Pointmaker

A TOXIC TANGLE

THE PUBLIC SERVICE PENSIONS BILL AND THE DWP'S WHITE PAPER

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SUMMARY

- This paper explains for the first time why the future cost of public service pensions could be more than £9 billion a year above current expectations.
- This has primarily arisen because of the interaction – or "toxic tangle" – between two pension proposals currently before Parliament: the Public Service Pensions Bill and the DWP White Paper on the single-tier pension.
- Together these have created two additional costs:
  - about £3.4 billion a year due to the loss of the public sector employers' NICs rebate following the end of contracting-out; and,
  - about £4 billion a year as a result of public sector employees continuing to enjoy an enhanced occupational pension, as if still contracted-out, whilst being entitled to further accruals within the new single-tier state pension, once it appears. In contrast, private sector employers who are today contracted-out will be permitted to change their scheme rules (and reduce the pensions paid) without trustee consent (not least to enable them to recoup their lost NICs rebates).
- A further £2 billion a year in additional cost may well arise as Lord Hutton's modelling used life expectancy rates that are now six years out of date.
- The Public Service Pensions Bill should therefore be stopped in its tracks until the White Paper's cost implications for it are thoroughly examined. This should include the use of up-to-date projections for life expectancy.
- It was already widely accepted that public sector employees already enjoy pensions which are far more generous and secure than the great majority of private sector employees. These new findings show that the sustainability of the post-Hutton pension settlement is even more questionable than previously thought.
- The need for bolder reform of public sector pensions is far greater than that proposed in the Public Service Pensions Bill.

1. INTRODUCTION

Data from the Office of Budget Responsibility (OBR) have shown a rapidly escalating cashflow shortfall between contributions and pensions in payment for public sector pensions.[1]

In 2005-06, that shortfall was an irrelevant £200 million. But for 2010-11 this had grown to £5.6 billion. By 2016-17 (i.e. *after* the current reforms recommended by Lord Hutton have been implemented), the OBR expects the shortfall to have increased to £15.4 billion – after which it will continue to rise. 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.

This shortfall has to be plugged by the Treasury – that is, the taxpayers of this and future generations.

However, the OBR's forecast does not take into account the cost implications stemming from the DWP's recent White Paper.[2] As a result, the OBR's forecast for the cashflow shortfall is likely to be far too optimistic: within a decade, the annual bill, ultimately borne by the taxpayer could be at least £41 billion – the equivalent to £1,600 a year for every household in the UK, comprised of:

- at least £17 billion in employer contributions;
- a cashflow shortfall of at least £15 billion as forecast by the OBR between pensions in payment and pension contributions;[3]
- at least £9 billion in additional costs identified in this paper.

This level of subsidy to public sector workers is neither affordable nor sustainable. The sooner that the Coalition can control this huge increase in costs, the better.

1. THE NEW STATE PENSION

The DWP's White Paper proposes a new single-tier pension (STP) to replace the basic State Pension (BSP) and additional State Pension (ASP), today accumulated in the form of the State Second Pension (S2P) and, previously, SERPS). It proposes a welcome simplification of the labyrinthine state pension framework. Ironically, this simplification is itself a hugely complex exercise (which may partly explain the long delay in publication of the White Paper).

The STP has two significant strengths:

- its proposed full amount of £144 per week[4] is well above the full BSP, and perhaps more importantly;
- it will be above the base level of the means test, thereby putting an end to any state-financed disincentive to save. The fiendishly complicated Pension Credit will be swept away.

In addition, the White Paper protects people's rights to past-accrued BSP and ASP, and translates their pre-implementation National Insurance records into a simple single-tier starting amount: the "foundation amount". If this exceeds the full amount of the STP, the surplus "protected payment" will also be paid, at State Pension age.

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1 Michael Johnson, *The approaching cashflow crunch: why Coalition reforms to public sector pensions will not hold,* Centre for Policy Studies, November 2012.

2 DWP, *The single-tier pension: a simple foundation for saving*, 14 January 2013.

3 Note that the estimates for employer contributions and the cashflow shortfall are for 2015/16, while the £9 billion estimate of additional costs is for the early 2020s. As the first two estimates are expected to increase significantly by the early 2020s, the £41 billion total cost in the early 2020s could be considered as low.

