Pointmaker

THE APPROACHING CASHFLOW CRUNCH

WHY COALITION REFORMS TO PUBLIC SECTOR PENSIONS WILL NOT HOLD

MICHAEL JOHNSON

SUMMARY

- This paper shows why another round of public sector pension reforms will be required, probably before 2020.
- The catalyst is likely to be the rapidly increasing cashflow shortfall between contributions and pensions in payment.
- These are forecast to rise to an unacceptably high level. In 2005-06 it was an irrelevant £200 million, before growing to £5.6 billion in 2010-11. By 2016-17 the OBR expects it to have increased to £15.4 billion – a 77-fold increase in 11 years.
- This will, eventually, have to be paid for by taxpayers. With employers' contributions of an extra £17.2 billion, the annual burden on taxpayers will be over £32 billion – the equivalent of £1,230 for every household in the country. Nearly £4 out of every £5 paid in pensions to former public sector workers will come from the taxpayer.
- The Coalition has justified its reforms on the grounds that they achieve a material reduction in the total liability. But the liability is a nebulous concept; and its modelling techniques unclear. The cashflow shortfall, as it emerges, will however be both clear and tangible.
- The current reforms will only produce significant cashflow savings after 20 to 30 years, far too late to assuage pressure for further reform. That said, the public's opprobrium could be fuelled as much by unfairness as unaffordability.
- During that time, public sector workers will enjoy certainty of income in retirement until the day they die, mostly paid for by the 80% of the workforce in the private sector, almost none of whom have that security.
- The Coalition should now:
  - put all its modelling assumptions for the reduction of the liability into the public domain;
  - start to prepare the public sector for a risk-sharing arrangement such as a cash balance scheme, en route, ultimately, to a wholly Defined Contribution framework.
- This approach would, at long last, provide comparable pensions across the UK, irrespective of the employment sector. Not to express such a vision would be to accept that the quality of pension provision in the (wealth-creating) private sector will, from hereon, be second class.

INTRODUCTION

Lord Hutton, the architect of the recent public sector pension reforms, has had second thoughts:[1]

"What we've seen is how very quickly the assumptions which underpinned my assessments of the long-term sustainability of public service pensions have been shown to be too optimistic. That is going to affect the sustainability of public sector pensions in a negative way."

So how sustainable are the current reforms to unfunded pensions in the public sector?[2]

1. THESE FOOLISH THINGS….

On 2 November 2011, Danny Alexander, the Chief Secretary to the Treasury, made a statement to the House of Commons concerning "enhancements" (i.e. government concessions) to the public sector pensions' reform package. His speech included the following:

"I believe this package is affordable. I believe it is also fair, not just to public sector workers, but delivers significant long term savings to taxpayers who will continue to make a significant contribution to their pensions.

If reform along these lines is agreed, I believe that we will have a deal that can endure for at least 25 years, and hopefully longer."

This may prove to be a thoroughly misleading statement: robust evidence is now emerging, to suggest that this is indeed the case.

[1] Interview with BBC Radio 4's *World This Weekend*, broadcast on 4 December 2011.

[2] This paper focuses on the public sector's unfunded pension schemes, covering roughly 85% of the workforce. A subsequent paper will examine the financial health of the funded Local Government Pension Scheme (LGPS), which covers most of the other 15% of the workforce.

2. DISTRACTION POLITICS

The Coalition has made much of the reforms to public sector pensions "halving the net liability". In July 2012, the Office of Budget Responsibility's *Fiscal Sustainability Report* (FSR) projected spending on public service pensions to fall from 2.2% of GDP (2016-17) to 1.3% (2061-62). This 40% reduction is significant. But it is half a century away.

In addition, this forecast entails colossal modelling risk, notably in the assumptions used for GDP growth (primarily driven by what may prove to be an excessively optimistic underlying assumption for productivity growth[3]), life expectancy, inflation, wage growth, the discount rate and the future size of the public sector workforce.

The OBR should re-run (and extend) its cashflow forecasts using a range of lower GDP growth rates.

In addition, the OBR should put all of its modelling assumptions, and results, into the public domain. There is no reason why these need to remain secret.

But focusing attention on the liability (funded or unfunded) is a red herring; it is a nebulous concept that does not manifest itself in day-to-day life. It imposes no meaningful political pressure, as well as diverting attention to unconstructive debates concerning the underlying modelling assumptions. What matters is cashflow, as any private sector businessman knows. On this, the FSR is silent.

