Social Time Preference Rate is the approach outlined in the Green Book and applied in economic appraisals across the public sector. As such it should be applied to setting contribution rates for public service pension schemes unless there are good arguments for adopting another approach or the Green Book itself is revised. This would provide a consistent basis for the assessment of spending and risks."

Fire Leaders Association

4.23 Some responses also noted that if a STPR-based methodology was adopted, it could result in lower contribution rates for employers at the 2020 valuations. Several employers argued that this was a pragmatic option as the alternative methodology under consideration would lead to a further increase in employer contribution rates and it was unclear whether employers would be funded, or otherwise be able, to meet these cost increases. Several employer associations representing non-public sector employers suggested that their preference for a STPR-based methodology was due to the possibility that employers may otherwise reconsider their participation in public service pension schemes.

4.24 Several responses from employers, SABs, and some unions argued that pensions should be understood as a form of investment, by deferring current consumption in favour of future welfare. They suggested that using the STPR as the basis for the SCAPE discount rate would provide a 'fair' assessment of costs, noting that government already stipulates that STPR is used in the appraisal of public sector investment decisions to transform the anticipated costs and benefits of a project, which may occur over different time spans, into a single net present social value. These responses also suggested that calculating the cost of providing pensions on this basis would facilitate fair comparisons between different uses of government revenue. Some responses also posited that a SCAPE discount rate based on STPR could provide intergenerational fairness, because the relatively greater stability in employer contribution rates, including past over - or under - payments, could reduce transfers between generations through the related pressure on employers' budgets

4.25 Although the level of STPR does consider expected changes in per capita wealth, both those who favoured this methodology as well as other responses noted that it is not based on the expected size of the tax base. The main concern raised in relation to a methodology based on STPR was therefore that it did not address the expected ability of the government to pay for pensions relative to its expected income. Some responses argued that this meant the methodology failed to meet the 'reflect future risks to government income' objective, although supporters of this methodology tended to suggest the risk to government income was low and not unique to public service pensions. Some responses which favoured this methodology also argued that it was right for the government to exercise political discretion in how it determined employer contribution rates, in light of other government priorities.

4.26 Likewise, several responses argued that STPR may fail to meet the 'fair reflection of costs' objective by failing to ensure employers pay an appropriate charge for making pension promises that reflects the cost being passed to future taxpayers. A number of responses, including the majority of actuarial professionals, expressed concerns that this could harm the sustainability of the wider public service pensions system. These responses argued that while STPR may provide greater stability in employer costs, the failure to account for pension costs in workforce decisions could lead to an unsustainable growth in the scale of pension promises being built up and result in wider fiscal instability in the future. Furthermore, a number of actuarial professionals argued that STPR was not intended for calculating the present-day cost of long-term guaranteed pension promises. Some responses also stated this methodology would represent further divergence between the approach taken for setting employer contribution rates in unfunded public service schemes and funded defined benefit schemes, noting that the costs of providing comparable benefits in the private sector are already higher as a share of pensionable pay than most current public service contribution rates.

"We do not believe that a SCAPE discount rate methodology based on the STPR would be appropriate. The objectives of the two are different: the STPR is used to support investment in long-term government projects for social benefit. These projects may succeed, fail and can be curtailed. By contrast, pensions reflect a guaranteed commitment by government (in practice, future taxpayers) to make index-linked payments to current employees which cannot be curtailed or allowed to fail. The cost of providing this guarantee needs to be reflected somehow."

Mercer

4.27 Responses also expressed concerns in terms of ensuring the cost to taxpayers of public service pension promises are reflected accurately and transparently. Some responses suggested that under a STPR-based methodology employer costs would not provide an indication of the share of future income expected to be required to meet pension promises. Likewise, they argued that the discount rate could not be compared against actual changes in the size of the economy to assess the extent to which previous employer contributions had overestimated expected growth in the size of the tax base, although some responses did suggest that margins between STPR and expected long-term GDP growth could be kept under review. A small number of responses suggested adopting a STPR based methodology may lead to criticism that the government had artificially reduced the cost of public service pensions.

4.28 Some responses reflected that a SCAPE discount rate based on STPR would not be appropriate for use in an 'economic check' as part of the cost control mechanism or noted that the government's proposal for the 'economic check' stated that if introduced, it would be set with reference to expected long-term GDP growth. However, other responses argued that such a discount rate methodology could be used for both setting employer contribution rates and an 'economic check', suggesting that this would negate the need for an 'economic check' which assessed whether members' benefits should be changed against long-term GDP growth because this methodology would provide greater stability in employer contribution rates instead.

4.29 Finally, some responses argued that as the level of the STPR is set out in Treasury guidance, this methodology would be the most transparent and simple. However, for the same reason, other responses suggested it may be less objective than independent long-term GDP projections.

Modifications

4.30 In relation to the two proposed modifications to a STPR-based methodology, the majority of responses in favour of a STPR-based methodology expressed the view that neither were necessary given that the risk that the government would not be able to meet pension liabilities was low, and any future risks to government income applied equally to all spending commitments. However, some responses nevertheless noted that they would still prefer a STPR-based methodology with modifications than an alternative methodology. A small number of responses supported the adoption of both modifications.

