NHS Pension Scheme: Proposed changes to member contributions

To: Department of Health and Social Care

By: The Intergenerational Foundation

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The Intergenerational Foundation (www.if.org.uk) is an independent think tank researching fairness between generations. IF believes policy should be fair to all – the old, the young and those to come.

Introduction

As a non-party-political organisation which exists to advocate for the rights of younger and future generations in British policy-making, IF has consistently argued that the generosity of public service pensions ought to be retrenched in the interests of intergenerational fairness.

1. **Do you agree or disagree that the member contribution rate should be based on actual annual rates of pay instead of members' notional whole-time equivalent pay?**

IF agrees with the move away from WTE pensionable earnings to actual earnings as it seems like a fairer system for people who work part-time. Part-time workers will experience the double benefit of increased take-home pay as well as from the fact that their lifetime contributions will more accurately reflect their pension entitlement.

2. **Do you agree or disagree with the proposed member contribution structure set out in this consultation document?**

IF agrees with the decision not to lower the average 9.8% contribution rate across the NHS despite less generous pensions for higher earners. We believe this is an important step towards making the NHS pension scheme more financially sustainable in the long term. We also feel it is appropriate that the tiered contribution structure should be kept, but somewhat flattened, in order to keep the scheme sustainable for lower earners.

Transitioning to a CARE-based pension system will reduce aggregate public sector pension liabilities compared to a final-salary based system. The proposed changes do not lower the average contribution rate in line with this reduction, which IF believes will make significant progress towards making the NHS pension scheme more sustainable in the long run.

3. **Do you agree or disagree that the thresholds for the member contribution tiers should be increased in line with Agenda for Change pay awards?**

IF agrees that the thresholds for member contribution tiers should be increased in line with AfC pay awards. As the tiers of the contribution system do not function like the increasing marginal tax rates of a progressive tax system, this allowance will reduce the likelihood of people having less take-home pay after a small raise.

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4. Do you agree or disagree that the proposed member contribution structure should be phased over 2 years?

IF supports the phasing-in of any changes to the contribution structure over a period of 2 years as rapid changes to people's take-home pay should be avoided at all costs. Regardless of the direction of change, tapering in any changes to the contribution system allows people to adjust over a couple of years, reducing the change of rapid shocks to members' take-home pay.

5. Are there any further considerations and evidence that you think the department should take into account when assessing any equality issues arising as a result of the proposed changes?

These changes fail to address the fundamental problem at the heart of the NHS pension scheme – that the discount rate being used to calculate the present value of future pension liability is far too high. This creates a large annual deficit between member contributions and costs to service NHS pensions that current younger, and future generations of, taxpayers will have to bear the brunt of.

Unlike pension schemes in the private sector, NHS pension obligations do not have any real "funding pot" from which to pay them. Pensions are instead paid by the contributions of members in employment and through the tax receipts of current and future taxpayers, making the NHS pension scheme "unfunded".

Like all pension schemes, the present value of future liabilities is discounted. There is a logic to discounting government unfunded pension scheme: GDP growth should increase tax receipts, allowing the state to cover larger contributions in the future. As such, the government uses the SCAPE rate to discount these future costs, which as of 2011 has been based on expectations of future GDP growth. In 2011 the SCAPE interest rate was set at 3% p.a. real, later reduced to 2.8% p.a. real in 2016, and again to 2.4% in 2018.[1] All of these discount rates are significantly higher than the annual 1.69% real growth rate between Q1 2010 to Q1 2020.[2]

Empirical evidence shows that GDP has grown much more slowly over the past decade than accounted for in the SCAPE rate. The SCAPE has therefore led to a significant underestimation of the present value of future pension liabilities and a resultant contribution rate that is too low to cover pension obligations.

On the other hand, the official cost to service public sector pensions is calculated by the Government Actuary and uses IAS19, an internationally recognised accounting standard that assumes a much lower discount rate than the SCAPE rate.

In the year 2020–2021, 30.4% of the NHS payroll was taken as pension contributions, while the official cost to service NHS pension obligations amounted to 62.2% of the payroll. This means that a deficit the size of 31.8% of the NHS payroll (£17bn) was left to be paid by current and future taxpayers in 2020–2021.[3] This gap is likely to be artificially high due to pandemic-related distortions as well as the impact of the McCloud remedy, however service costs have exceeded member contributions every year for the past five years.[4] This amounts to a hidden structural deficit in government accounts that places an excessive burden on current and future taxpayers.

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[1] Record, *Great British Rake-Off*, Institute of Economic Affairs, p.15
[2] ONS, GDP quarterly national accounts time series
[3] NHS 2020-21 Pension Accounts, Table G, p.17
[4] NHS Pension Accounts show that this deficit ranges between 10.5 (2016-17) and 31.8% (2020–21) of the NHS payroll

The above disparity shows that the current manifestation of the NHS pension scheme is unsustainable. This annual deficit will be somewhat reduced by the move to CARE pensions. However, many retired members retain their right to final salary benefits and the McCloud remedy means that all members are entitled to benefits from the old scheme between 2015–2022, meaning the change will take decades to show up in government accounts.

These proposals neither raise the average member contributions or significantly lower pension liabilities in the short-term, meaning they ignore the hidden costs of NHS pensions. At some point, something will have to give. Tough decisions must be taken to make the NHS pension scheme more sustainable. At present, future generations and younger NHS members and taxpayers are footing the bill for a broken public service pension system. Significant reform is required to ensure this will no longer be the case.

IF recommends that the government gives control of setting the discount rate for public sector pensions to an independent body to limit the impact of vested interests. This body should either continue to use the SCAPE methodology (with assumptions of slower GDP growth) or adopt industry-standard discount rates such as IAS19 or index-linked gilt rates, both of which are much lower than the current SCAPE rate. This information should then be used to generate a solution to mess of public sector pensions that is intergenerationally fair.