Are Government Pensions Unfair On the Younger Generation?

"Public and private sector pensions used to be broadly comparable, but now they are worlds apart in terms of take-up and the benefits they pay."

Lord Matthew Oakeshott[1]

"Lord Hutton's recommendations on public sector pensions have led to calls for industrial action by public sector unions, but the reality is that his proposals will still leave them with hugely generous pensions that most private sector workers could never hope to achieve."

Ros Altmann, Director General of Saga[2]

"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."

Lord John Hutton[3]

Foreword by Ed Howker, Co-founder
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Foreword

Britain's public sector pension system is a mess. Largely unfunded, it will cost the Treasury more than a trillion pounds in the coming decades. Everyone, it seems, is angry about that.

Public sector workers feel their pensions have been unreasonably targeted for cuts by a government pursuing fiscal austerity. They can justifiably claim that their bountiful pension agreements were part and parcel of their employment packages and should be honoured as such. Now, they are poised to strike.

Meanwhile private sector workers have a particular reason to feel unhappy about the situation: their pensions are not only much more parsimonious, but many – 13 million people in fact – do not have one at all. Put simply, a chasm has opened up between what private sector and public sector workers can expect in retirement. The size and depth of that chasm is revealed in this paper.

New figures compiled by the Intergenerational Foundation show that more than 78,000 ex-public sector workers collect annual pensions of £25,900 or more – Britain's average salary. Of these, 12,000 receive more than £50,000 and many more will join them in the coming decade. Today in Britain, the average annual public sector pension is about £7,000, the private sector equivalent is a little more than half that: £3,700.

Some on the right argue that the state has no alternative but to find ways of closing this gap and making public sector pensions more affordable by cutting the payouts. As a result the government proposes to bring the public sector pension age in line with the state pension age, to increase employee contributions and to tie inflation-linked pension increases to the Consumer Price Index rather than the faster-growing Retail Price Index. The Unions, meanwhile, have dismissed these moves as creating a race to the bottom arguing that public pensions shouldn't fall simply because their private equivalents are inadequate.

Whatever your opinion on the matter, it seems certain that both systems could be in better shape. Throughout the 1990s politicians on the left and the right debated how best to address the implications of increased longevity. In an era when private sector pension funds were booming the future seemed much brighter than it has turned out to be. Proposals were made to privatise the public system at that time and Hansard became littered with exchanges between the Social Security Secretary and his Shadow on the issue, though little serious reform was completed. A golden opportunity was lost.

But in the debates – past and present – about public sector pension reform, there is one constituency who are too often ignored in it – future workers. And that's a huge problem because decisions made on pensions today are felt in full effect for decades. They are the ones who will pay.

This paper offers a range of suggestions about how the system might better reflect their interests and be made more robust. I do not endorse all of its proposals but there are two that it seems impossible to argue with:

Firstly, it is high time that the government becomes more transparent about future public sector pension costs. As things stand, the future liability is modelled using a very narrow set of parameters and it is not modelled often enough. The projected unfunded liability is based on assumptions about the size of the public sector workforce and a growth rate which are, by definition, uncertain. It would be reasonable for public sector pension schemes to produce official projections of their future liabilities every year, that incorporate a range of different discount rates and longevity assumptions.

Second, it seems reasonable that a catch-all clause should underpin public sector pension, spending as happens in Japan. The total extent of government expenditure on public sector pensions could be capped at, for example, 2 per cent of GDP simply in order to ensure that spending is kept within reasonable limits. If the projections completed by Lord Hutton - who undertook the most recent pension review for the Coalition - are correct, the catch-all wouldn't apply in any event. He suggests that the costs won't ever breach 1.9 per cent if his reforms are adopted. This, therefore, is an uncontroversial proposal that offers a copper-bottomed guarantee that taxpayers won't get any more nasty surprises.

Hammered by falling annuity rates and rising inflation, pensioners from both the public and private sectors have good reasons to feel anger. For too long, Britain has been run for short-term advantage rather than long-term stability and the cumulative effects are being felt across the generations. The challenge in the coming decades will be to make our pensions as well as the rest of our economy robust once more.

Ed Howker

Co-founder, IF and co-author of *Jilted Generation*

April 2012

Executive Summary

The Intergenerational Foundation (IF.org.uk) is a politically independent charity that promotes the interests of younger and future generations in British policy-making. IF examined the intergenerational fairness of pensions in the public sector (civil servants, teachers, the armed forces, the police and NHS staff) and made some startling discoveries:

* The total liability from public sector pension schemes is equivalent to over £1.2 trillion (£1,200,000,000,000), which is more than **£45,000 per UK household**. Most of these schemes are unfunded. No money has been put aside to pay them.

* The current public debate is on whether these pensions can be afforded. **Intergenerational fairness** is virtually ignored. To make the pensions affordable in the short term, commitments have been made which attempt to tie the hands of future generations of taxpayers.

* There are already over **78,000 ex-public sector workers receiving annual pensions of more than £25,900.**

* Over **12,000 ex-public sector workers collect pensions of over £50,000 per year**, according to FOI responses obtained by the Intergenerational Foundation.

* 88% of public sector workers are currently entitled to pensions related to their final salaries, **compared to less than 10% of workers in the private sector**.

* Payments for these public sector pensions will largely come from people who can't even afford to save for a pension themselves: **13 million private sector workers will currently get no pensions other than the state pension**.

* The average public sector pension is about £7,000 p.a., **compared to an average of £3,700 among retired private sector workers with private pensions**.

* **The pensions debt, to be paid by future generations, is increasing rapidly** because the government is not putting aside anything to meet its obligations to employees.

The report suggests some policy options, including taxing high public sector pensions and eliminating pension benefits that are not contractually guaranteed, including from future earnings.

Background

The quality of pensions available to public and private sector workers has become increasingly polarised in recent years, raising the prospect of a serious intergenerational injustice.

Through their taxes, younger workers in the private sector have to pay for unfunded public sector pensions that are likely to be much higher than anything they will themselves receive in the course of their own retirements.

To follow how this has happened, it needs to be understood how pensions work in the first place. There are two types of pension: Defined Benefit (also referred to as "final salary") and Defined Contribution (also referred to as "money purchase").