4.31 Some respondents said that if a STPR methodology was adopted it could be appropriate for modifications to be applied to allow for uncertainty regarding the value of the components of STPR in the future given the long-term nature of pensions liabilities. The majority of such responses agreed that this would be consistent with Green Book guidance for the application of STPR. For this reason, some responses did not view this as a 'modification'. However, some respondents questioned why this step had not been taken when the SCAPE discount rate was set based on the STPR prior to 2011. Some responses also questioned whether applying different discount rates for cash flows falling over different time periods would add complexity to the valuation process.

4.32 Alternatively, a number of responses stated the 'catastrophic risk' element of STPR did not apply in the public sector pension context and should be removed when setting the SCAPE discount rate. However, other responses disagreed, on the basis that they believed catastrophic risk was as relevant to public service pensions as other types of public spending.

Choice of discount rate methodology

Responses

4.33 Responses to Question 5 were not required to express their views in a binary way, however a total of 44 responses received indicated a discernible preference of methodology. As set out above, many responses cited both advantages and disadvantages of both methodologies. Likewise, some responses expressed a preference for an alternative methodology if their preferred choice was not taken forward. In general, several responses noted that the appropriate methodology may depend on the government's purpose for valuations and wider priorities.

4.34 A minority of responses expressed a preference for a methodology based on expected long-term GDP growth, including some modifications. As elaborated above, these responses typically argued that this methodology best met the balance of objectives, while some argued that the 'fair reflection of costs' and 'reflect future risks to government income' objectives should take priority over other objectives.

4.35 A significant majority of responses expressed a preference for a methodology based on the STPR, including some modifications. As elaborated on above, these responses predominantly explained this preference with reference to its performance against the 'stability' objective, although some responses argued that this methodology met all three objectives.

4.36 Remaining responses favoured other methodologies or expressed no clear preference.

Government's response

4.37 Following careful consideration of responses and the arguments raised in favour of the discount rate methodologies considered, the government has concluded that the SCAPE discount rate will continue to be set based on expected long-term GDP growth and none of the modifications considered will be adopted. The government believes that this methodology will best provide that workforce decisions made today fairly reflect the costs of pension benefits and ensure that pension promises are made in a way that is sustainable and affordable to future taxpayers.

4.38 The government recognises that the main alternative to this discount rate methodology, a methodology based on the STPR, was supported by the majority of responses to the consultation. However, the consultation clearly stated that the methodologies would be considered against the government's three proposed objectives in the round.

4.39 Set against this context, responses in favour of a methodology based on the STPR predominantly focused on its performance against one objective – the 'stability' objective. While the government agrees that a methodology based on the STPR would perform best against the 'stability' objective in isolation, the government believes a methodology based on expected long-term GDP growth best meets the overall balance of objectives. This assessment is made on the basis of its evaluation against all three objectives, including its anticipated better performance against the 'fair reflection of costs' and 'reflect future risks to government income' objectives. The government will also take steps to address concerns related to the 'stability' objective.

4.40 The government's assessment of both methodologies against each objective is set out below.

Assessment of methodologies considered

Fair reflection of cost

4.41 The government believes that a discount rate set based on long-term GDP growth best meets the 'fair reflection of costs' objective.

4.42 As set out in Chapter 2, this objective is interpreted as requiring that employers pay an appropriate charge for pension promises made to employees that is fair considering the associated costs that will be passed to future taxpayers. The government believes expected long-term GDP growth meets this objective for two reasons. First, expected long-term GDP growth is a proxy for the future tax base, and so reflects the revenue from which future taxpayers will meet the costs of pensions being provided now. As a result, if the size of the future tax base is expected to shrink compared to previous expectations, the cost to employers of making additional pension promises will increase, reflecting that those pension promises are now expected to be relatively more expensive for future taxpayers to meet. Second, this cost to current employers is appropriate because it is necessarily equal to the expected cost to future taxpayers as a share of expected future revenue of meeting those promises.

4.43 The use of independent long-term GDP projections in applying this methodology further supports its fairness. Further detail on how SCAPE discount rates will be set is set out in Chapter 6.

4.44 While under this methodology, employers may face different costs for offering the same pension benefit to members at different times, it is right for the contributions made by employers to reflect the latest assessment of the cost of pension promises being passed to future taxpayers. The government believes that this is justified given the interpretation of this objective.

4.45 The government agrees that this methodology applies similar principles to the way contribution rates are set in funded schemes, though adapted to the context of unfunded public service pension schemes. The government believes this provides a reasonable level of fairness between sectors in determining what is an appropriate charge for employer in unfunded public service schemes.

4.46 The government shares the concern of some responses that a discount rate based on the STPR may not provide a 'fair reflection of costs.' The STPR is calculated using academic assessments of the relative value to society of current and future consumption and, although it is partly derived from estimates of future income per capita, is not intended to reflect the size of the future tax base. Employer rates calculated using a discount rate based on STPR would not have a discernible reference to the associated costs of pension promises that are being passed to future taxpayers. Likewise, employer rates would not change even if independent assessments of expected ability of future taxpayers to meet these pension promises changed. This could distort employers' workforce decisions and could lead to unfair costs being passed to future taxpayers.

