**REFORM OF THE PUBLIC SECTOR PENSION SYSTEM – LET US GET IT RIGHT!**
**ADDRESS BY HUGH REID**
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**JAMAICA PEGASUS HOTEL**

**The current public sector pension arrangements can be summarised as follows:**

- Defined Benefit - the pension payments are based on a formula based on salary history, tenure of service and age rather than on investment returns earned on contributions paid by employers or employers,

- Unfunded Pay-as-you-go (PAYG) model – the pension payments are based on the current income of the employer rather than on funds set aside in advance based on invested contributions,

- Pension debt - **20% of GDP** (Est.),

- Pensions paid from the consolidated fund i.e. from taxes which you and I pay or debt which you and I will have to repay,

- **80,971** members or public sector employees with some workers not covered e.g., contract

That summary however only tells a part of the story. Let me paint the human story – 3 teachers who retired 20 years ago after giving long and faithful service to this country.

- Teacher A started with a pension of $671 pm and is now receiving a pension of $24,191 pm, $4,191 pm more than the current minimum wage.

- Teacher B started with a pension of $204 pm and is now receiving a pension of $20,765 pm, $765 pm more than the current minimum wage.

- Teacher C started with a pension of $979 pm and is now receiving a pension of $25,758 pm, $5,758 pm more than the current minimum wage.

There is broad based agreement that the public sector pension system is not only inadequate but also fiscally unsustainable because of the benefit provisions and payment terms. However, it is my contention that the reform proposals being considered by the Government **WILL NOT** correct this and could in fact continue the cycle of a fiscally unsustainable public sector pension system. To prove my *point* let us dissect the major recommendations of the two tiered proposal (defined benefit scheme plus NIS) currently being considered by Government.

**1.** A funded defined benefit scheme which by implication means that if the funds contributed (by public sector workers and the Government) and invested are insufficient to meet the cost of the defined benefits due to pensioners at retirement **it is the tax payers who will pick up the deficit (in addition to funding the annual pension contributions due from public sector employees and the Government)!**

**2.** The rate at which past service pensions will accrue to public sector workers under the age of 50, for every year of service, will be **RETROACTIVELY** changed to 2% of the final 5 year average salary – where is the equity as persons retiring just before the transition date will get a pension substantially better than persons retiring just after the transition date although their years of service might be comparable.

**3.** **The unfunded past service liability of $223 billion could be reduced to $163 billion primarily as a result of the reduction in the accrual rate referred to in 2 above, retirement at 65 and a reduction of 5% pa in the pension payable for early retirement .**

**4.** The NIS, which is a first tier contributory pension system, must be reformed to properly supplement the pension benefits received, in light of the inadequate pensions it currently generates.

However it is my view that the financial assumptions being used to support the current reform proposals are optimistic and we could easily find ourselves in a situation where the Government's budget is inadequate to fund future public sector pensions if projected rates of return, interest rates, salary increases vary from what has been assumed which is not unlikely. We seem to have forgotten that the case for public sector pension reform was based on the fact that **the current and projected levels of pension payments required by the Government was fiscally unsustainable** and the country needed to reform public sector pensions to reduce the level of Government expenditure going forward.

In this regard it has been recommended that some of the funding required for public sector pension reform could be found by replacing the national debt incurred as a result of the 1990's financial crisis with low cost multilateral debt which would by their calculation generate savings of 3.5% of GDP. I disagree as **borrowing to fund public sector past service benefits is extremely suboptimal** when you consider the country's current fiscal deficits and the opportunity cost of the borrowed funds exceed the current cost of funding through the budget.

An alternative three tiered model (NIS, defined benefit scheme, approved retirement scheme) based on the PSOJ reform proposal outlines what I believe to be a more feasible sustainable option, to the current reform proposal:

1) **All Public sector workers would contribute 5% of their salary to a defined contribution (DC) scheme** depending on period of service and this would contribute to an additional pension of more than 20% of final salary.

2) The contributory (Government and worker) NIS Scheme could also contribute pensions in excess of 20% of final salary (a NIS pension is now approximately 20% of final salary for someone retiring on $750,000 per annum). This should be considered to be an important part of the public sector workers' total pension benefit.

3) **The Government's cost of future service benefits (after the transition date) should be reduced from 2.2% to 1% Final Salary** – over the long term the cost savings would be huge, which is the raison d'être for public sector pension reform but this now seems to have been forgotten. For a new employee after 35 years of service the pension based on this would be 35% of final salary. For current employees the pension would be higher since the benefit for a part of their service would be based on the 2.2% accrual rate.

**4)** **The accrued benefits should not be reduced –** these would continue at 2.2% of final salary per year of service to transition date (2015). **Of note to public sector workers is that this proposal is in line with the principle of the preservation of past service benefits.**

**5)** Government would continue to operate a PAYG system for the Public Sector workers, as while the Government operates with significant budget shortfalls, **funding a defined benefit public sector system is risky where pension accrual rates continue to be high and there is always the risk of funding deficits which the Government i.e. taxpayers would have to meet**.

I will now outline 9 benefits of this alternative proposal:

1. **COST SAVINGS** as the Government would not have the burden of providing the full pensions of the public sector employees as public sector worker would be contributing to future service costs via the DC plan. We estimate the ongoing costs of this proposal to be $17 billion to $20 billion (the same as is currently being incurred via the PAYG public sector pension system while preserving prior service benefits for public sector workers) compared to the $23 billion to $25 billion in the current reform proposals which is based on cutting prior service benefits (accrual rate, final five year average etc).

2. Public sector workers' pension (comprised of the Government's PAYG scheme, the DC plan and the NIS scheme) would still be **attractive** e.g. a new public sector worker retiring after 35 years service would receive a pension between 64% and 93% of final salary

(depending on salary)

3. **No possibility of government interference** in the DC plan as these would be managed by the private sector

4. There are 14 different private sector DC plan providers which provide the advantages of **competition** to employees who can switch from one DC provider to another and this would not apply in the case of a DB plan.

5. Contributions to a DC plan are **open to temporary and contract staff** (the latter can contribute as self employed persons) while this is not the case for DB plans

6. Each employee in a DC plan can determine how their contributions are invested providing **a better match to individual risk appetites and investment preferences**

7. The DC plan provides **additional flexibility** to employees who would be able to contribute up to 20% of their salaries towards their pension (with the attendant tax savings for employees) while in the proposed DB plan it is likely that employees would be limited to 5%

8. The reduction to 1% in 2015 in the accrual rate could trigger a spurt in retirements but this could be an advantage since reduction in the size of the public sector is also being contemplated. A critical success factor is the **proposed 3-year transition period** in the PSOJ proposal which will allow planning by the employees and the Government as well as an education campaign around the new pension system.

9. It is important to begin to **reduce the exposure of the Government and tax payers** for investment and inflations risks re future pension service costs - partly accomplished by investing employee contributions in a DC plan.

LADIES AND GENTLEMEN – LET US NOT IN OUR HASTE TO SATISFY “PRIOR ACTIONS” JUMP FROM THE FRYING PAN OF THE CURRENT PUBLIC SECTOR PENSION SYSTEM TO THE PROPOSAL NOW BEFORE CABINET WITHOUT CAREFULLY CONSIDERING ALL THE OPTIONS AS WE MAY NOT BE ABLE TO PAY THE ULTIMATE PRICE.

It should also be noted that this does not mean any undue delay in the reform timetable but rather ensuring that what is implemented will achieve the desired objectives of affordability and protection for the workers. Thank you and have a great and productive afternoon.

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