Pointmaker

THE £100 BILLION NEGOTIATIONS

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SUMMARY

- Full implementation of Lord Hutton's proposals, let alone anything weaker, would not fulfil the most fundamental of Lord Hutton's own criteria: the new arrangements would not be sustainable, from both affordability and fairness perspectives.
- The ONS calculation – that public sector workers receive pay packages 13% higher on average than those in the private sector – is a significant underestimate. In reality, the pensions of today's public sector workers will be between double and treble those of similarly skilled private sector workers.
- The Coalition is being out-manouevred by the trade unions in its negotiations over public sector pensions.
- This matters. Cutting the cost of public sector pensions by 25% would save taxpayers billions of pounds *every* year, stretching into the future. The present value of such an annuity saving would be over £100 billion in today's money.
- Within a few years, the private sector will have become a Defined Benefit pensions desert, in which pensioners assume their own longevity risk. Even if Lord Hutton's reforms were to be implemented in full, in a few years time, a future government will have to embark upon a second round of arduous public sector pensions reform.
- This could be avoided by the Coalition indicating that contribution rises agreed in current negotiations would be used to fund compulsory NEST participation (from 2013, once NEST has "bedded down").
- In parallel, it should swiftly implement an improved (and simplified) State Pension and commence preparations for the introduction of a notional Defined Contribution framework, arriving in ten years' time, to sit alongside employees' NEST accounts.
- One important consequence of a pure DC framework for the public sector would be that all of the state's limited capacity to absorb pensions-derived longevity risk would be concentrated into an improved State Pension.
- Public and private sector workers with similar skills and responsibilities would then have broadly equivalent incomes in retirement.

INTRODUCTION

In March 2011 Lord Hutton's Independent Public Service Pensions Commission published its final report. It was prompted by the widespread recognition that public sector pensions are unaffordable, and hence unsustainable. Indeed, today's framework is similar to a Madoff-style pyramid, now collapsing under the weight of insufficient contributions, rising longevity (the DWP expects more than ten million people in the UK today to live to see their 100th birthday) and an ageing workforce (i.e. fewer workers to support each pensioner).

The Coalition has broadly accepted Lord Hutton's recommendations for watering down the quality, and thereby the cost, of public sector pensions. In so doing, it has assumed a Herculean challenge, which starts with union negotiations over the structure of the reforms. A period of staff consultation is expected to follow, with the intention that agreed changes will be introduced from April 2012.

This timetable is extremely tight. The Isle of Man's Government started similar negotiations, in respect of its (mere) 9,000 public sector workers, more than four years ago. The process continues to drag on, burdened by multiple rounds of consultation. Consequently, implementation has yet to start, and once it does, transition is still expected to take up to a further seven years.

But the timetabling difficulties are mere details. Even if Lord Hutton's proposals were to be implemented as they stand, from the perspective of economic and fairness (vis-à-vis the private sector), they remain inadequate.

THE SHORTFALL WILL STILL GROW

Public sector pensions are mainly unfunded; they operate on a pay-as-you-go (PAYG) basis, contributions being immediately recycled in order to pay current pensions.

This PAYG approach leads to opacity, not least because the immediate funding requirement is disconnected from the cashflow consequences of pension promises. It also harbours behavioural risk, notably the temptation for employers to defer some of today's employment costs. But the most serious unintended consequence of the PAYG framework is the perpetration of generational injustice.

Five years ago, contributions and pensions were roughly in balance. But this is changing. This year, public sector pension payments are expected to exceed pension contributions by £5.8 billion. By 2015-16 (assuming that Lord Hutton's proposals are implemented in full), the gap is expected to be £8 billion, and rising. This worsening cashflow shortfall has to be plugged by the taxpayer.

It is therefore clear that reforms are required that go well beyond Lord Hutton's. Without them, we will continue to impose on successive generations a legacy of rising contributions (and taxes), to pay the previous generation's pensions.