4.47 The government disagrees that employer contribution rates calculated using a SCAPE discount rate based on STPR would be fair because the STPR is used to discount the social costs and benefits of public sector investment in other contexts. While the government requires the STPR to be used when conducting appraisals of projects, programmes or policies, the purpose of these appraisals is to evaluate whether to proceed with the project, programme or policy in question based on an assessment of its expected benefits and social costs (including any associated pension payments that form part of a project). In this context, the STPR ensures that these costs and benefits, which may occur over different time spans, are comparable by discounting them in the same way. However, the STPR is not otherwise used to determine an appropriate charge on the public sector for promising to make a payment in the future, as it is designed for a different purpose.

4.48 While the government agrees that political discretion must be exercised in determining the size of the public sector workforce, these decisions should be made transparently at fiscal events rather than through the choice of discount rate.

Reflect future risks to government income

4.49 The government believes that a discount rate set based on expected long-term GDP growth best meets the 'reflect future risks to government income' objective.

4.50 This is because expected long-term GDP growth is a proxy for the expected size of the future tax base, which represents the main source of government income from which public service pensions are paid. Under a GDP-based methodology, revisions to the discount rate as part of each valuation cycle (as set out in Chapter 5) will ensure that employer contributions reflect the best estimate of the income government expects to have in the future to pay pensions from. If that estimate changes, it is appropriate for this change to be reflected in employers' workforce decisions (such as hiring more employees or increasing pay) in the form of new employer contribution rates following scheme valuations, as it implies that the government now expects to have higher or lower income available to pay out pensions in the future.

4.51 The government acknowledges that long-term GDP forecasts are inherently uncertain and the income available to a future government may turn out to be higher or lower than expected. The government's assessment of whether further modifications to a discount rate methodology based on expected long-term GDP growth are necessary to meet this objective is set out below. The government also notes that this uncertainty emphasises the need to ensure pension promises are made in a sustainable way and so is consistent with meeting the 'fair reflection of costs' objective, which a GDP-based methodology performs best against.

4.52 The government believes a discount rate methodology based on the STPR fails to adequately meet this objective. As set out above, the STPR is a tool used to make a comparable assessment of social costs and benefits that occur over different time periods and is not intended to be a proxy for government's expected future income (the tax base). A discount rate based on STPR could introduce an unacceptable risk that the amount of pension promises being made, and government's future income, diverge by an amount which is greater than that future government's ability to raise additional revenue.

Stability

4.53 The government believes that a methodology based on the STPR would best meet the 'stability' objective. In contrast, a methodology based on long-term GDP growth performs less well against this objective. However, the government will adopt mitigations to support this methodology to provide greater stability set out in Chapter 5. On this basis, the government believes a GDP-based methodology best meets the balance of objectives in the round.

4.54 While the STPR is reviewed by the Treasury regularly, most recently in 2020, it has remained stable since 2003. This has facilitated economic appraisals to be conducted on a comparable basis over time. Assuming the STPR continued to change infrequently, a SCAPE discount rate based on STPR would be likely to undergo fewer changes than if it were set using an alternative methodology. Employers would also face less uncertainty regarding when and how the SCAPE discount rate might be changed. However, it is important to note that in this scenario employer contribution rates would still fluctuate at valuations, as other assumptions would continue to change. Nevertheless, given the importance of the SCAPE discount rate to the outcome of valuations, these changes would, on average, be less than would be the case where the SCAPE discount rate also changed at valuations.[2]

4.55 In contrast, there is an inherent tension between the desire from employers for stability of contribution rates and a discount rate methodology based on expected long-term GDP growth. Long-term GDP projections are revised periodically (though less often than short-term GDP projections), and these revisions are not timed with reference to the valuation process. The government recognises that, as a result, the uncertainty of when and how long-term GDP projections will be revised, and so the SCAPE discount rate changed, creates uncertainty for employers.

4.56 Changes in employer contribution rates following valuations are also likely to be greater where the SCAPE discount rate has also changed. As there is a higher likelihood that expected long-term GDP growth may change between valuations, the government agrees that pension costs may fluctuate more under a GDP-based methodology. This means that this methodology may not prevent fluctuations in employer costs which are not caused by changes in expected future expenditure on pensions, which forms part of the 'stability' objective.

4.57 Despite performing less well against the 'stability' objective, the government has concluded that a methodology based on

[2] It should be noted that this may not always be the case. For example, if the SCAPE discount rate increased, placing a downward pressure on contribution costs, and changes to other assumptions placed an upward pressure on contribution costs (Scenario 1), the overall change to contribution costs may be smaller than if the SCAPE discount rate was unchanged and other assumptions changed placed an upward pressure on contribution costs (Scenario 2). In Scenario 1, the effect of changes in the SCAPE discount rate and other assumptions may partially cancel each other out, but not in Scenario 2.

expected long-term GDP growth best meets the balance of objectives. Although the government has explained that the 'stability' objective does not entail total stability of employer contribution rates and should not be understood as a replacement for fiscal decisions over the size of the public sector, the responses received to this consultation demonstrate that there is an inherent tension between meeting this objective and the other objectives for the SCAPE discount rate. The government has therefore considered ways in which the 'stability' objective might be better met whilst retaining the current methodology, and believes that the intention to align reviews of the SCAPE discount rate with the valuation cycle set out in Chapter 5 will help to support the stability objective. With regard to the 2020 valuations, further detail on the government approach is provided in box 4.A.