Defined Benefit (DB) or "Final salary" pensions used to be the most common type in both the public and private sectors, but now the vast majority of them are found in the latter, as Fig. 1. illustrates. These work by allowing employers to deduct a certain percentage from an employee's income (their "contribution rate") which then goes into the pension scheme. This is typically somewhere between 6% and 12% per year. When they retire, **they** are paid a pension through this scheme which is equal to a proportion of their final salary, usually either two-thirds or half. Many people assume that their contributions have built up a personal "pension pot" from which their pension is then paid out, implying that they have paid for the pension they receive directly. In actual fact, most final salary pension schemes run on an unfunded, or "pay-as-you-go" model, where the contributions paid in by current workers are immediately paid out again to pay the pensions of current retirees. Workers who have been contributing have no personal "pension pot" to fall back on at all; all they have is a promise (sometimes explicitly contractual) that they will receive a pension under the same system when they retire themselves. Exactly how legally binding this promise really is has been the subject of litigation.

The key element of this is that the contribution rate is NOT a way of saving for your own pension, but instead is more like a kind of tax based on how many pensioners need to receive a pension at any one time. This explains why, for example, many people in final salary pension schemes were given reduced contribution rates and even "contribution holidays" as recently as the 1980s. This was because in the 1980s Britain still had a much more favourable demographic profile. The number of workers was relatively high because the children of the early 1960s baby boom were just entering the workforce, while a combination of World War One, the Spanish Flu epidemic and Britain's low fertility during the Great Depression decades meant there were relatively few people in their 60s and 70s who were receiving pensions.

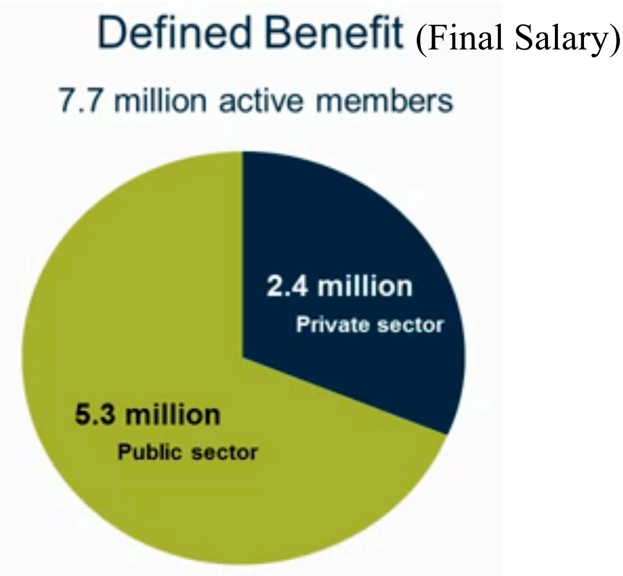

Fig. 1. Defined Benefit (DB) pension enrolments, number of active contributors, 2009[4]

The UK labour force contains roughly 29 million active workers, of whom 6 million work in the public sector and 23 million work in the private sector.[5] Figure 1 indicates that 88% of public sector workers are currently contributing to a Defined Benefit (DB, or final-salary) pension scheme, compared to just over 10% of workers in the private sector. As most private sector employers have closed their DB schemes to new members, this 10% represents the older part of the private sector workforce. Most existing DB schemes also no longer allow current members to accrue further pension rights, which again disproportionately disadvantages younger workers. Even the figure of 2.4 million workers is exaggerated, as the total for the private sector incorporates people working for organisations that are largely government-funded, including both the Royal Mail Pension Fund and the BBC Pension Fund.

Increases in longevity throw up huge problems for such schemes, which is why the vast majority of private sector companies have shut down their final salary pension schemes or closed them to new members.

Fig.2. is taken from the Hutton Report into public sector pension schemes. It shows that the typical person retiring today from a professional occupation can now expect to live for 28–30 years. This is indicative of the huge increases in longevity which were witnessed in the latter part of the 20th century.

This has posed a serious challenge for private sector final salary pensions because, as longevity increases, more and more pensioners are alive at the same time, meaning the annual bill that needs to be paid by the contributions from existing workers keeps on increasing. Many private sector final salary pension schemes have ended up with large deficits between the outgoings of their schemes and the contributions that have been coming in to pay for them. In order to avoid legal action from pensioners who haven't received their pensions, companies have had to start using their turnover to plug the gap, costing businesses money.

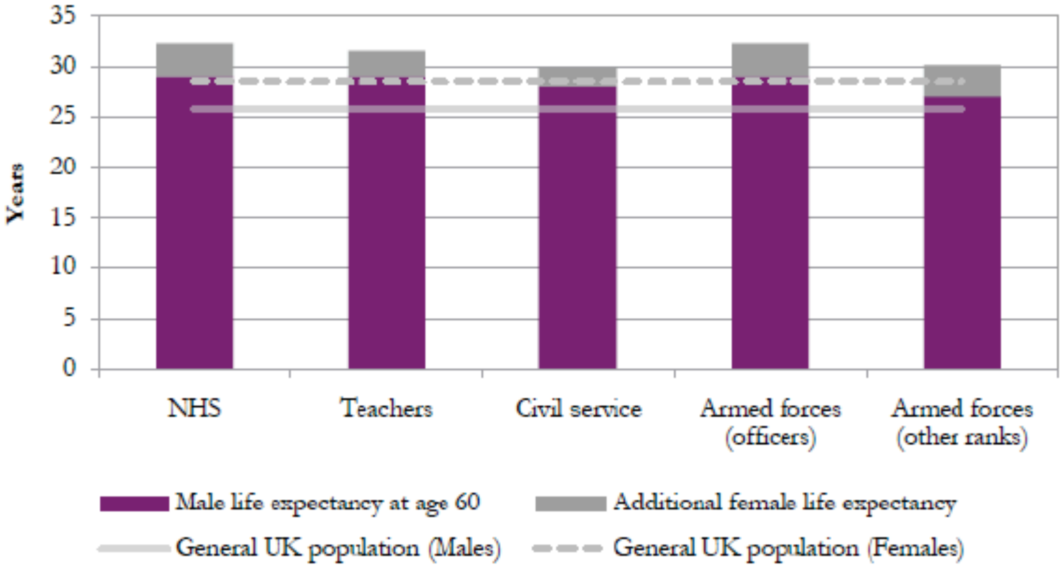

Fig. 2. Projected life expectancy at age 60 for members of public sector pension schemes[6]

The same process has occurred in the public sector, except the government uses general taxation to plug the gap between the contributions from younger workers, and the pensions demanded by older workers. This has created an intergenerational unfairness, as will be explained later.

Defined Contribution (DC) pensions are the only option available to workers in the private sector whose employer has withdrawn the offer of a final salary scheme. They work in a different way. Once again the employee has to make contributions, but this time they are stored in a personal pension fund, which is usually managed on their behalf by a financial institution and invested in the stock market. The idea is that through healthy investment returns and the substantial build-up of contributions, the fund grows to a big enough size to provide workers with a decent income when they retire. At that point they have several options: most workers with this type of pension use their fund to purchase an annuity from an insurance company – a financial product that will pay them a fixed income for the rest of their life. The bigger the personal pension fund, the larger the annuity. However, many people start saving too late, or their pension scheme fails to grow significantly, and they end up with only a small pension income in retirement. This is also explained in section 2.