4 To be uprated by inflation between now and the introduction of the single-tier pension.

2. THE UNACKNOWLEDGED COSTS OF FUTURE PUBLIC SERVICE PENSIONS

The White Paper provides some clarity in respect of two additional costs of meeting future public service pensions. Neither is included in the cost modelling behind the Public Service Pensions Bill.

2.1 NICs rebate circularity

Contracting out of S2P will end with S2P's demise. In the meantime, in 2012-13, contracted-out NICs rebates are expected to cost the Treasury £6.3 billion.[5]

But ending the rebate will ***not*** produce a £6.3 billion annual cashflow saving. Consider the following:

- There are seven million contracted-out workers: 1.7 million (24.3%) in the private sector and 5.3 million (75.7%) in the public sector.
- Assuming that the average wage (and wage distribution) in the two sectors is the same, the NICs rebate attributable to the public sector is £6.3 billion x 75.7% = £4.8 billion, split as £3.4 billion due to employers and £1.4 billion due to employees (reflecting their respective rebate rates of 3.4% and 1.4%).

Public sector employers – in other words, the state – will have to fund the NICs increase themselves. Thus, from 2017, there will be an additional cost to meeting public service pensions of £3.4 billion per year. This appears to have been ignored in the modelling underpinning the Public Service Pensions Bill.[6]

As an aside, it is not clear whether public sector employers' additional NICs will count in terms of hitting the employers' cost cap mechanism within the Bill. Final details of how this crucial cost control mechanism will operate are not yet in the public domain.

2.2 Single-tier pension transition costs

Contracted-out occupational pension schemes have historically used employer NICs rebates to provide a larger pension, to compensate employees for their lack of S2P accruals. After the introduction of the new STP, such schemes will lose the employer rebate (contracting-out having ended), and could therefore be expected to reduce benefits, or increase member contributions.

Indeed, the DWP White Paper specifically permits private sector employers to amend scheme rules without trustee consent. However, because the Government gave a commitment to Parliament that the public service pensions reforms should remain unchanged for 25 years, public sector employers will not be able to offset their increased NICs by reducing benefits.[7] Consequently, public sector employees will continue to enjoy their enhanced occupational pensions, as if still contracted-out, ***but they will also be entitled to further accruals within the single-tier state pension.*** Conversely, many of today's contracted-in (private sector) employees will *not* be able to add any accruals to their STP entitlement.

An example to illustrate how public sector workers will benefit disproportionately from this is provided in the box, overleaf.

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5 HMRC Statistics Table 1-5, *Estimated costs of the principal tax expenditure and structural reliefs.*

6 While the DWP's Green Paper on state pension reform (*A state pension for the 21st century*, April 2011) was published a month *after* Lord Hutton's final report, there has subsequently been almost two years in which to acknowledge the cost consequences, for public service pensions, of ending contracting-out rebates.

7 See page 40, paragraph 65 and page 41 paragraph 71, respectively, in the White Paper.

How public sector workers will benefit: an illustration

In 2017, John and Joan will both have been working for 30 years, and each will be earning £40,000 p.a. in 2017 money (the year the STP is likely to commence). John is in the Civil Service, while Joan is in the private sector.

The contracted-out (predominantly public sector) worker
As a public sector worker, John is currently contracted-out of the additional State Pension (ASP). In 2017 he will have accrued weekly pension entitlements of approximately:

Basic State Pension: £107.45p, the full BSP after 30 years of paying NICs.

Additional State Pension: Nil, as he is contracted-out.

Occupational pension: £300, which includes £100 to substitute for being contracted-out of the ASP.

John's foundation amount is therefore £107.45p (BSP plus ASP). This is less than the forthcoming STP maximum of £144. As a result, from 2017 he will accumulate additional STP accruals at the weekly rate of £4.11 for each qualifying year of working (capped at £144), until reaching the State Pension age (as will the relatively few contracted-out employees in the private sector).