FEW OPPORTUNITIES FOR QUICK WINS

Lord Hutton's proposals will start to produce meaningful economic benefits in 15 to 20 years' time, primarily through his (sensible) proposal to link the retirement age to the State Pension Age. But this is too distant to be of any immediate value: in today's hard times, the Chancellor needs immediate cashflow savings. Here, public sector pension reform has little to offer. There is little scope to increase employee contributions as the impact of so doing is too immediate (witness the current opposition), and while pensions in payment could be reduced, this is seen as politically impossible.[1]

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1 Albeit not in other countries. Dutch and Swedish pension schemes, for example, incorporate mechanisms to reduce pension payments in the event of financial distress.

That only leaves reforms such as putting an end to contracting out of the State Second Pension (S2P). The Government would then no longer have to pay NICs rebates, producing an immediate cashflow saving of around £1.5 billion per year in respect of public sector employees.[2]

UNRESOLVED UNFAIRNESS

Historically, the more generous public sector pensions have been justified by pay being lower than in the private sector.

Table 1 (below) debunks this argument. It shows that both mean (i.e. average) gross pay and total reward are higher in the public than in the private sector, by 4% and 13% respectively. However, this data significantly understates the value of public sector pensions as "total reward" only reflects employer contributions, which bear no resemblance to the cost of meeting the pension promises. In particular, the "price" of public sector workers continuing to enjoy certainty of income in retirement, until the day they die, is ignored. This still has to be paid for, by taxpayers.

In addition, public sector workers bear no investment risk, their pensions being (mostly) unfunded.

Using pension contributions as a proxy for pensions' value, it is evident that the pensions of today's public sector workers will be between double and treble those of similarly skilled private sector workers.

Private sector DC occupational schemes' contributions typically total 12% of salary. This is roughly a third of PWC's estimate that private sector workers would need to contribute about 37% of their salary to their pension pot over their working lifetime, to match the retirement income paid to a public sector worker on an equivalent wage.

Thus the "total reward" differential, in favour of the public sector, is much wider than reported by the ONS.

The cost of providing certainty of income in retirement is now prohibitive, as the private sector has discovered. This is because people are living longer in retirement. And, as the population ages, so the number of workers supporting each pensioner is declining. Consequently, the burden on taxpayers is likely to rise, leaving the (on average) less well-off private sector workers with less to save for their own retirement.

[2] Public sector employer rebates are not a "saving", the cashflow being circular, i.e. within government.

Table 1: Gross pay and total reward: summary statistics

	*£ weekly**	Mean	1st quartile	Median	3rd quartile
Gross pay					
	Private sector	£581	£330	£465	£677
	Public sector	£605	£393	£539	£722
Total reward**					
	Private sector	£614	£335	£479	£719
	Public sector	£692	£444	£615	£830

** Full-time employees on adult rates of pay whose earnings were not affected by absence.*
*** Total reward is defined as gross pay plus employer pension contributions.*

Source: ONS; *Economic & Labour Market Review Table 1*, September 2010. Underlying data from *The 2009 Annual Survey of Hours and Earnings (ASHE),* 12 November 2009.

Today, almost all private sector workers have defined contribution-based (DC) pensions, through which they assume their own income-in-retirement risks. Unless they purchase a lifetime annuity at retirement (which is increasingly expensive), their subsequent income is uncertain because they do not know how long they will live, nor how their assets will perform. It is surely unreasonable to expect them to assume, and pay for, the longevity risk of others.

THE UNIONS' PERSPECTIVE

Lord Hutton justifies his proposals by, quite rightly, emphasising the unaffordability of today's public sector pension arrangements. Unfortunately, Chart 1B in his final report would appear, *at first sight*, to support the union's claim that there is no affordability issue. It shows a projection of the cost of unfunded[4] public sector pensions falling from a peak of 1.9% of GDP (this year) to 1.4% of GDP by 2060.