Some 7.4 million private sector workers have a **defined contribution (DC)** private pension, although the benefits these pay out are usually far less valuable than those provided by a DB scheme, and the individual bears all the risk with regard to how investments perform.

The rest of the private sector workforce – 13 million people – have no private pension at all, meaning at present they will have little income in retirement beyond the basic state pension. This is disproportionately the younger part of the private sector workforce, and yet at the same time their taxes are paying for the more generous pensions available to those in the public sector – hence, they are forced to fulfil a bargain they played no part in creating. This raises questions of intergenerational injustice.

The Current Debate

In order to examine ways of putting public sector pensions on a more sustainable footing, the government launched the Independent Public Service Pension Commission, chaired by Lord John Hutton. Their final report, published in March 2011, made a number of recommendations for reform of the major public sector pension schemes, which included:

- Calculating pensions based on career average salary, rather than as a percentage of the final salary
- Increasing the retirement age for most state employees to bring it in line with the basic state pension age, which is currently 65
- Higher contribution rates for current and future workers[7]

His recommendations also included a commitment to maintaining defined benefit pension schemes for state workers and honouring all previously accrued pension rights at their present level. He did not look at ways of making them more affordable. The age structure of the public sector workforce means this will do little to alleviate the burden on the current younger and future generations of taxpayers.

Following negotiations with public sector unions, the government may well blunt the impact of its reforms if it ends up agreeing to an arrangement that would see all public workers who are currently within ten years of retirement retire at the age they previously expected to on final salary pensions[8]. The age structure of the public sector (see Fig. 7.) means that this would enable a huge number of workers who belong to the post-war generation to retire without the government saving any money, a bargain that cynically puts a larger burden onto both taxpayers and younger public sector workers, who would have to pay higher contributions as a result.

This paper argues that our current national debate about public sector pensions hasn't gone far enough to address an imbalance: The cost of funding generous pensions for workers soon to retire are being piled unsustainably onto future generations of taxpayers but these rich benefits are likely to elude the younger workers who will pay them. We will also suggest a variety of policies that could change this.

Public Sector Pensions vs Private Sector Pensions

The average public sector pension is claimed to be something close to £7,000 per year,[9] although this is a misleading figure because it includes three categories of people who between them are receiving a large number of very small pensions:

1. Those who only worked in the public sector for a small part of their career, meaning they only accrued a few years' worth of pension rights
2. Part-time public sector employees
3. Pensions being paid as legacies to widows/widowers and, in some cases, dependant children

Yet even if this figure is used as the average, the pension income of most workers in the private sector who have DC pensions is still likely to be even lower, as Fig. 3. indicates:

	Age	
	60	65
Single life, level, no guarantee	£5,535	£6,081
Single life, level, 5yr guarantee	£5,526	£6,066
Single life, 3% escalation, 5yr guarantee	£3,764	£4,317
Joint life 50%, level, no guarantee	£5,143	£5,627
Joint life 50%, 3% escalation, no guarantee	£3,360	£3,805

Fig. 3. Annual annuity rates available to a man retiring with a personal pension pot worth £100k[10]

As explained above, when workers with a DC pension retire, they usually use the money they have built up in their pension fund to purchase an annuity from an insurance company – a financial product which pays them a fixed income for life. As so many private sector workers only have personal DC pensions available to them, the "annuity rate" (the percentage of the total value of their pension pot they will receive each year) is therefore what determines the size of the income they will receive when they retire.

Fig 3. demonstrates that annuity rates in recent years have been very low. In fact, the highest retirement income workers retiring from the private sector at 60 (the age at which many public sector workers retire) would be able to obtain **would be £5,535 per year**, if they had managed to build up a pension pot worth £100,000 during their career.

However, few private sector workers are likely to have saved up this much. In the first half of 2009, the average private pension fund was worth just £24,330;[11] and the average single pensioner annuity for a male was just £3,692 per year.[12] While annuity rates are influenced by short-term factors, which mean they go up as well as down, Fig. 4. shows that a steady decrease has been the dominant trend for most of the last twenty years:

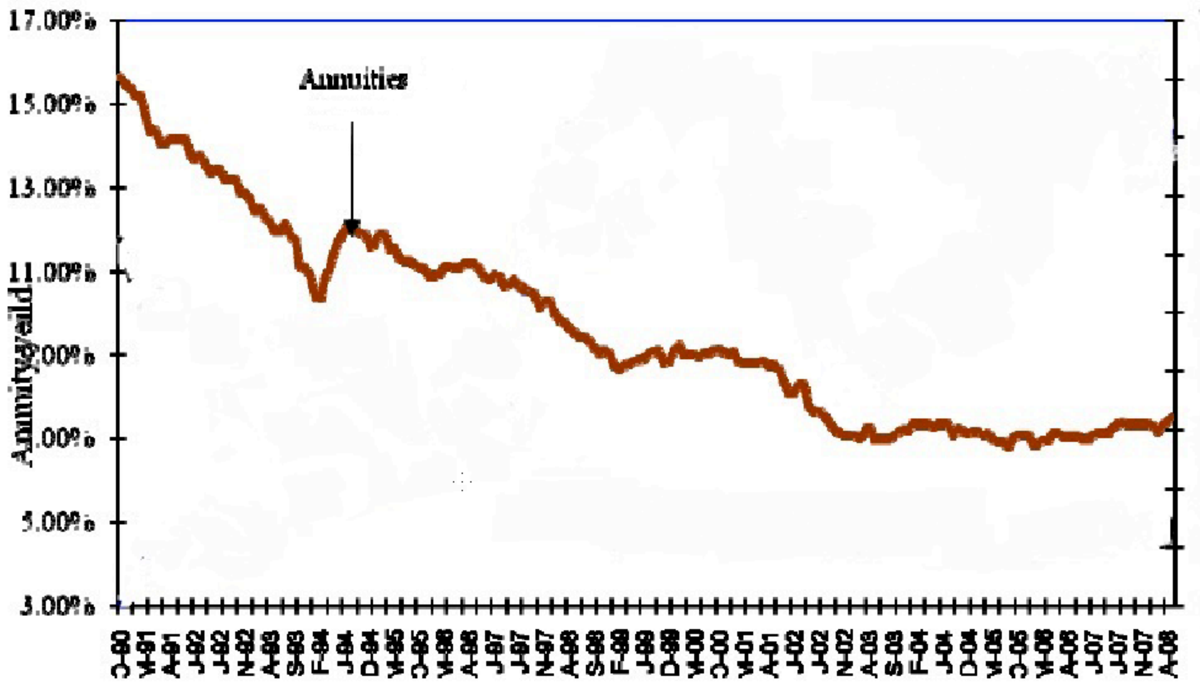

Fig. 4. Average annuity rates, 1990-2007[13]

Someone retiring in 1990 could expect to get over 16% of their fund's total value each year as retirement income, but that had fallen to nearly 7% in 2007, and the sums quoted in Fig. 3. indicate rates are around 5% at present.