The contracted-in (private sector) worker
Joan is in the private sector and is contracted-in to the ASP (as are almost all private sector workers). On transition to the STP, she will have accrued weekly pensions of approximately:

Basic State Pension: £107.45p

Additional State Pension: £100

Occupational pension: £200, which assumes Joan is in a defined benefit (DB or final salary) scheme on a par with John's scheme.*

Joan's foundation amount (£207.45p) *exceeds* the STP of £144, so she will *not* be eligible to accumulate any further STP accruals over her remaining working life.

Analysis
If John and Joan were both to continue working for another five years beyond 2017, each of them would have a total of 35 years' of NICs. Consequently, John would now be eligible for a STP of £128 (£107.45p of full BSP plus £20.55p, after five years of additional STP accruals at the weekly rate of £4.11 for each year). Conversely, Joan would have not any additional accuals to add to her foundation amount of £207.45p (which she will be paid, as £144 of STP plus a protected amount of £63.45p). John's ability to continue to accrue STP rights is blatantly unfair, as well as representing another unforeseen cost associated with providing public service pensions, once the STP is introduced.

* In reality, her occupational pension is likely to be DC-based and far smaller, the private sector having become almost a DB desert.

The cost of additional STP accruals

One method of estimating the annual cost is to project the annual total of all public sector employees' STP accruals in excess of their foundation amounts (their STP entitlement on the day it is introduced), up to the maximum of £144 per week. This would require assumptions to be made for how long each employee would remain working in the public sector after 2017, and their life expectancy in retirement.

Thus, for example, if employees working in the public sector when the STP is introduced were, *on average,* to continue working within the public sector for four more years, the additional annual cost to the Treasury, in increased STP entitlement, would be in the region of £4 billion per year.[8]

This figure takes into account the additional income that the Treasury will receive from higher employee NICs (their 1.4% rebate having ended with the introduction of the new STP). In the meantime, public sector employees would continue to accrue benefits within their occupational pensions at an enhanced rate, as if they were still contracted-out.

2.3 A "rebate-derived amount"

The White Paper gently refers to a "rebate-derived amount", to be deducted from the single-tier valuations of those who are, or have been, contracted-out of the ASP prior to the introduction of the STP.[9] The objective would appear to be to take account of the lower rate of NICs paid when contracted-out: this *could* signal an intention to restore some equality between contracted-in and contracted-out employees, but no further details are yet available (notably in respect of how large the amount would be).

[8] See Appendix I for details of this calculation.

[9] See page 47, paragraphs 84 to 86.

2.4 Fairness: a broader perspective

People who are currently contracted-out (predominantly public sector workers) have more to gain from the proposed STP than those who are contracted-in (mainly private sector employees). But contracted-out employees are predominantly the same population which enjoys defined benefit (or final salary) pensions. In other words, they already have the best pensions in the land.

Thus it would seem that the ability to accrue future STP is focused on those who need it least. Surely it should be those who are currently contracted-in who should qualify for more state pension support, through the new STP architecture?

3. INCREASING LIFE EXPECTANCY

Full population projections for the UK are produced every two years, the current set being referred to as 2010-based (published in October 2011 by the ONS). The 2012-based projections are expected to appear later this year, and when they do, they will be six years "fresher" than the 2006-based projections used in the modelling that underpinned Lord Hutton's proposals. Furthermore, the rate of improvement in life expectancy has long been underestimated.

Life expectancy in the UK has, for many years, been improving at a rate of between three and four months per year.[10] If we assume that this were to continue, then it would be reasonable to update the Lord Hutton modelling by adding another 21 months, say, to life expectancy. This would add £2.1 billion per annum to the cost of public service pensions.[11]

[10] In 2010, average life expectancy at birth across the UK, for both men and women, rose by four months to 78.2 and 82.3 years respectively: ONS.

[11] See Appendix II for details of this calculation.

4. WHAT NEXT?

At this late juncture, one option would be to pursue a judicial review. There are two specific paragraphs in the White Paper that warrant attention in this regard:

Page 40, paragraph 59:

> *The Government recognises that losing the rebate will be a challenge for sponsoring employers of Defined Benefit schemes. The Government believes it is right to enable private sector employers to change their scheme design to adjust for the additional cost since this is a direct result of a government policy change.* ***The Government therefore proposes to give employers powers to change scheme rules for this purpose without trustee consent.***

Page 41, paragraph 71.

