PIC Thought Leadership Commentary on 2009 Pre-Budget Report

(Bob Swarup and Frank Eich, 11th December 2009)

- **The 2009 PBR presented the government's short-term economic outlook and sketched out its broad strategy to bring the public finances back under control but provided little detail on where the significant spending cuts will fall.**

- **Even on the government's current fiscal consolidation path, it could take decades for the public debt to GDP ratio to fall back to pre-crisis levels. And that is before the fiscal costs of an ageing population – including from pensions –are taken into account**

- **No new policies on pensions but more details on previous announcements, including on "cap and share" under which public-sector employer contributions to pension schemes will be capped and employees expected to pay more. More transparency is needed though how these contribution rates will be calculated given the continuing disconnect between the true value of the accrued pension benefit and contributions**

- **Lack of clarity on how to deal with the burgeoning deficit will cause short and medium term gilt yields to rise as markets worry about the net public debt burden**

Against the backdrop of the deepest recession in living memory, a huge fiscal deficit and a general election within the next six months, Alastair Darling's 2009 Pre-Budget Report not surprisingly was highly political, and focussed on the near-term outlook of the economy and public finances. To bring the public finances back under control, Darling acknowledged the need to raise taxes (and national insurance, a tax but in name) and to slash spending…but not before the election. Darling was careful not to spell out in any details where the spending cuts would fall. According to the Institute for Fiscal Studies, the required cuts are very substantial - £36bn between 2011-12 and 2013-14. The government hopes to achieve a third of this through efficiency savings (though its record in achieving these in the past has been patchy) and a further £15bn through as yet unspecified cuts.

Even on the government's current fiscal consolidation path it could take decades for the public debt to GDP ratio to fall back to pre-crisis levels. And that is before the fiscal costs of an ageing population – including from pensions – are taken into account, which will put additional pressures on the public finances in years and decades to come. That this is not some far away problem is brought home by the fact that the first wave of baby boomers, those born after the 2nd world war, are now moving into retirement.

The Chancellor also made a few pension-specific announcements, largely to do with reducing the increasing burden on the public purse, though there was little new. He provided more details on his plans to cap future increases in employer contributions to public sector pension schemes, hoping that this will save the Exchequer £1bn per year from 2012-13 and more in the long term. Instead, Mr Darling expects public sector workers to contribute more to finance future increases in pension spending, for example due to increased longevity. While this might save the Exchequer money in the future, what it does not do satisfactorily is to provide much more transparency with respect to the true value of the accrued pension benefit and contributions.

He also clarified the government's position on tax relief on pension contributions for those with gross income of £150,000 or more – a policy announced in Budget 2009 - with the government now defining "gross income" to include all employer pension contributions. That implementing this policy will not be a straightforward exercise should already be clear by looking at the 130 page explanatory document, which came with the announcement.

The document is distinctly long on words and short on clarity. Still, Alastair Darling deserves some applause for trying to tackle these politically-charged issues – high earners and trade unions are already equally appalled and outraged. Ultimately though, the announcements can only be seen as fiddling around the margin and as a sign for much more substantial changes in the realm of pension in years to come, whichever party will win the next general election.

Given the lack of detail on how the deficit will be reduced, gilt yields will likely rise over the next 2-3 years. Issuance is already going to be large over the coming year – coupled with worries over the size of the deficit and the need for a credible plan to tackle public finances; this does not bode well. The risk of a gilts crisis is growing albeit small – any rise in yields is likely to be gradual rather than violent at this stage. Ironically, the rise in yields is positive for pension fund liabilities as it translates into a higher discount rate and lower liabilities. The problem is that such a situation would inevitably be accompanied by volatility on the asset side – large rises in yields could well lead to government austerity and growing worries over the sustainability of the current 'recovery'.