The soaring costs of government pensions

May 2019

About the Intergenerational Foundation

The Intergenerational Foundation (www.if.org.uk) is an independent, non-party-political charity that exists to protect the rights of younger and future generations in British policy-making. While increasing longevity is to be welcomed, our changing national demographic and expectations of entitlement are placing increasingly heavy burdens on younger and future generations. From housing, health and education to employment, taxation, pensions, voting, spending and environmental degradation, younger generations are under increasing pressure to maintain the intergenerational compact whilst losing out disproportionately to older, wealthier cohorts. IF questions this status quo, calling instead for sustainable long-term policies that are fair to all – the old, the young and those to come.

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Executive Summary

- IF believes these figures should be in the public domain but are not provided by the government. They have had to been obtained using Freedom of Information (FOI) requests.

- The number of high annual government pensions has more than doubled over the last seven years. The NHS now has more than 20,000 retirees getting pensions of over £50,000 a year.

- A total of 375 retired government workers now receive pensions of over £100,000 a year.

- Those receiving pensions of over £50,000 are costing the nation over £1.2 billion each year, and the number receiving them has increased by 239% in just 7 years.

- Over 115,000 government pensions are above the average annual wage of £28,600 a year.

- The NHS is the biggest source of these generous pensions: of those receiving over £100,000 a year in the three big schemes (Teachers, NHS and Civil service) 76% are in the NHS scheme.

- There is an increasingly extreme divide between the pensions, which the best-paid public sector workers receive, and the full new state pension, which is only worth £8,500 pa.

- The system is a major burden for younger generations, but there are several easy-to-implement ways to improve intergenerational fairness. This paper provides six recommendations.

Introduction

Britain's young people have been dealt a particularly harsh hand in comparison to previous generations. The lack of well-paid, secure job opportunities, the crippling levels of university debt, the scarcity of affordable housing and exorbitant rent rates in the more economically productive regions of the country are just a few of the social and economic challenges facing many young people. This is against a backdrop of the welfare retrenchment policies which have been implemented since the 2008 global financial crisis. Indeed, it has been found that young people have disproportionately borne the brunt of government austerity.[1]

The burden on younger generations is made even greater by the profligacy of public sector pensions. There are three reasons why this is the case. Firstly, as taxpayers, younger generations will have to foot the bill. Secondly, young people will on average get far less generous pensions than those which they are funding for older generations – whether they are in the public or private sector. And thirdly, employee contribution rates have been too low for far too long even with recent reforms.

This present report follows a study that the Intergenerational Foundation (IF) published in 2012 covering the financial year 2010/11.[2] IF's original work showed a surprising number of public sector pensions in the higher brackets (over £50k pa and over £100k pa), but these figures have since soared as a result of rises in final salaries and increased numbers of higher-paid government employees reaching retirement age.

These pensions will seem excessive to many, but they are the result of a set of flawed assumptions made many years ago principally about life expectancy, interest rates, contribution rates required, and the level of pay in the public sector.

A review under Lord Hutton, published in March 2011,[3] was supposed to improve the position but its main result was to preserve the current system: it ensured that younger public servants receive lower pensions by moving them to pensions based on career average salary rather than final salary – but those in their 50s at the time of the review were excluded from this reform. There have been increases to contribution rates since the Hutton review but they are still inadequate and nothing whatever has been done to shift towards a fully-funded pension system: so today's pensions are still

[1] See for example CASE/London School of Economics analysis under the title "Social Policy in a Cold Climate" (2015): http://sticerd.lse.ac.uk/case/_new/research/Social_Policy_in_a_Cold_Climate.asp

[2] Hanton, A. and Kingman, D. (2012), "Are Government Pensions Unfair on the Younger Generations?", Intergenerational Foundation: http://www.if.org.uk/wp-content/uploads/2014/05/Final-Pensions-Report.pdf

[3] Hutton, J. (2011) Independent Public Service Pensions Commission: final report by Lord Hutton: https://www.gov.uk/government/publications/independent-public-service-pensions-commission-final-report-by-lord-hutton

really just a government IOU and are paid for by current contributions and by increasing taxpayer contributions.