[3] This assumption, at 2.2% a year, has been unchanged for years. This may well be too generous: indeed, it would be prudent to assume that our ageing population will become *less* productive over time.

3. CASHFLOW FORECASTS

The Treasury's Public Expenditure Statistical Analyses (PESA) annual report provides a forecast for the cashflow gap between contributions (from employers and employees) and pensions in payment to former public sector workers. The data is in respect of the unfunded (i.e. pay-as-you-go, PAYG) schemes, which cover roughly 85% of public sector employees (the principal exception is the funded Local Government Pension Scheme).

Table 1 below compares the 2011 and 2012 PESA reports' cashflow forecasts. It shows that since 2005-06 an alarming cashflow shortfall has developed, and it is forecast to continue to deteriorate. Particularly surprising, indeed shocking, is the *increase* in the forecast shortfall between the two reports, because the 2012 report *includes* the recent (cost-saving) reforms. One would expect the forecast shortfall to start *reducing* after 2014, when the reforms are implemented… but the opposite is expected to happen.

Over the four year period commencing in 2011-12, the forecast aggregate shortfall is nearly £10 billion *more* in the 2012 PESA report than the 2011 report. The shortfall has to be paid for by the Treasury, i.e. taxpayers (who are already funding the employers' contributions).

Table 2 shows the OBR data and calculations prepared for the recent Budget reports.

It is clear that the OBR (in the Budget 2012 report) and the 2012 PESA report are in broad agreement: that, following implementation of the reforms, the annual cashflow shortfall is expected to rise further. Why is this, given that employee contributions are rising and given that the reforms include moving from a final salary to a career average basis of accrual, linking pensionable age to the (retreating) State Pension Age?

Table 1: Cashflow shortfall: comparison of 2011 and 2012 PESA reports

2011 PESA report										** Planned*
£ billion	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13***	**2013-14***	**2014-15***
Total contributions	£17.4	£18.0	£19.2	£19.4	£20.7	£21.4	£21.7	£21.6	£21.6	£22.0
***less* pensions in payment**	£17.6	£19.1	£21.4	£22.6	£24.4	£25.9	£27.4	£28.9	£30.2	£31.7
Shortfall, pre-reforms	**£0.2**	**£1.1**	**£2.2**	**£3.2**	**£3.7**	**£4.5**	**£5.7**	**£7.3**	**£8.6**	**£9.7**
2012 PESA report										
Total contributions	-	-	£19.2	£19.4	£20.7	£21.4	£21.1	£22.1	£22.3	£22.4
***less* pensions in payment**	-	-	£21.4	£22.6	£24.4	£26.0	£27.8	£32.1	£33.8	£35.2
Shortfall, post-reforms			**£2.2**	**£3.2**	**£3.7**	**£4.6**	**£6.7**	**£10.0**	**£11.5**	**£12.8**
***Increase* in shortfall between PESA reports**			**£0.0**	**£0.0**	**£0.0**	**£0.1**	**£1.0**	**£2.7**	**£2.9**	**£3.1**

Table 2: Successive OBR cashflow forecasts

	**outturn*								
£ billion	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**
Budget June 2010 (pre-reforms)	£3.1*	£3.1	£4.0	£5.1	£5.8	£7.3	£8.9	£10.3	-
Budget March 2011 (pre-reforms) A	-	£4.7*	£5.8	£7.0	£7.8	£8.0	£8.7	£9.7	-
Budget March 2012 (post-reforms) B	-	-	£5.6*	£8.4	£11.6	£12.2	£13.2	£14.3	£15.4
***Increase* in forecast shortfall *after* reforms (B - A)**				£1.4	£3.8	£4.2	£4.5	£4.6	

4. THE TIDE IS COMING IN

There are three main reasons why the 2012 forecast for the cashflow shortfall shows a marked increase on what was expected only a year earlier, in spite of the reforms in the interim period:

(i) the inclusion of the Royal Mail pension scheme between the last two Budget reports, adding (from 2012-13) £1.5 billion per year to the forecast shortfall;

(ii) lower income from contributions than was forecast in Budget 2011, because of the public sector wage freeze (contributions are linked to wages). Meanwhile, pensions in payment continued to rise with CPI; and

(iii) a marked increase in forecast pension and lump sum payments. This could be partly explained by the anticipation of more redundancy-induced, and very costly, early retirements, over the next few years, along with further improvements in longevity.