With an annuity rate of 5%, retirees only get one-twentieth of the total value of the personal pension fund ("pension pot") they've built up during their working life in annual pension income. This means that, by comparison, the final salary pensions which are available in the public sector would be very expensive for someone in the private sector who has only personal defined benefit pensions available to them.

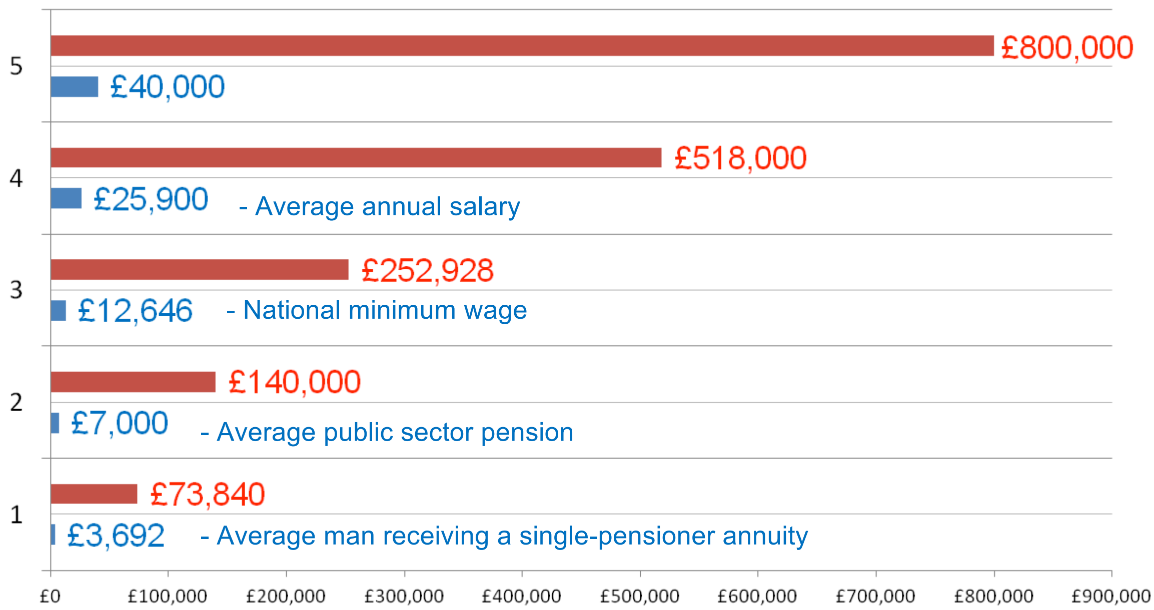

Fig. 5. Different levels of pension (in blue) expressed in comparison to the size of the personal pension fund which someone in the private sector would need in order to get them (in red) assuming an annuity rate of 5%, 2011

Fig. 5. shows that just the average public sector pension of £7,000 is equivalent in cost to a private sector worker having accumulated a personal pension fund worth £140,000 by the time they retire. Yet this would still only provide a relatively modest income in retirement; to get a pension which is equivalent to the current national minimum wage (£12,646 per year), the retiree would need a fund worth over a quarter of a million pounds, while a pension which matched the average annual salary of £25,900 would require a fund worth £518,000. In order for a couple who both worked in the private sector to retire on a combined income of £40,000, their total "pension pot" would need to have a value of at least £800,000. This demonstrates how far out of reach the type of public sector pensions identified in Fig. 6. are for most workers in the private sector.

To summarise, most private sector workers are now on their own when it comes to funding a pension, with minimal (if any) financial assistance from their employer. Yet through their taxes they also have to subsidise pensions in the public sector.

Public Sector Pensions – The Facts

While many individual public sector pensions are small, some retired public sector workers benefit from an extremely large transfer of wealth from younger taxpayers.

To illustrate the scale of the largest intergenerational transfers, the Intergenerational Foundation used Freedom of Information requests to investigate how many former public sector workers in each of the major public sector pension schemes are currently receiving:

a) a pension worth more than the average annual salary of £25,900[14]
b) a pension worth over £50,000
c) a pension worth over £100,000[15]

The results revealed that:

Pension Scheme	Category A: £25,900+	Category B: £50,000–£100,000	Category C: £100,000+
NHS	36,787	8,714	97
Civil Service	18,768	969	12
Teachers	12,947	497	8
Armed Forces	9,684	344	10
Local Government	Not Included	1,371	20
Police	Not Included	368	1
Total	**78,186**	**12,263**	**148**

Fig. 6. Number of current public sector pensions in each category

The real amounts of money involved in these transfers are substantial. To take the example of the smallest group – those receiving a pension of over £100,000 per year – they are the beneficiaries of a transfer from younger taxpayers in the private sector to retired public sector employees which is worth at least **£14.8 million per year**. This is a transfer which, because of changes to private sector pension arrangements, many of these workers are having to finance at the same time as they fund the entire burden of their own pensions themselves. The scale of this transfer is also set to increase rapidly as large numbers of doctors and civil servants who belong to the post-war generation are nearing retirement age.

Fig. 7. demonstrates the rapid ageing of the civil service workforce between 1991 and 2011. 67% of its members are now over the age of 40, compared to just 44% twenty-one years ago[16]. This suggests large numbers of civil servants will be retiring in the near future, leaving behind relatively few younger workers whose contributions are meant to pay for the retired cohort's benefits. It also demonstrates how the impact of Lord Hutton's reforms will be blunted if the government allows everyone over the age of 50 to maintain their existing benefits, as this accounts for more than a third of the present Civil Service workforce.