Contributions from current public service employees are still too low because the government insists on using discount rates that are too high, with the result that the liabilities are understated. But even increasing these contributions would still leave a “take as you go” system, as Professor Laurence Kotlikoff describes it[4] – one where liabilities are built up for other people, mostly younger, to pay.

According to the Office for National Statistics (ONS), at the end of 2015 total accrued-to-date pension liabilities for unfunded defined benefit workplace pensions for public sector employees was estimated at £917 billion (equivalent to 49% of GDP). Even funded defined benefit workplace pension liabilities for (mainly) public sector employees have reached £334 billion (equivalent to 18% of GDP).[5]

[4] See, for example, his 2016 paper “You’re Hired: A Trump Playbook for Fixing America’s Economy”: https://kotlikoff.net/sites/default/files/You%27re Hired! A Trump Playbook For Fixing America%27s Economy.pdf -
[5] ONS (2015): https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/articles/pensionsinthenationalaccountsafullerpictureoftheuksfundedandunfundedpensionobligations/2010to2015

Main findings

The research for this paper was carried out in late 2018 and early 2019 and established the number of government employees in receipt of annual pensions at different levels within the three biggest government schemes – for the NHS, Civil Service and Teachers. All these are unfunded schemes, which means that there are no assets to pay these pensions and they are paid from current employee contributions and, where necessary, additional funds raised from general taxation.

Looking back first to the 2010/11 figures, the numbers for those receiving higher pensions were:

Pension scheme	Category A £25,900 – £49,999 pa	Category B £50,000 – £99,999 pa	Category C over £100,000 pa
NHS	36,787	8,714	97
Civil service	18,768	969	12
Teachers	12,947	497	8
Total	68,502	10,180	117

The figures recently obtained through Freedom of Information requests for the year 2017/18 show the following:

Pension scheme	Category A £28,600[6] – £49,999 pa	Category B £50,000 – £99,999 pa	Category C over £100,000 pa
NHS	47,732	20,900	287
Civil service	19,336	1,876	54
Teachers	23,224	1,573	34
Total	90,292	24,349	375

[6] For the 2017/18 year the figure in Category A of £28,600 was used as it is the median gross annual earnings for a full-time employee as measured at April 2017 (the start of the financial year).

By comparing the figures for the two years, one can see that the numbers of higher-paid pensioners have increased dramatically in just 7 years. In summary:

- The number drawing government pensions of over £50,000 pa has increased by 239%.
- The number receiving government pensions of over £100,000 pa has increased by 320%, and is now 375.
- The number receiving a government pension of more than the typical annual salary has increased by 46% to over 115,000 people (the total of categories A, B and C).
- The number of people receiving higher government pensions (over £50,000 pa) has increased sharply since 7 years ago, going up from about 10,000 to almost 25,000.
- The NHS scheme pays the bulk of high pensions, with over 20,000 retirees getting pensions of over £50,000 pa.
- The NHS has more than three-quarters of the most generous pensions: of those getting over £100,000 a year in the three big schemes (NHS, Civil Service and Teachers) 76% are in the NHS.
- The 24,000-plus people who receive pensions of over £50,000 pa cost over £1.2 billion each year.
- There is an increasingly extreme divide between the pensions which the best-paid public sector workers receive and the full new state pension, which is only worth £8,500 pa.

The value of these pensions on an individual basis, when compared to a personal pension, underlines their extraordinary generosity. To achieve a £50,000 annual pension a personal pension pot of about £1 million would be required. There are 20,000 NHS retirees getting pensions of over £50,000 pa; this, in the private sector, would assume a total pension fund of at least £20 billion, but under the NHS scheme, that fund does not exist.

The wider picture of increasing public sector pension liabilities

Pension liabilities in the public sector are almost all unfunded and, because of increasing life expectancies and rises in government pay, these have become a large burden on younger taxpayers and are therefore a matter of intergenerational fairness.