Assessment of modifications

4.58 The government has carefully considered the points raised in relation to the possible modifications to both discount rate methodologies that were set out in the consultation, as well as other modifications that were proposed by respondents.

4.59 The government has concluded that, on balance, no modifications to a GDP-based methodology are appropriate at this time.

Modifications in consultation

4.60 The government believes that the two modifications to a GDP-based methodology that were identified in the consultation could help this methodology better meet the 'fair reflection of costs' and 'reflect future risk to government income' objectives. However, the government agrees with responses which argued that they would detract from meeting the 'stability' objective and could add complexity to the valuation process.

4.61 The government recognises that the use of expected GDP growth in each future year for discounting each year of expected pension payments could support contribution rates to be a fairer reflection of costs. This is because it would provide a more precise picture of the expected cost of pension promises to future taxpayers in each year (although this impact may be limited, as valuations look at expected pension payments over many decades while GDP forecasts tend to revert to the long-term average within a much short period of time).

4.62 Likewise, the government notes that actual GDP experience provides a more accurate and certain measure of the income the government will have to pay out in pensions, as it is measures recorded changes in the size of the tax base. Actual GDP experience can differ significantly from expected long-term GDP growth, so this modification could provide more substantial improvements against both the 'fairer reflection of costs' and 'risks to future government income' objectives.

4.63 However, both modifications could have significant negative impacts on the 'stability' objective. Short-term GDP growth forecasts are likely to change more frequently than long-term projections, including in response to recent or ongoing events. Using these to set employer contribution rates could therefore mean contribution rates could be affected depending on which set of potentially volatile forecasts are used to complete scheme valuations. This would significantly complicate the process for setting the SCAPE discount rate and increase the likelihood of a scenario in which the relevant forecasts change multiple times within a valuation period. This modification may therefore make it more difficult to meet the aim set out in Chapter 6 to review the SCAPE discount rate once per valuation cycle.

4.64 Similarly, using actual GDP experience to identify past over - or under - payments, rather than changes in the expected size of the tax base since previous valuation, would mean the charge paid by employers could be significantly affected by short-term GDP experience. This would further exacerbate the possibility, already noted in relation to a GDP-based methodology with no modifications, that contribution rates could fluctuate dramatically despite no change in expected future expenditure on pensions. The government does not think it would be proportionate for public sector employers to bear the risk that pension costs relating to pension promises which will be paid out over the long-term may fluctuate to this extent due to performance of the economy.

4.65 Given that the government has concluded that a GDP-methodology performs less well than the main alternative against the 'stability' objective, modifications which could increase instability would not be proportionate relative to the potential improvements against the other objectives. However, the government will consider options for monitoring any divergence between actual GDP experience and the SCAPE discount rate to ensure that actual changes in the size of the economy are being given proper consideration.

Other modifications

4.66 The government has carefully considered the proposal raised by some responses to align schemes' notional assets with changes in schemes' liabilities when caused by changes in the discount rate. The government acknowledges that this change could reduce the impact that changes in the discount rate have on contribution rates. However, the government has concluded that this change is not appropriate as it would be inconsistent with the 'fair reflection of costs' objective. As explained in Chapter 2, when determining a fair charge on employers for offering additional pension benefits, the government believes that it is right for this charge to also reflect changes in the expected cost to future taxpayers of pension promises made in the past. The government disagrees that a distinction should be made between whether this change is due to changes in the discount rate or changes in other factors, as the effect of both is a change in the expected share of revenue that taxpayers will have to meet these pension promises.

4.67 The government has carefully considered alternative modifications which respondents suggested could help a GDP-based methodology better meet the 'stability' objective, such as revising the discount rate less frequently and/or extending the period over which past over - or under - payments are recovered through employer contributions (the 'spreading period'). The government's assessment shows that while these modifications could reduce the impact that changes to the discount rate have on employer contribution rates, significant instability would be likely to remain if they were adopted. In addition, these suggestions could detract from the 'fair reflection of costs' objective and result in greater costs being passed to future generations of taxpayers. Specifically, increasing the spreading period would mean that a smaller share of any under-payments is recovered in each year, while extending the period over which this relatively smaller share of the deficit is being taken into account in workforce decisions.

4.68 Alternatively, the government does not believe that it is appropriate to apply a prudence margin or any other reduction to expected long-term GDP growth to account for risks to future government income. The government does not think this would be proportionate in the context of unfunded public service pensions and governments' likely ability to raise finances in the short-term to meet any shortfalls in income required to meet its commitments. The government notes that such a change could reduce intergenerational fairness by requiring public sector employers to allocate more resource towards pension costs now, to the detriment of current generations, than is considered necessary based on expectations of future taxpayers' ability to pay out pensions. Furthermore, this would reduce the ability of the government to invest revenue now in ways which could increase its future income, and so may be counterproductive.