The reforms' increase in employee contribution rates (by an average of 3.2% of income) is expected to raise an additional £1.2 billion (in 2012-13), rising to £2.9 billion in 2016-17.[4] This additional income is included in the 2012 Budget report, but it is dwarfed by the scale of the relentless increase in pensions in payment. Hence the rising forecast for the annual cashflow shortfall.

Defenders of the *status quo* will point out that the unfunded schemes' contributions are set to meet the cost of the accruing benefits, *not* the cost of meeting pensions in payment. But will the general public care (or understand) the nuances of how a PAYG scheme is supposed to work when, in 2016-17, the OBR is expecting a cash shortfall of £15.4 billion? This, added to that year's forecast for employers' contributions (£17.2 billion), means that taxpayers will then be contributing nearly 80% (£32 billion) of the cost of paying pensions to former public sector workers.

Public sector pensions have, for decades, been hugely under-priced (on a PAYG basis), contributions being woefully insufficient to meet the accruing benefits. The legacy of successive governments' inability to implement the necessary radical reforms is now manifesting itself as a rising tax burden on today's workers.

Yet, following the latest reforms, most employee contributions will still be less than 10% of incomes. Danny Alexander made this point himself, in his November statement to the House of Commons, when describing the pensions that a teacher and a nurse could expect:

"To earn the equivalent pension in the private sector… both would require an annual contribution of around a third of their salary".

5. THE REFORMS' FATAL ERROR: GRANDFATHERING

Danny Alexander's November statement also contained the following sentence:

"*Anyone ten years or less from retirement age on 1 April 2012 are assured that there will be no detriment to their retirement income".*

At a stroke, this concession to the unions vaporised the prospect, for at least the next decade, of exerting any significant control on the widening cashflow shortfall.

[4] The OBR's forecasts in the Budget 2012 report used the Hutton reform contribution increases set out in Table 2.13 from the Autumn 2011 Economic and Fiscal Outlook (EFO).

To get a deal done, the Coalition punted the prospect of smaller pensions sufficiently far into the future, so as not to concern many public sector employees. Consequently, the reforms only deliver significant savings in the long term. As the OBR and PESA reports illustrate, the growth in pensions in payment will continue to accelerate faster than the increase in employee contributions.

To-date, the lack of transparency inherent in public sector pensions' PAYG structure has allowed successive governments to put off reform. But the rapidly growing, and highly visible, cashflow shortfall means a larger tax burden. That will translate into a political pressure point that readily punctures the recent reforms' upside of a smaller liability, as espoused by the Coalition. The latter is too remote from individuals' day-to-day experience (as, indeed, are subjective concepts such as affordability or sustainability). On the other hand, higher taxation is immediate and unambiguous, and is likely to be accompanied by a growing appreciation of the unfairness of the public sector's pension arrangements.

Even after the latest reforms, public sector workers will continue to enjoy certainty of income in retirement until the day they die, predominately paid for by the 80% of the workforce in the private sector, very few of whom enjoy such certainty. For how long will this unfairness be sustainable?

6. THE NEXT STEPS IN UNFUNDED PUBLIC SECTOR PENSIONS REFORM?

6.1 Diametrically opposed views

The position of the TUC and the public sector unions is that private sector employers should do more for their workers and improve the quality of their pension provision. The business perspective is the reverse, namely that the relative generosity (i.e. cost) of public sector pensions should be curtailed, as Figure 1 illustrates.

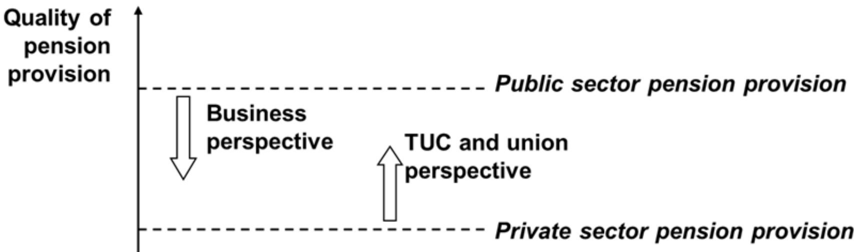
Resolving this difference in opinions is similar to trying to push together the wrong ends of two magnets.

6.2 A light in the dark: defined ambition?

The DWP is currently investigating a pensions third way, the "defined ambition" pension scheme. This, it is hoped, would bridge the disparate worlds of Defined Contribution (DC) schemes and Defined Benefit (DB) schemes. Working groups are examining what "DB Lite" and "DC Plus" could look like, seeking a mixture of risk-sharing between employer and employee, somewhere in the regulatory No Man's Land that today separates the very different DB and DC regulatory regimes.