The case for public sector pensions being more generous than those in the private sector has traditionally rested on the argument that public sector workers were being compensated for lower salary levels. However, research released by the Institute for Fiscal Studies earlier this year showed that in fact public sector pay is actually 7.5% higher, on average, even when education, age and qualification are factored in.[17]

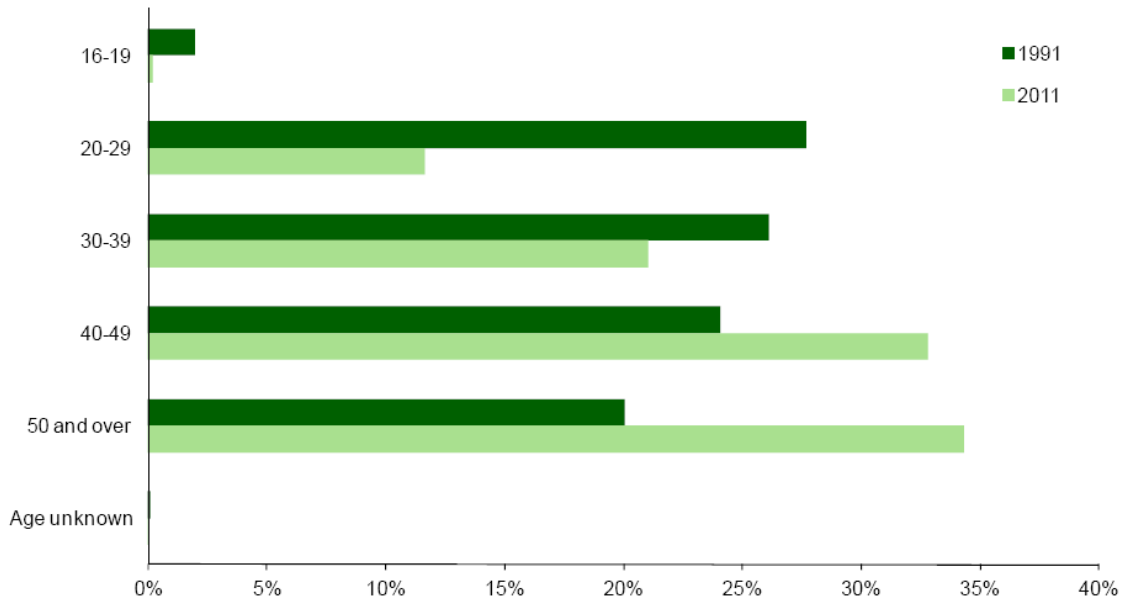

Fig. 7. Civil Service membership by age, 1991 and 2011[18]

In addition to being more generous on average, public sector pensions also have a range of other advantages over the DC pensions which now predominate in the private sector:

Index-linking – Most of the major public sector pension schemes are index-linked, meaning the pensions they pay rise with inflation, whereas Fig. 3. shows that DC pensions usually don't have this advantage unless the buyer pays for it by accepting a lower annual sum in return. A non index-linked pension effectively goes down in value each year, eroding the incomes of former private sector workers.

Investment risk – A private sector worker with a DC scheme has to bear the investment risk; this is the danger that, as their pension savings are usually invested in the stock market, their fund will not perform well enough for them to have sufficient money in retirement. If the fund underperforms, they get a lower annuity rate as a result. As the benefits of people in DB schemes are fixed regardless of how much money there is to pay for them, public sector workers do not have to bear this risk.

Longevity risk – Public sector workers with DB pensions are guaranteed to receive the income they've been promised every year for life, with the state bearing all the additional costs if they live longer than expected. However, private sector workers with DC pension arrangements have the longevity risk transferred to them in the form of lower annuity rates; increasing longevity has been the main driver of the steady decline in private sector annuity rates over the last twenty years.

Contributions – Private sector workers who take out a DC private pension because they have no occupational scheme available to them usually don't receive an employer contribution, meaning only they put money into the pension fund, whereas public sector DB pension schemes do receive employer contributions.

The Problem with Unfunded Schemes

The most important point is that higher public sector pensions aren't necessarily unfair on the younger generation in themselves; rather, they are unfair because they are **unfunded**, meaning the current younger generation of taxpayers (and further generations of taxpayers stretching into the future) will have to pay for them out of general taxation.

Pay as you go public sector pensions are fine unless there is a particular demographic hump, in which case the burden on taxpayers rises dramatically and, overall, those taxpayers end up paying a higher proportion of their income to the cohort of public sector workers than previous or future generations. This is precisely the problem Britain is currently facing.

A solution would need to redress this imbalance by redistributing the cost between the generations. It would have to involve either taking more from earlier generations (an option which it is now too late to pursue), raising the contributions of current public sector workers, and/or lowering the payouts to retirees. Hutton's recommendations contained elements of both of these last two strategies, although as mentioned above, if workers over the age of 50 are allowed to retire without the changes coming into effect it will do little to improve the overall situation.

Most public sector pension schemes are unfunded, including the ones for the Civil Service, NHS, Police, Teachers and Armed Forces. The Local Government pension scheme is more complicated because, while it is funded, it is ultimately underwritten by the government, meaning it still increases the overall taxpayer liability.

The Intergenerational Consequences

As pension liabilities are deferred into the future, it will ultimately be future generations of taxpayers who foot most of the bill for our unfunded public sector pension schemes.

This can be expressed in terms of liabilities. As people live longer, and unfunded schemes need to pay out more and more money to retirees, the public liability keep on increasing. Fig. 8. shows how the government's estimates of its unfunded public sector pension liabilities increased from £380 billion in 2002 to nearly £1 trillion in 2010 as it had to repeatedly revise up the projected longevity of the people who would be receiving them. Some economists put the liability at nearer £1.3 trillion (£50,000 per UK household).

This means that the bill for today's pensions apartheid is being handed down the generations to be paid for by our children and grandchildren. However, the long-term affordability of public sector pensions is a controversial area, with the Office for Budget Responsibility arguing that the cost of paying for public sector pensions will peak as a percentage of GDP in 2015-16 at 2% and will have fallen to 1.4% by 2060-61.[19]