Box 4.A: Approach to the 2020 valuations

This box sets out the government's intended approach to the 2020 valuations which are currently underway for the main public service pension schemes.

Review of the discount rate

As part of this valuation cycle, the government will review the SCAPE discount rate in line with the discount rate methodology and approach set out in this consultation response.

The government plans to announce the updated SCAPE rate alongside publication of this consultation response. The independent Office for Budget Responsibility (OBR) has recently published long-term GDP projections in its July 2022 Fiscal Risks and Sustainability Report. These will be taken into account in order to ensure that the discount rate reflects the most recent assumptions.

Setting of new employer contribution rates

As part of the SCAPE process, the discount rate is used alongside other factors such as earnings changes, changes to life expectancy, demographic assumptions and many more. These factors are being used in 2020 valuations to determine new employer contribution rates which the government aims to implement from April 2024.

The government recognises that any increase in employer contribution rates at that time could lead to pressure on existing departmental budgets agreed in the Spending Review (SR) 2021. The government will look to ensure that budgets set in SR 2021 will not come under undue pressure because of a change in the contribution rates resulting from the updated SCAPE discount rate. Therefore, for employers whose employment costs are centrally funded by departments, HM Treasury will exceptionally provide funding for any increases in employer contribution rates resulting from the 2020 valuations as a consequence of changes to the SCAPE discount rate. For devolved administrations, the Barnett formula will apply in the usual way. It is for the devolved administrations to decide how to allocate funding in devolved areas.

Outcomes of the 2020 valuations are yet to be finalised. The outcome will be affected by various demographic and financial assumptions which are being determined, as well as the result of the review of the SCAPE discount rate described above. Results will be confirmed when valuation reports are signed, which is expected to take place later this year.

Chapter 5

Future reviews of the SCAPE discount rate

5.1 Unfunded public service pension schemes undergo valuations every four years. The consultation proposed that the level of the SCAPE discount rate should be reviewed in line with the valuation cycle, with an aim of conducting one review per valuation cycle. This proposal differs from the intention set by the government in 2011 to review the discount rate level every five years, which was made prior to the main unfunded schemes adopting a four-year valuation cycle. Respondents were asked whether they agreed with this proposal.

5.2 The consultation proposed that the government retain the ability to conduct additional reviews in the event of a significant change in circumstances.

Responses

Alignment with the valuation cycle

5.3 Forty-one responses to Question 7 were received. All responses to this question expressed support for the proposal to align reviews of the SCAPE discount rate level with the valuation cycle, and none opposed it.

5.4 Several responses acknowledged that aligning reviews of the discount rate with the valuation cycle was logical and in keeping with the principle of conducting valuations using latest actuarial assumptions.

5.5 A number of responses agreed that aligning reviews of the SCAPE discount rate level with the valuation cycle could help minimise the need for 'out of cycle' reviews of the discount rate and that this could reduce uncertainty for employers. Several responses suggested that this could therefore support the 'stability' objective, by preventing the chance that valuations are affected by changes to the discount rate shortly before new contribution rates are due to be introduced. This was particularly supported by stakeholders who said that the 'out of cycle' review of the SCAPE discount rate in 2018 had led to budgeting issues.

"SAB is in agreement that the SCAPE discount rate reviews should be aligned with the scheme valuation cycle. The main arguments behind this support are that the proposal … minimises the need for an out-of-cycle review because the discount rate is less likely to be considered to be out-of-date. This goes some way to meeting the stability objective of the discount rate."

NHS Pension Scheme (England and Wales) Advisory Board

5.6 A number of responses also expressed that the 'out of cycle' review in 2018 had given the impression that the valuation process could be "tinkered" with and had undermined confidence in its objective, mechanistic nature. Accordingly, they argued that minimising the need for 'out of cycle' reviews could help to make the valuation process more transparent and less subjective, by reducing the occasions on which government might need to determine whether to conduct an 'out of cycle' review of the discount rate.

5.7 While expressing support for the proposal in principle, a number of stakeholders who favoured a STPR-based discount rate methodology observed that the proposal was less relevant under such a methodology, given their expectation for the STPR level to be changed less frequently.

Timing of rate reviews

5.8 Several responses commented on the timing of reviews of the discount rate level within valuation cycles.

5.9 Some responses suggested that by aligning rate reviews with valuation cycles rather than reviewing the rate according to a predefined frequency, this proposal offered some flexibility for the timing of rate reviews within valuation cycles. Some of these responses asked that government engage with stakeholders to determine the most appropriate timing for rate reviews, to take into account stakeholders' financial planning requirements.

5.10 In contrast, a number of responses expressed preferences for the timing of rate reviews to be either fixed or to occur at an early point in the valuation cycle to allow employers to anticipate impacts. This view was especially prominent amongst (but not limited to) stakeholders in the education sector, several of whom highlighted different budgeting periods employed in the sector which meant that employers and administrators required earlier notice of new employer contribution rates. A small number of these employers suggested that rate reviews should facilitate new contribution rates to be known at least one year in advance of implementation to allow employers to budget for pension costs and for administrators to implement necessary changes, while others suggested a 'cut-off date' for changes to the discount rate.