The latest available Whole of Government Accounts (for year ending March 2017) shows a total unfunded pension liability for the public sector of £1.7 trillion.[7]

Of this, about £1.25 trillion is made up of the NHS, Teachers and Civil Service schemes (about £600 billion for the NHS, £400 billion for Teachers and £250 billion for the Civil Service). These are huge figures but, even so, some experts put the figures much higher, perhaps 50% more due to accounting methods that are not conservative enough.

These pension liabilities are not being effectively contained as shown by the fact that in the last year for which figures are available, they increased by 28.8% over the figure for the previous year.[8]

In many countries government pensions are funded with a real pot of investments to pay the pension commitment. This is the case for US pensions and even for parts of the UK system such as the Bank of England pension scheme (fully funded), and the Local Government Pension schemes (two-thirds funded). Where there is a real fund and pensions are limited to those assets, then the hard decisions have to be made and put into effect – for instance, the Universities Superannuation Scheme (USS) has been making such decisions recently, and a few years ago the BBC had to adjust its scheme to reflect the reality of scarce resources. By contrast, the unfunded schemes have tended to make short-term decisions, with a steady drift towards passing very large liabilities to the next generation.

[7] https://www.gov.uk/government/publications/whole-of-government-accounts-2016-to-2017. Page 133 gives details.
[8] Ibid.

Methodology

- IF submitted Freedom of Information requests (FOIs) to the administrators of the three main government pension schemes.
- We asked for the numbers of people receiving pensions at three different levels, starting with those receiving more than the median gross annual earnings for full time employees.
- The NHS failed, despite chasing, to supply the figures for the 2017/18 year so we have used figures for the 2016/17 year and, based on the clear upward trend in all categories, we confidently assume that the actual 2017/18 figures will be even higher.

Summary and recommendations

The current system feels out of control and is creating an increasing intergenerational unfairness.

Government has made some efforts to limit the escalation of the costs, including the move to a career average basis and the switch to using CPI inflation – but there are many further moves that could be made to reduce some of the ongoing liabilities and resultant intergenerational unfairnesses in the system, such as the following:

SIX RECOMMENDATIONS

1. Given that these pensions are so much more generous than was originally envisaged, the government could disqualify those receiving higher pensions (say over £50,000) from also receiving the state pension – about £8,500 pa. If applied to the public sector alone, this would save over £200 million a year.

2. Higher contribution rates are needed that more accurately reflect the cost of financing these defined benefit pensions. The costs are underestimated because the government uses too high a discount rate. Correcting this would lead to current employees paying a contribution that more accurately reflects the costs of the benefits to which they will become entitled.

3. National Insurance above a certain threshold could be applied to unearned income such as pension income. At present, income from pensions, rents and investments (which principally go to older generations) are lightly taxed compared to earned income – which bears National Insurance (tax) at around 10% and, for most young people, is their only source of income.

4. More joined-up measuring is needed: at present these figures are not collected by central government. Each of these schemes are run independently and create "silos". The key figures presented in this paper have only been unearthed thanks to the work of the Intergenerational Foundation.

5. Raise the State Retirement Age (SRA) more quickly. In spite of recent falls in longevity, the long-term trajectory is upwards.

6. Change the tax-free lump sum rules for pensions, so that a fixed amount is tax-free rather than 25% which is clearly regressive. This tax break is especially generous to the better off in both the public and private sector. For example, by using the Local Government Pension Scheme

calculator, we can calculate that a recent government retiree receiving a pension of £100,000 pa would be entitled to take a tax-free lump sum payment any time after retirement of about £430,000.[9] This is a historical anomaly – with most tax-free allowances (such as income tax or capital gains tax) the allowance is a fixed sum, but perversely here the tax break is greater for those who are already better-off. A cap of, for example, £20,000, for the tax-free element, would be far fairer and more consistent with the current system of progressive taxation.

[9] The Local Government Pension Scheme (2019) [Accessed 12 March 2019]: https://www.lgpsmember.org/more/lump-sum-calculator.php