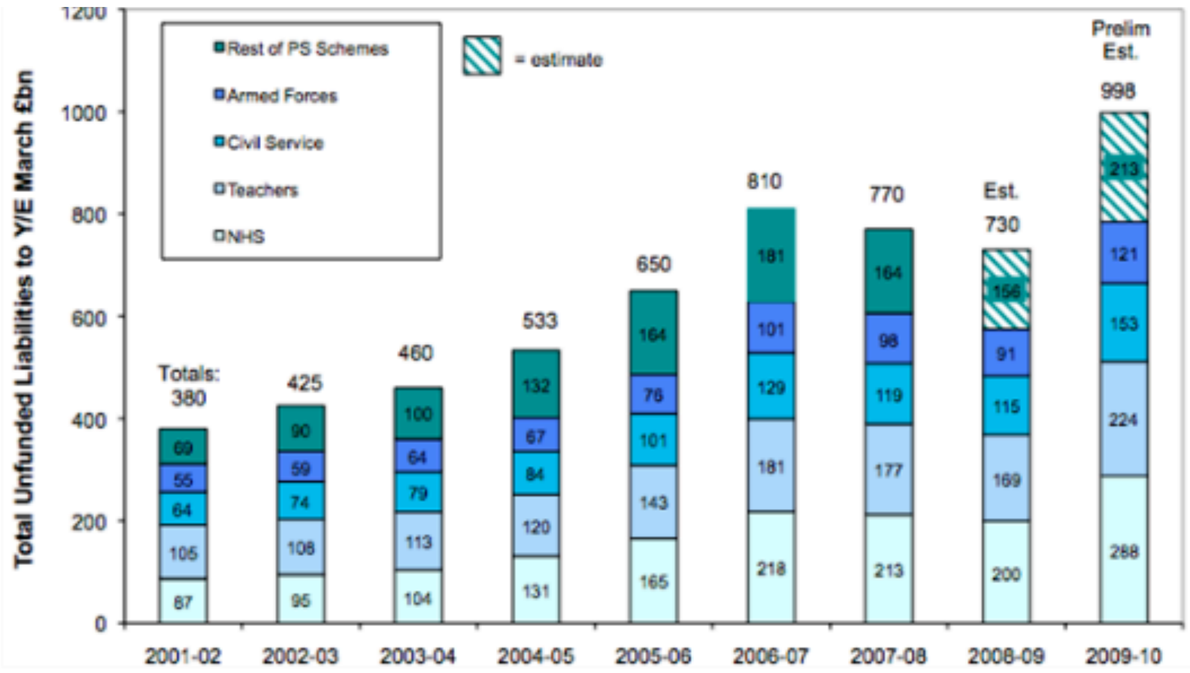

Fig. 8. UK public sector occupational pension unfunded liabilities, March 2010 estimate[20]

This is merely a projection, and it relies on a number of assumptions which mean public sector pensions may well end up being more expensive than this. In order to be realised, it relies on the British economy achieving a mean GDP growth rate of 2% a year, which was the average during the last half century.[21] There are several good reasons why our GDP growth may not return to this level:

1) **Changes from the past** – In a number of ways, Britain enjoyed highly favourable conditions for generating economic growth during the twentieth century which are unlikely to be repeated over the next 50 years.

Growth of 2% a year during this period was achieved through the youthful endeavours of the post-war generation who are now ageing and being replaced by a smaller generation of younger workers; it gained an initial boast from the huge post-war reconstruction project; government borrowing was able to rise over the long term, whereas now we will have to start paying it back, and North Sea oil was a strong source of revenue for nearly 25 years, but we are now a net importer of energy.

2) **Changing distribution of global economic activity** – The spread of globalization has seen the "developing" world grow richer, and an ever larger proportion of global economic activity taking place outside the traditional "developed" world of Europe, the US and Japan. Competition for investment is likely to become much fiercer, especially from the so-called "E7" group of the seven largest emerging markets: China, India, Brazil, Russia, Indonesia, Mexico and Turkey. The OECD estimates that by 2020 less than half of global GDP will be generated by its members, and this figure will then decline even further to just 43% by 2050.[22]

The economist Richard Ehrman argued in his 2009 book *The Power of Numbers: Why Europe Needs to Get Younger* that "as developing countries become more sophisticated and their educational levels rise, we can expect more [service] jobs to follow their manufacturing predecessors to the low-cost, fast growing economies of the East and Latin America. It will not just be call centres that are sent offshore; highly paid experts like software engineers and financial analysts will be equally vulnerable."

The UK has a younger labour force than most developed countries, but is still highly vulnerable to the ageing and slowing of the continental economies because they are our major trading partners. If Britain struggles to find new sources of growth, the entire welfare state may become vastly more difficult to fund.

Even if we do achieve the ambitious levels of GDP growth predicted by the OBR, this is still a flawed way of looking at the problem for several reasons:

Unfairness – Saying public sector pensions are affordable in the long term because they may require a smaller share of GDP does nothing to address the unfairness between public and private sector pensions which is perpetuated under the present system, and will only be carried forward into the future unless reforms are made.

Short-termism – Arguing that public sector pensions are going to be affordable decades into the future because they will cost less in terms of GDP actually demonstrates a very short-term perspective. It means that people in the future will be committed to paying these pensions, whether they can afford to or not, and it transfers all the risk that would result from Britain not achieving the predicted levels of GDP growth onto the shoulders of future generations.

Failure to achieve reforms now when we have the opportunity would be a terrible legacy to leave to future generations. By allowing unfunded pension liabilities to go on accruing, we are tying the next generation's hands, forcing them to pay for an unfair intergenerational bargain which they played no part in creating. If we want a financially equitable future, we have to stop sending the bill for public sector pensions to the "bank of son and daughter".

The financial circumstances of each of the main centrally-administered public sector pension schemes will now be explained individually in Section 3.

Individual Public Sector Pension Schemes

NHS Pension Scheme[23]

- The NHS Pension Scheme is the largest centrally-administered public service pension scheme in Europe.
- As of 31 March 2011:

Active Members (contributors)	Deferred Members	Pensions in Payment
1,320,479	560,332	669,090

- Current pensioners are receiving £4.93 billion per year between them
- Official liabilities: **£257.7 billion**
- Official funds to pay this: **Nil (unfunded)**
- The scheme's official liabilities of £257.7 billion represent a fall from £287.6 billion the year before. However, this represents a one-off decrease which is explained by the change from RPI to CPI for pension indexation. In any case, liabilities will continue to grow in the coming years, and arguably could be even higher if a discount rate of 1% was used rather than the 3% which has now been adopted.
- 16,630 pensions ceased during the 2010–11 financial year because of pensioner mortality, but 42,010 people were newly-retired. Fig. 9. shows the extent to which new retirees have outstripped pension cessations in each of the last four financial years:

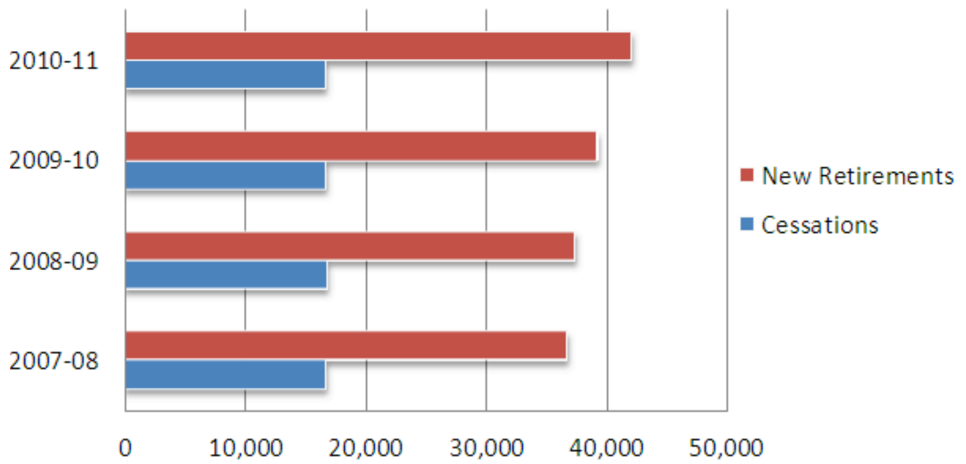

Fig. 9. Pension cessations vs new retirements in the NHS pension scheme, 2007-2011 financial years[24]