> "Employers need to be able to budget appropriately and cannot do this if costs can increase significantly at the last minute. It should also be noted that for academic employers their financial year does not align with 1 April pension scheme year."
>
> Universities and Colleges Employers Association (UCEA)

5.11 A small number of respondents suggested that the government published indicative discount rates each year outside of formal reviews of the SCAPE discount rate, to signal potential changes to employers, aid budgeting, and boost transparency.

'Out of cycle' reviews

5.12 A number of responses, while supportive of the proposal, also commented on the consultation's suggestion that the government would retain the ability to conduct additional reviews of the discount rate in the event of a significant change in circumstances.

5.13 Some responses argued that the 'stability' objective meant that the government should be either disinclined or formally prevented from conducting more than one review of the SCAPE discount rate within a valuation cycle. Likewise, a number of responses argued that retention of this option undermined confidence and transparency in the valuation process, with some stakeholders commenting that retention of this ability made an impression that the government could manipulate the outcome of scheme valuations.

> "We do agree with the need for a settled sequence and therefore agree in principle that it makes sense to align the SCAPE discount rate review with the valuation cycle, provided this is not utilised as an economic check. This concern is heightened by the government setting aside the opportunity for 'significant changing circumstances' to be used as a pretext for them to intervene whenever they wish. This absolutely goes against the stability objective in allowing the government to alter a long-term scheme as a result of short-term events. Furthermore, it undermines the objective of a fair reflection of costs if the government can make changes as and when they see fit. We would therefore emphasise our opposition to this element of the proposal."
>
> British Medical Association (BMA)

5.14 Alternatively, other responses argued that additional reviews of the discount rate would be unnecessary to meet the 'fair objective of costs' objective. For example, some responses noted that because any discount rate would only be in place for approximately four years before being reviewed, there would be very limited circumstances in which a further discount rate review was required. As mentioned above, stakeholders who favoured an STPR-based methodology noted that additional reviews of the discount rate would rarely be necessary under a STPR-based methodology.

Government's response

5.15 Going forward the government will review the discount rate in line with the valuation cycle rather than every five years. As scheme valuations are held every four years, this means that the government will aim to review the SCAPE discount rate once every four years.

5.16 Strong support for this change amongst all respondents was evident. The government agrees that this represents a logical change considering the shift, since the last discount rate methodology consultation, to a four-year valuation cycle. The government also agrees that this is consistent with the broad principle that valuations should be conducted using the latest actuarial assumptions. Notably, this would prevent the scenario, under a five-year cycle for reviewing the discount rate, where a valuation cycle occurred in which the discount rate was not reviewed.

5.17 The government also believes this change could reduce the number of changes to the discount rate. Currently, the misalignment between the current valuation cycle (typically every four years) and the five-year cycle for reviewing the discount rate means that in practice the discount rate is likely to be reviewed more frequently than once every five years through 'out of cycle' reviews. In contrast, aligning reviews of the discount rate with valuation cycles is intended to mitigate the need for 'out of cycle' reviews of the discount rate by reducing the risk that scheduled reviews of the rate fall at inconvenient or inappropriate points in the valuation cycle – which gives rise to the need to consider whether additional reviews of the rate are necessary under the current misalignment. The government therefore agrees that this change should contribute towards the 'stability' objective by giving employers greater confidence that the discount rate will not change repeatedly, or at a late stage, in any valuation cycle.

5.18 The government recognises the preference of some stakeholders for this review to take place at an early or fixed point in the valuation cycle and recognises the particular importance of this for employers' budgeting needs. However, the government notes that new employer contribution rates cannot be certain until scheme valuations are completed, which can only occur after the discount rate has been reviewed. As such, determination of the SCAPE discount rate will not in itself provide certainty regarding new contribution rates.

5.19 Furthermore, the government believes a preference for early certainty should be balanced against the interest in ensuring that reviews of the discount rate are based on the most up-to-date assumptions available, so that contribution rates represent the fairest possible reflection of the costs. For example, failure to consider more recent GDP projections could mean that contributions paid by employers do not reflect changes to the government's expected ability to pay out pensions in the future. This could result in workforce decisions which do not properly reflect the cost of public service pensions and lead to unaffordable pension costs being passed to future generations. For this reason, it would also not be appropriate to foreclose the possibility of conducting additional reviews of the discount rate in the event of a significant change of circumstances. In such a scenario, a decision will be made with regard to the full balance of objectives.

5.20 The government will therefore aim to conduct one review per valuation cycle, with the precise timing of the review determined by HM Treasury based on the valuation timetable and the expected publication of new long-term GDP projections by the OBR, as part of its role in overseeing the scheme valuation process at each cycle.

5.21 Under this framework, there would be minimal scope for the perception that government has manipulated the level of the SCAPE discount rate, as the rate will be based on the most recent independent OBR projections of long-term GDP growth at the time of any review. The Government Actuary will continue to be consulted as part of the process for setting a new discount rate. Where additional reviews are needed, the government will aim to set out its reasons for doing so clearly and at the earliest opportunity. Even so, this change should strengthen the mechanistic nature of the process by minimising the circumstances in which the government may need to decide on whether additional reviews are needed in the first place.

