The recommendations of the Hutton Report will protect workers and pensioners, but we must come to terms with retiring later

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*Many questions and concerns have arisen from the publication of the Hutton Report on public sector pensions. Here, **Nicholas Barr** provides an essential question and answer toolkit for assessing the recommendations of the Hutton Report, concluding that the move to career-average pensions will help many workers, and that for pensions to remain sustainable we will all have to wait longer until we are able to retire.*

Final salary versus career average: who wins?

A critical assumption (and something worth manning the barricades to protect) of the Hutton Report is that the accrual rate before retirement should be tied to earnings not prices, to ensure that the pension a worker gets when he or she retires bears a clear relation to earlier real earnings.

In a final-salary scheme, contributions are broadly on the basis of career average but benefits are based on final salary. Thus there is a cross-subsidy from people whose earnings grow more slowly to those whose earnings grow rapidly later in their career. The former group tends to be those with lower earnings, the latter the high flyers. Thus on average, final-salary schemes redistribute from care workers to senior managers. It follows that, provided the accrual rate for benefits is tied to earnings, the change to career average is progressive.

How safe is the career average pension? Who bears the risk?

In what is known as a defined-benefit pension, the risks of financial market turbulence are borne by the employer and/or taxpayer. This is true both of final salary and career average schemes. In a defined-contribution scheme, in contrast (for example a system of individual accounts), the individual worker has to face the risks of financial market turbulence. The move from final-salary to career-average pensions, since both are defined-benefit, continues to protect workers and pensioners from the risk of short-run financial turbulence.

How large is the pension?

The proposals in the report are designed so that the combination of state pension and public service pension will provide pension benefits of two-thirds of a person's previous earnings for people below median income.

When is the pension paid?

Increased life expectancy is arguably the greatest welfare gain of the twentieth century. But an inescapable consequence is that people will need to work longer. Failure to grasp that nettle means that at some future date the system will blow a gasket, that is, become so unsustainable that it will no longer be possible to reform gradually and in good order. Put another way, failure to reform now puts the safety of people's pensions at risk in the long-run.

How much choice is there over retirement?

The report rightly argues that if someone works for a year beyond normal retirement age, his or her pension will increase actuarially, and vice versa for early retirement. Thus someone who wants a larger pension has the option to work longer. A parallel recommendation is that someone who wants to combine pension with part-time work can choose to do so with no loss of pension. Such choice is desirable for its own sake. People vary widely in their preferences and personal circumstances. Thus many people do not want to retire fully as soon as they are allowed, because of the extra income, because of possible extra pension, and/or because they continue to enjoy working in their current job or another one.

Are all rights earned to date fully protected?

The report proposes that all promises to date will be kept. Thus there will be little or no change for workers close to retirement. This is the right policy, given the importance of ensuring that changes are gradual and give workers a long time to adjust.

Who pays?

The costs of pensions have to fall somewhere. Costs can fall on pensioners as a lower monthly pension or through later retirement on a non-reduced pension, or on workers, employers, and/or taxpayers through higher contributions. These ways of paying for pensions can be used individually or in combination; there are no other ways of paying for pensions. It follows that if workers want an unchanged pension at an unchanged retirement age with no additional contributions by workers, the costs have to fall on employers or taxpayers. As life expectancy rises, those costs rise. As discussed earlier, this is not sustainable. The right policy aim is to optimise across all these instruments in such a way that contributions do not have to rise so much that workers opt out.

What should be fought for?

The following recommendations in the Hutton Report are the ones to fight to retain:

- full protection of rights earned to date;
- future benefits to be career average not defined contribution;
- career average benefits to be based on an accrual rate during working life tied to earnings, not prices;
- no precipitate increase in retirement age;
- and choice over retirement age and choice over options for combining pension with part-time work.

The Universities Superannuation Scheme (USS) is facing similar issues and similar recommendations. The list of things to fight for is identical.

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