Civil Service Pension Scheme[25]

- As of 31 March 2010:

Active Members (contributors)	Deferred Members	Pensions in Payment
574,000	345,000	592,000

- The 592,000 pensions in payment paid out £3.67 billion between them
- This means that in 2010, for every person receiving a Civil Service pension there were only **0.97 workers** providing contributions to pay them
- The scheme had a net income of £3.38 billion (mostly from contributions made by current employees) but had net outgoings of £10.72 billion – creating a shortfall of £7.34 billion
- Official liabilities: **£153 billion**
- Official funds to pay this: **Nil (unfunded)**

Teachers' Pension Scheme[26]

- As of 31 March 2010:

Active Members (contributors)	Deferred Members	Pensions in Payment
658,351	426,496	588,441

- The 588,441 pensions in payment paid out **£6.15 billion** between them
- There was a shortfall of **£2.53 billion** between contributions from active members and the pensions in payment, an increase from £2.14 billion during the 2009-10 financial year
- Official liabilities: **£192.4 billion**
- Official funds to pay this: **Nil (unfunded)**
- The scheme's official liabilities of £192.4 billion represent a fall from £223.9 billion the year before. In any case, liabilities will continue to grow in the coming years, and arguably could be even higher if a discount rate of 1% was used rather than the 2% which has now been adopted.
- The key demographic trend among members of the scheme is that people are retiring at a rate which is much faster than pensioner mortality, leading to a rapid increase in the number of pensions being paid. In the 2010-11 financial year 15,080 pensions stopped being paid because of pensioner mortality, but 35,850 previously active members of the scheme retired.
- Fig. 10. shows that in the five-year period between 2006 and 2011, nearly three new pensions started being claimed for every single pension which ceased; in total, 63,730 pensions stopped because of pensioner mortality, but 157,131 members of the scheme retired.

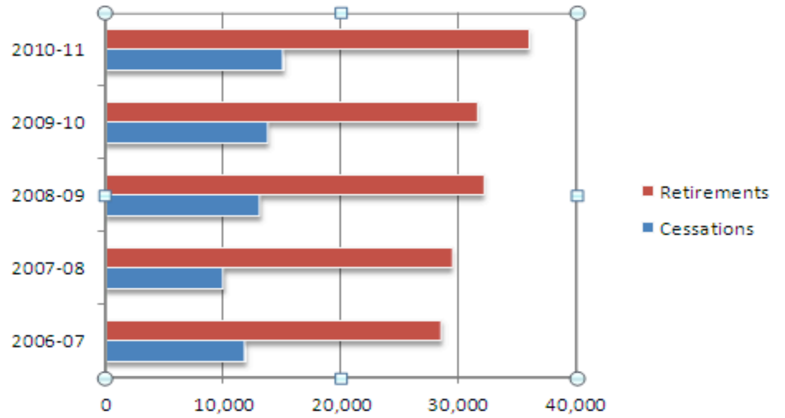

Fig. 10. New retirements vs pension cessations per year, 2006-11[27]

Armed Forces Pension Scheme[28]

- As of 31 March 2010:

Active Members (non-contributory[29])	Deferred Members	Pensions in Payment
198,032	405,865	398,840

- Official liabilities: **£120.7 billion**
- Official funds to pay this: **Nil (unfunded)**
- In the 2009-10 financial year 10,585 pensions stopped being paid because of pensioner mortality, while 14,016 members of the scheme began receiving their benefits; however, this scheme is dissimilar to the other unfunded public sector pension schemes in this regard because members begin claiming their benefits at a variety of different ages, depending on when they leave the army and whether they are invalided out.

Solutions

In order to address the intergenerational injustice of public sector pensions, we need to find some way of reforming the system through which they are funded. For such a solution to be intergenerationally fair, it would need to satisfy several key criteria:

- **Not tying the hands of future generations.** The problem with our current system of unfunded public sector pensions is that they allow people to accrue commitments to receive pensions from future taxpayers regardless of the ability of those future taxpayers to pay. We need a new system in which people take much more of the direct financial responsibility for their own retirements so we do not burden people with paying for them in the future.

- **Limiting the risk.** Under the present, unfunded system, future taxpayers bear all the risk of people living longer than they were expected to in their retirements. There is also the injustice that our current way of assessing pension affordability using projections of future GDP growth transfers all the problems of us not meeting those targets onto people in the future. We must find a way of not passing these risks onto our children.

- **Accepting more of the responsibility.** Current public sector workers must mirror the changes in pension funding that have been applied across most of the private sector, and take more financial responsibility for their own retirements, rather than simply accruing entitlements which will weigh heavily on the shoulders of future taxpayers.

Recommendations

The Intergenerational Foundation proposes several possible changes to the current system of unfunded public sector pension schemes, all of which would help to readdress the balance in favour of current and future taxpayers:

1. Phase out final salary pensions in the public sector

If we accept that it is wrong for workers in the private sector to be funding more-generous pensions for those in the public sector, then the obvious answer is for the public sector to mirror the private sector and gradually phase out final salary pensions, in favour of the defined contribution model. This would be the fairest solution for younger and future private sector workers, as it would mean nearly all workers took full financial responsibility for their own incomes in retirement, so the hands of future generations would no longer be tied by inherited pension commitments.

The changes which have been made to the BBC pension scheme offer a useful blueprint for how such reforms could be carried out. Until 2010, the BBC pension scheme was like the rest of those in the public sector, offering unfunded final salary pensions. However, this created a large deficit between its total liabilities and the amount of money which was being provided by contributions to pay for them – estimated at £1.6 billion in May 2011.[30]

In order to plug this gap, it was decided that from 1 December 2010 the final salary pension scheme would be closed to new entrants. People who were already members would still receive their benefits from the final salary scheme, but their pension would be calculated in a different way. Rather than receiving half or two-thirds of the salary they were receiving during their last working year at the BBC for the rest of their lives, existing members would instead get their salary at the time the scheme was closed to new members plus a maximum of 1% for each subsequent pay rise. This will dramatically lower the cost of paying out many of the pensions which have been promised under their scheme, and represents an important step towards minimising the exposure of future taxpayers to the cost of unfunded final salary public sector pensions.