5.22 The government has considered the suggestion of publishing indicative SCAPE discount rates between formal reviews of the rate. The government believes that this could risk introducing uncertainty by making it more difficult for stakeholders to know the SCAPE discount rate in effect at any one time, and notes that it would not in itself provide stakeholders greater clarity of new contribution rates outside of the wider valuation process. As the

SCAPE discount rate will be set based on expected long-term GDP growth, based on the OBR's long-term projections, the publication of new projections is therefore considered a sufficient means for stakeholders to track how the discount rate may change.

5.23 The government plans to announce the updated SCAPE discount rate alongside the publication of this consultation response.

Chapter 6
Equalities assessment

6.1 The consultation sought views on the equalities impacts of a change to the methodology used to set the SCAPE discount rate. Given the scope of the consultation, the government did not anticipate any equalities impacts from a change in methodology.

6.2 The equality impacts of introducing an 'economic check' to the cost control mechanism, based either on expected long-term GDP growth, and potentially using the SCAPE discount rate, was not in scope of this consultation; these impacts are addressed in the government's response to the consultation on reforms to the cost control mechanism.

Responses

6.3 A total of 38 responses addressed Question 6. The majority of responses to this question did not identify specific equalities impacts arising from changes to the SCAPE discount rate methodology. However, several responses encouraged the government to conduct an Equalities Impact Analysis before reaching a final decision.

6.4 Several responses further elaborated that this should encompass consideration of the impacts on intergenerational fairness. Some of these responses implied that costs on current employers was the most relevant consideration for intergenerational fairness, and consequently that a STPR-based methodology better delivered intergenerational fairness. However, others argued that intergenerational fairness required assessing the impact of alternative methodologies on the burdens passed on to future taxpayers, with some responses advising that future generations may already be heavily burdened due to demographic and other long-term issues. These respondents tended to favour a GDP-based methodology.

> "The critical consideration is that of inter-generational fairness, not just of those in the schemes but also taxpayers who aren't in the schemes."
>
> Association of Consulting Actuaries

6.5 Several responses argued that retaining a GDP-based methodology would have equalities impacts because they expected that, under this methodology, the discount rate would reduce further at the next review of the rate and lead to an increase in pension costs for employers. It was suggested that this could impact both employees and public services if increased costs were not funded by the government.

6.6 It was highlighted that when the SCAPE discount rate increased in 2018, employers in the public sector received additional funding, but employers in public service schemes which are not directly funded by government did not benefit. A small number of responses argued that this created an unequal playing field between employers. Responses from some unions and other stakeholders suggested that if increases in employer contribution rates were not funded by government, and public service providers were required to make cuts to other expenditure there could be a disproportionately detrimental impact on those with protected characteristics.

6.7 Some stakeholders representing employers in public service schemes suggested that employers which participate in schemes on a voluntary basis may choose to leave if costs increased further. This was particularly raised in relation to independent schools, which they argued may leave the Teachers' Pension Scheme (TPS) if the cost of pension provision increased. They suggested that this could lead to differences in pension benefits between longer-serving employees, who were likely to be older, and newer employees, who were likely to be younger. Alternatively, some unions suggested that employers may be more likely to manage unstable pension costs through reductions to periphery or supporting roles, which may be disproportionately occupied by women and part-time workers, or by adopting more cautious recruitment practices.

> "Uncertainty and violent fluctuations in employer contributions inevitably result in employers being cautious in the number of teachers they recruit. This is disadvantageous to younger teachers seeking to enter or progress in the profession."
>
> Independent Schools Council (ISC), Independent Schools' Bursars Association (ISBA)

6.8 Several responses argued that the choice of methodology could have an indirect effect on reducing the gender pensions gap, noting the relatively higher proportion of women in public sector workforces and the role of good quality public service pensions in addressing this.

6.9 A small number of responses pointed out that changes to the SCAPE discount rate methodology may indirectly impact those scheme factors that are set with reference to the discount rate. Several unions encouraged any impact on members because of this effect to be considered carefully and transparently. One union suggested that, as some member choices which apply scheme factors are associated with age, this could result in a discriminatory age impact.

6.10 A small number of responses suggested that consideration should also be given to equality between the public and private sectors. However, some unions opposed such a comparison, arguing that unfunded public service schemes benefitted from inherent efficiencies which did not apply to schemes in the private sector.

> "Unfunded public service pension schemes are significantly cheaper to finance than funded private sector schemes and have much greater covenant strength and hence there is no logic, nor any advantage to members, taxpayers or the government in looking to align the two."
>
> Unison

Government's response

6.11 The government has considered the equalities impacts raised by responses. Although the consultation sought views regarding the impact of a change in SCAPE discount rate methodology, the government has also considered points raised in relation to retaining a methodology based on expected long-term GDP growth.

6.12 As a general point, the government notes that the SCAPE discount rate influences the charge placed on employers for making pension promises, but new contribution rates only become certain when scheme valuations have been completed. These results are based on several factors, including demographic and financial assumptions which are set at each valuation. It would therefore not be appropriate to speculate on possible contribution rates implemented following 2020 or subsequent valuations and the impacts these may have on employers' workforce decisions or ability to deliver public services. The government will comply with public sector equality duties with regard to funding decisions once the outcome of the 2020 valuations is certain.