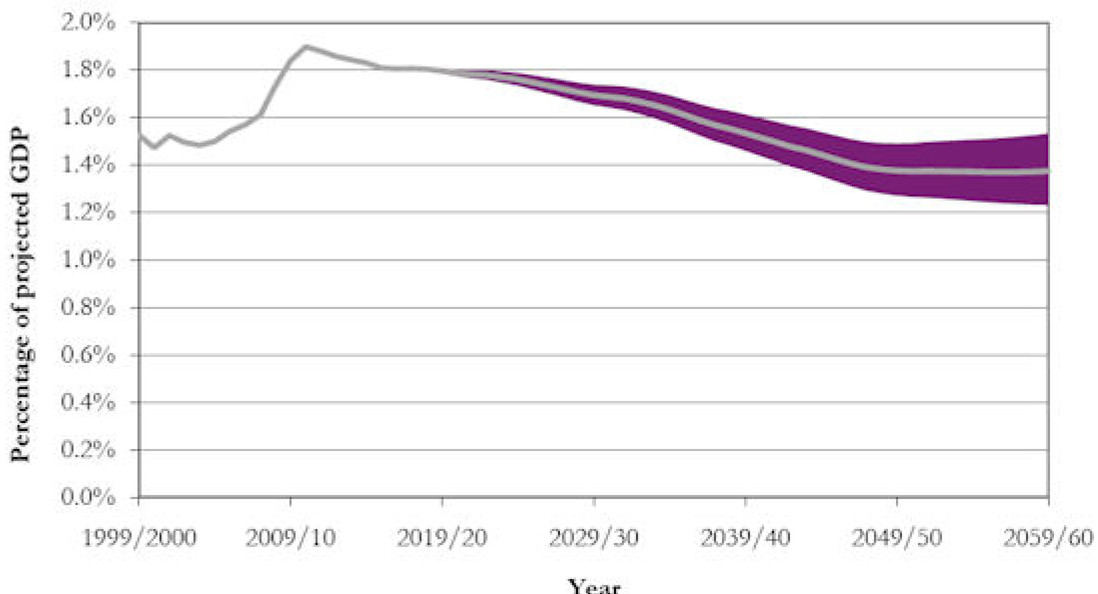
Chart 1B repeatedly comes back to haunt the Coalition. Unsurprisingly, the unions have latched on to it, to justify their case that there is no issue concerning pensions affordability.

There are several assumptions behind the chart which the unions do not acknowledge. For example:

- the projection assumes that pension accruals and pensions-in-payment will grow with CPI, rather than the more costly RPI. But the unions are opposing this change. Analyses from both the NAO and the OBR irrefutably demonstrate that unless CPI is

[4] i.e. excluding the 15% of public sector pensions that are funded, notably the Local Government Pension Scheme (LGPS).

THE MISLEADING CHART 1B



adopted, the cost of pensions, as a percentage of GDP, will rise. The unions cannot have it both ways. They either accept that CPI should be used in calculating future pension payments; or they should not use this Chart as a demonstration of long-term affordability.

- Chart 1B assumes that the public sector workforce will grow at 0.25% a year. This assumption seriously influences the calculation of the cashflow shortfall. For example, if the workforce were to contract (a real possibility), then the cashflow shortfall would be exacerbated (there being fewer contributors, but not fewer pensioners).
- Chart 1B also assumes that real earnings will grow at 2% a year, which is probably over-optimistic, not least because of the increasing competitive pressure from the emerging markets. The productivity growth assumption, also 2%, is also questionable; it is quite feasible that our ageing workforce could become less productive than previous, younger, workforces. These two assumptions have a major impact on the GDP growth projection. If they turn out to be over-optimistic, then the cost of pensions, expressed as a percentage of GDP, will be higher than otherwise.

HOW THE UNIONS ARE WINNING A HIGH STAKES NEGOTIATION

The economic implications of the negotations over public sector pensions are perhaps as great as any other negotiations between government and unions in history. The cost of pension benefits are expected to rise from £25 billion (2009-10) to over £60 billion (2059-60) a year. Cutting the latter by 25%, say, would save the Treasury (and taxpayers) billions of pounds *every* year, stretching into the future. The present value of such an annuity saving would be well over £100 billion in terms of today's money.