People who joined the BBC after December 2010 will now be enrolled in a new defined contribution scheme called LifePlan, administered by Friends Provident. Members of this scheme are allowed to contribute up to 10% of their salary a year, which will be matched by the BBC. Friends Provident runs a variety of investment funds into which they can put their money, with most people expected to purchase an annuity when they retire.[31]

In intergenerational terms, this has the potential to be a very successful model, with the burden upon future taxpayers being minimised by the fact that the scheme members will be shouldering most of the risk. There seems to be significant potential for replicating similar reforms in other branches of the public sector.

2. Create a fund to help future generations

The government is already paying a large amount towards the cost of public sector pensions, but as these are currently unfunded the amount it pays out in one year does nothing to assist with paying the pensions again the following year.

Instead of passing this burden onto future generations, the government could phase in the development of a fund to help pay its future pension liabilities, using both its employer contribution to these pensions and the employee contributions of current workers. This fund could be invested in the stock market or public infrastructure, creating a valuable source of finance which would help the wider economy.

3. Publish data on pension liabilities

The unfairness of the present arrangements is compounded by the fact that the total public sector pension liabilities are not calculated regularly enough, and when it does publish them the government often chooses to use a high discount rate, making the liabilities appear smaller than they really are.

Currently a discount rate of 3% is used because the government assumes economic growth of 3% per annum will be achieved. It would be helpful also to calculate the liability with a discount rate of 0%, 1%, or 2%. Official projections also require certain assumptions about pensioner longevity which only produce one view of the possible future scenario.

In order to create a better-informed debate about the liabilities we are leaving for future taxpayers, the public sector pension schemes should be required to produce official projections of their future liabilities every year, which incorporate a range of different discount rates and longevity assumptions. Publishing such information would incur little cost, and would enable us to have a much more comprehensive debate about the burdens we want to leave to our descendants.

4. Impose a progressive tax on the highest public sector pensions

As explained elsewhere in this study, there is a large gap between the amount public sector workers have paid towards their pensions in contributions and what they will receive once they have retired. This is most significant for the public sector workers who have the highest pensions.

One way of addressing this imbalance without having to re-draw existing contracts would be for the government to levy a progressive tax on public sector pensions that are above a certain threshold (for example, £20,000 per year). Two consecutive governments have set a precedent for specific taxation of certain types of income with their tax on bankers' bonuses, which was designed partly to avoid having to re-draw existing contracts. To ensure it was progressive, the tax rate would have to rise with the level of pension (so people on higher pensions paid more).

5. Explicitly protect future taxpayers

Public sector contracts could be re-written so that their pension arrangements explicitly protect future generations of taxpayers from being unfairly burdened with commitments.

A system could be devised to limit taxpayer exposure, under which the total amount of government expenditure on public sector pensions is capped at 5% of the government's total tax take or 2% of GDP, whichever is lower, similar to the strategy which was adopted several years ago by the government of Japan. A mechanism would need to be devised for scaling-down payments progressively in the event that this ceiling was breached.

Alternatively, the government could put a cap on pension accrual for workers in final salary pension schemes which would limit the maximum pension they had to pay out to each worker – this could be £40,000 per annum, for example.

Once workers reach this limit, they could have the option of supplementing their pension income by paying additional contributions into a workplace defined contribution scheme (which the government would also make employer contributions towards), if they wanted to top up their pension income further.

6. Establish a new commission on public sector pensions

The recommendations of the previous commission chaired by Lord Hutton have proved inadequate in the face of a rapidly worsening economy (as his quote on the cover of this report illustrates), while several of the assumptions they relied upon have proven to be too optimistic, and the concessions made by the government in negotiation with public sector unions have produced a settlement which is still unfair on younger and future generations.

A new independent, bipartisan commission should be created by the government to help adjudicate between the competing demands of public sector workers and the general taxpayer, as well as the needs of future generations, in order to produce a concrete settlement which can stand the test of time.

Conclusion

Rising longevity means that Britain's pension systems must change in order to remain affordable. This is inevitable; yet there is a serious danger that the younger generation will end up getting the worst of both worlds, forced to uphold the bargain they've inherited which guarantees generous pensions to their parents and grandparents, only to retire with a very meagre income themselves.

Millions of young workers in the private sector are sleepwalking towards a retirement where an annuity income of £5,000 per year will seem generous. The average annuity income for a male pensioner at the moment is just £3,692, and the long-term trend is downwards. Meanwhile, one lucky cohort of post-war public sector pensioners is insulated from the trouble.

If we imagined, just briefly, that Britain was starting from scratch tomorrow; that public sector and private sector workers were both in vulnerable positions and that we had £1.3trillion of spending to enhance their retirements, we almost certainly would not connive to create a system as iniquitous as that which currently stands – with millions of private-sector pensioners left out in the cold while the public sector retirees thrive.

Indeed, as governments are forced to raise taxes to pay for the costs of our ageing population, younger workers may well put even less aside for their own retirements, reinforcing the severity of the hardship they will face when they eventually reach old age themselves.

This is why it represents an unfair intergenerational transfer for younger workers to have to support public sector pensioners on pension incomes which are much more generous than anything they will be able to afford themselves. As the evidence in this report has shown, most of the unfunded public sector schemes are supported by the general taxpayer because of a deficit between their contributions from active workers and the amount they have to pay out in pensions.

Whilst the recommendations of the Hutton Report promised to improve this position, they have been watered down so that the differences between public and private sector pension provision remain stark. The proposed changes do nothing about the fact that large numbers of public sector workers who belong to the baby boomer generation will retire under the present – intergenerationally regressive – system.

They also do nothing about the fact that we are currently having the wrong debate on public sector pensions. Discussions of public sector pension reform have so far been very concerned with affordability – whether Britain will have enough money to pay former public sector workers the substantial pension rights they have accrued.

Yet this takes no account of whether it is fair to let them accrue these rights in the first place, or fair towards younger and future taxpayers. In an age when virtually all private sector workers are having to fund the entirety of their own pensions themselves, is it still fair for workers in the public sector to enjoy the privilege of having theirs subsidised by taxpayers?

Indeed, the real debate is whether private sector taxpayers should still be subsidising the pensions of another group of workers when they, on average, earn higher salaries, live longer and have more generous pensions. Expressed like this, surely the present situation represents a total dereliction of duty towards our younger and future taxpayers?

The American president Thomas Jefferson may well have agreed. As he said in 1816, "the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale."

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