Defined ambition was born out of Steve Webb's laudable desire to resuscitate private sector occupational schemes: it is unlikely that public sector pensions are on his radar. But among the myriad of potential structures, one in particular could provide the next step in public sector pensions reform: a cash balance scheme.

Figure 1: Different perspectives on pensions reform



6.3 The "pay twice" problem

Cash balance schemes were first developed in the US, to replace conventional (funded) DB schemes. But here the "pay twice" problem arises. Adopting a funded framework would mean that today's workers would have to contribute both to their own pension pots and contribute (directly or via taxation) towards paying for the previous generation's pensions in payment. This could be thought of as a hangover, following addiction to the convenience of an unfunded, PAYG, framework.

Consequently, introducing a cash balance arrangement would (initially) have to be on an unfunded basis.[5] Employee and employer contributions would be *notionally* credited to each employee's personal retirement account, the actual cash returning to the Treasury, to help it continue to meet pensions in payment. The accumulating notional balance would grow at an assured rate of return, such as CPI, the yield on a Treasury bill or, given the context, the discount rate used to determine the size of the public sector pensions liability. Consequently, employers assume the investment risk, up until retirement. At retirement, the "cash balance" is passed to the retiree who is then encouraged to purchase an annuity at the prevailing market rate, thereby creating certainty of income in retirement: a "pension". Thus, crucially, longevity risk (arguably the most significant risk) resides with the individual, not the state.

For legal purposes, in the US cash balance schemes are still treated as DB schemes. However, the promised benefit is the size of an account balance at retirement, not a specific, on-going, income in retirement. Ideally a similar legal accommodation could be obtained in the UK.[6]

7. CONCLUSION

After Lord Hutton's reforms have been implemented, weakened by subsequent concessions, public sector pensions will remain unsustainable. Over the next few years it will be become impossible to ignore the furiously ringing alarm bell that is the burgeoning cashflow shortfall between contributions and pensions in payment.

It is therefore time to consider a solution that will be lasting, affordable and fair.

5 Subsequently we could slowly move to a funded structure, as more fully described in *Self-sufficiency is the key*, Chapter 5 (CPS, 2011).

6 Morrisons, the supermarket operator, has just announced (October 2012) a cash balance scheme for its employees, but most details (including the regulatory treatment) are not yet in the public domain.

SOME REACTION TO PREVIOUS REPORTS BY MICHAEL JOHNSON

Pensions: bring back the 10p rebate
"Are you listening, Mr Chancellor?" – *Professional Pensions*

"Confront vested interests over higher rate relief and salary sacrifice says influential think tank." – *Money Marketing*

The £100 billion negotiations
"Public sector pensions amount to a risky 'Madoff-style pyramid' because they are unfunded to the tune of billions of pounds, a think-tank warned last night." – *The Daily Mail*

"Government 'given too much ground to unions' in public sector pensions row" – headline in *The Daily Telegraph*

Self-sufficiency is the key: address the public sector pensions challenge
"Britain's civil servants must be weaned off their gold-plated final salary pensions to avert a 'fiscal calamity', a new report into the looming pension crisis has warned." – *The Daily Telegraph*

Simplification is the key: stimulating and unlocking long-term saving
"The government has called for us to make suggestions on reform of tax and benefits and it couldn't do better than listen to the proposals from the Centre for Policy Studies on simplification of the pensions and savings regime." – Lorna Bourke, *Citywire*

"Complexity is a real issue here, and not just when it comes to CGT. The title of the Centre for Policy Studies' new paper on pensions by Michael Johnson, Simplification is the Key, says it all, really." – *The Sunday Times*

Don't let the crisis go to waste: a simple and affordable way of increasing retirement income
"The Government is leaving itself open to accusations of a future mis-selling scandal if it allows Personal Accounts to go ahead in their current form, according to an influential think tank." – *IFA online*

"The Centre for Policy Studies this week blasted personal accounts as fundamentally flawed. Low earners would accumulate footling amounts in the new scheme, it argued, and might actually be worse off because they might no longer qualify for pension credit. This invited "a major mis-selling scandal", it said." – *The Times*

Put the saver first: catalysing a savings culture
"Michael Johnson spares no industry blushes in his forensic investigation of the principal/agent problem that has created a "dysfunctional" model….Industry practitioners should not dismiss his ideas…he is continuing a fine tradition of ideas for industry reform from such luminaries as Paul Myners, Ron Sandler and Adair Turner." *The Financial Times*

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