Age

6.13 The government has considered the impacts of a choice of discount rate methodology on age. On balance, the government believes that a methodology based on expected long-term GDP growth best supports intergenerational fairness. This is because the government has interpreted the 'fair reflection of costs' objective as achieving a fair balance between the charge paid by current employers for making pension promises, and the associated costs passed on to future taxpayers. The government's assessment for why this methodology best meets this objective is set out in Chapter 3. In particular, the government considers that it will best ensure that unsustainable costs are not passed to future taxpayers. The government has taken other decisions, including in relation to possible modifications to this methodology, on the basis that they could impose disproportionate burdens on current employers.

6.14 Any impact on members because of the indirect impact that a choice of SCAPE discount rate methodology may have on employer costs will be the same regardless of age. Contribution rates are necessarily calculated based on expected pension expenditure across the scheme as a whole and expressed as a percentage of pensionable pay. This means that the cost to an employer of making an additional pension promise is the same, as a proportion of pensionable pay, in relation to all members in a scheme, regardless of age (although some schemes operate tiered contribution rates according to salary, which may be indirectly related to age).

6.15 Likewise, the level of benefits received by members of public service schemes of all ages is not impacted by this consultation. This includes benefits associated with scheme factors. Scheme factors are largely set by schemes on the advice of scheme actuaries. It would not be appropriate to speculate on the equality impacts of decisions individual schemes may make regarding scheme factors due to the choice of discount rate methodology.

6.16 The government recognises that some private sector employers which participate in public service schemes on a voluntary basis may opt to leave the scheme due to the choice of methodology itself, even if future cost changes are not yet known, and that such a decision would mean that future employees, who may be more likely to be younger, do not benefit from public service pensions. However, these types of employers may also decide to leave for other reasons; this ability is set out in scheme rules and it is for individual employers to decide.

6.17 In the specific case of independent schools, which participate in the TPS on a voluntary basis, the government has recently taken measures to reduce the number of independent schools leaving the TPS entirely by introducing 'Phased Withdrawal'. This allows independent schools to withdraw from the TPS for future employees while allowing existing employees that are members of the TPS to continue to accrue benefits in the scheme. This mitigates any indirect impact by age between existing employees at the point at which an employer may decide to leave the scheme, by allowing all employees who are members of the scheme at that point to continue to accrue benefits in the scheme, regardless of when they joined. While it does not mitigate the impact on future employees, who may be more likely to be younger on average than the existing employees, the government does not believe there is a proportionate way to mitigate this impact given these employers can already leave the scheme at any time.

6.18 The government also accepts that employers may be more conservative in retaining existing employers or hiring new employees if a discount rate methodology is chosen that may lead to more dramatic changes in pension costs than an alternative methodology. It further accepts that this may disproportionately impact those at the start of their careers who are disproportionately younger. However, the government has not seen evidence to suggest that this impact is more important than other uncertainties related to employment costs that employers face. Furthermore, the government believes that any impact of this type would be justifiable given the assessment of methodologies set out in this consultation, including the conclusion that a methodology based on expected long-term GDP growth will best support intergenerational fairness.

Sex

6.19 As explained above, the level of benefits received by male and female members is not impacted by this consultation. Likewise, any indirect impacts on members because of indirect impacts of a choice of SCAPE methodology on employer costs will be the same regardless of sex.

6.20 The government agrees that public service pensions play an important role in reducing the sex pensions gap more generally. However, the government does not see how the choice of SCAPE discount rate methodology could impact the number of women benefitting from public sector pensions. It is the level of the SCAPE discount rate, as well as several other factors, which jointly determine the outcome of valuations. Furthermore, while employer contribution rates may influence marginal decisions in the size of the public sector, and so the number of women benefitting from public service pensions, decisions over the size of the public sector are ultimately made when setting departmental budgets; the equalities impact of such decisions should therefore be assessed at that time.

6.21 The government also accepts that if a discount rate methodology is chosen which indicates greater instability in employer costs, this disproportionately impacts workers in peripheral or support roles that are more likely to be occupied by women and part-time workers. However, the government has not seen evidence to suggest that this impact is more important than other uncertainties related to employment costs that employers face. Furthermore, the government believes that any impact of this type on women would be justifiable given the assessment of methodologies set out in this consultation, including the conclusion that a methodology based on expected long-term GDP growth will best support intergenerational fairness. While the government has given careful consideration of possible discount rate methodologies against the 'stability' objective, it would not be appropriate or proportionate to select a discount rate methodology to avoid this impact given its purpose and wider fiscal impacts.

Other protected characteristics

6.22 The government has not identified any disproportionate impacts of a choice of methodology on members with other protected characteristics such as race or disability.

6.23 As explained above, the level of benefits received by members is not impacted by this consultation. Likewise, any indirect impacts on members because of indirect impacts of a choice of SCAPE methodology on employer costs will be the same regardless of any protected characteristics.

6.24 The government is not aware of evidence to suggest that members with other protected characteristics may be disproportionately impacted by the choice of a methodology which may indicate greater instability in employer costs, or that this impact is more important than other cost uncertainties that employers face.

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This document can be downloaded from www.gov.uk

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