Despite the importance of these negotations, the Coalition would appear, so far, to have been out-manoeuvred by the unions. The Chief Secretary to the Treasury's media blitz ahead of the one day strike (June 30) came over as informing the unions of the pre-determined outcome, which would not have helped relations around the negotiating table. Much more serious, though, is the unions' success in persuading the Coalition to accept separate negotiations for each of the main pension schemes, a delaying tactic that puts more pressure on the Coalition's own tight deadline.

The unions are also winning the media campaign, not least because of their preparedness to take advantage of, in any discussion of pensions, the unparalleled opportunities for obfuscation and bamboozlement. They happily co-mingle the facts, and languages, of funded and unfunded schemes to suit their purposes, unchallenged by interviewers who are even more unfamiliar with the subject.[5] Ministers have been equally unconvincing, not least because they would appear not to have been fully briefed, particularly in respect of the nuances of Chart 1B.

Given progress to-date, the unions might be feeling confident of severely limiting Coalition ambitions to cut the cost of pensions. But if this were to materialise, it may ultimately be a Pyrrhic victory. If there were no real reform today, then the pain will only be deferred as future governments will be obliged to take more drastic action tomorrow, as the unfairness gradually and inevitably worsens over time.

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[5] For example, Evan Davis interviewing Dave Prentis (Unison General Secretary), The Today Programme, 15 June 2010. Davis asked questions about unfunded schemes; all of Prentis's answers concerned funded schemes.

AN ALTERNATIVE APPROACH

The Coalition should step back from the current negotiations and swiftly raise the State Pension to at least £140 a week, for every individual (irrespective of marital status). This was originally proposed as Coalition policy in 2010, but little has been heard of it since.

By putting in place a level of retirement income above the means-testing threshold, the Coalition could claim to have addressed the unions' legitimate concerns over pensioner poverty. It would then be in a much stronger position to negotiate a route map to a wholly DC-based framework for public sector pensions, based on the following principles.

NEST and notional DC

All public sector employees should be compelled to participate in the DC-based NEST,[6] with additional pension provision provided by notional DC schemes. NEST participation would represent the start of tip-toeing towards a *partially*[7] funded framework. It would be funded by the Treasury foregoing the cashflow from the widely-anticipated additional contributions, but "spend to save" thinking is not entirely alien to it. Furthermore, the opportunity to encourage a savings culture amongst 20% of the working population should be seized (subsequently boosting investment).

The bulk of public sector pensions should be provided by an unfunded ("notional") DC arrangement, along the lines already adopted in Sweden and elsewhere. Individuals would each have a notional account detailing their (and employer) contributions, but the cash would continue to flow to the Treasury, and would therefore be available to be paid contemporaneously to retirees. A rate of return would be "deemed" on the contributions (GDP growth should be used, not least to reflect the state's ability to pay) and, at retirement, the notional account would be converted into an annuity using a market-based rate.

How to implement a pure DC framework

The Coalition should pursue a public sector pensions reform "two step". There should be an initial ten year phase of NEST participation and watered-down DB provision, along the lines that Lord Hutton has proposed (i.e. career-average rather than final salary-based). The latter would then be replaced by the notional DC schemes.

The Coalition's notional DC intentions should be signalled ten years ahead of introduction. Reforming public sector pensions is foremost an exercise in effective communication and negotiation, rather than a technical challenge.

The challenge includes determining the size of contributions, accrual rates, and so on. This should be determined at individual scheme level, through negotiation between employers and unions. Central government should not be involved; its role should be limited to setting two crucial boundary conditions:

1. public sector employers would have to become pensions self-sufficient within ten years, to coincide with the introduction of the notional DC schemes. Thereafter, the Treasury door would be shut, i.e. any cashflow shortfalls would have to be met by employers; and
2. the taxpayers' contribution would be capped at 65% of pensions in payment.

How employers achieve pensions self-sufficiency should be entirely up to them; they should have complete discretion.

[6] The National Employment Savings Trust; auto-enrolment of private sector employees commences in 2012.

[7] Fully funding the public sector's pension liabilities should be, at best, a very distant objective (requiring the accumulation of over £1 trillion of assets, in today's money terms).

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ISBN 978-1-906996-37-6

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