> *The Government has given a commitment to Parliament that the reforms to public service pensions should endure for 25 years, setting a high bar for future scheme changes in the Public Service Pensions Bill.* ***Public service employers will therefore not be able to pass the cost of increased National Insurance contributions onto their employees by reducing the value of pension scheme benefits or by increasing employee contribution rates to their pension schemes.***

This would appear to discriminate against private sector employers' pension arrangements. Every Bill must be certified as being compliant with the Human Rights Act 1998. That in turn incorporates European Convention on Human Rights (ECHR) jurisprudence. If it is discriminatory, then it will be in breach of the ECHR, and therefore not certifiable. That avenue is now being explored but, to be clear, the ultimate objective would be to influence amendments to the Public Service Pensions Bill, not to halt progress towards a single-tier state pension.

5. CONCLUSION

Given that the full cost implications of future public service pension provision appear not to have been understood, it is essential that the Public Service Pensions Bill is reconsidered before it can complete its passage through Parliament.

The unacknowledged additional costs, predominantly those introduced via the DWP White Paper, will manifest themselves as a much larger cashflow shortfall, between contributions and pensions in payment, than is currently envisaged. By 2016-17 the OBR expects the shortfall to be £15.4 billion (or £32 billion if employer contributions are included). But if the DWP's White Paper were to be implemented as it stands, within a decade, the shortfall could be approaching £24 billion. In addition, the taxpayer would still be ultimately funding employer contributions of at least a further £17 billion.

So, if the Bill were to become law as it stands, we would be embarked upon an almost unparalleled perpetration of inter-generational injustice: the young will have to pay for the older generation's pensions at the expense of their own provision. Furthermore, even after the latest reforms, public sector workers will continue to enjoy certainty of income in retirement until the day they die, predominantly paid for by the 80% of the workforce in the private sector, very few of whom enjoy such certainty.

APPENDIX I

The cost of additional STP accruals: an example

If everyone working in the public sector at the time the STP is introduced (probably in 2017) were to continue working within the public sector for an average of four more years, the increase in STP entitlement would create a substantial additional annual cost to the Treasury. Ignoring inflation and indexation effects, this would be £4.4 billion, determined as:

5.2 million employees x weekly accrual rate of £4.11p x 52 weeks x 4 years

This figure does not take into account employees' lost NICs rebates of 1.4% of band earnings, which would be additional income for the Treasury. If we assume as average annual income of £25,000, i.e. £480 per week, then:

(£480 – primary threshold of £146) x 1.4% in additional NICs x 52 weeks = £244 per year in extra NICs per employee.

On average, this would be paid each year for four years, by 5.2 million employees, raising:

£244 x 4 years x 5.2 million = c. £5.1 billion

This lump sum needs to be converted into an annual sum. Assuming everyone lives for 15 years in retirement, then the additional income to the Treasury is equivalent to:

£5.1 billion / 15 = £340 million per year.

The net cost to the Treasury, after adding back the additional NICs income due to the end of the NICs rebate, would then be:

£4.4 billion – £340 million = **c.£4 billion per year**

APPENDIX II

The additional cost of rising life expectancy

The modelling that underpinned Lord Hutton's proposals is now out of date by six years: in particular, 21 months should be added to life expectancy projections. The approximate additional cost for the provision of public service pensions (beyond 2017) would then be as follows.

Public service pensions' cost for 2011-12:	£27.4 billion
Number of public service pensioners:	3.2 million
Average pension:	£8,560

If the additional 21 months of life expectancy were to arrive instantaneously, all today's workers aged within 21 months of retirement (i.e. the next 21 months of the pensioner population) would become pensioners before any of today's pensioners die, thereby boosting the pensioner headcount, and allied cost.

Data from the 2011 census indicate that there are 1.3 million people in this age group, 19% of whom work in the public sector.

1.3 million x 19% = 247,000 additional public sector workers who will become pensioners, in addition to the existing pensioner population.

The additional cost of pensions in payment would then be:

247,000 x £8,560 average pension = **£2.1 billion per year**

THE AUTHOR

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