NATIONAL AUDIT OFFICE

Report by the Comptroller and Auditor General

Gibraltar Pensions

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Comptroller and Auditor General

National Audit Office
15 February 1990

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies use their resources.

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1. In December 1988, the Minister of State for Foreign and Commonwealth Affairs told the House of Commons that the Gibraltar Social Insurance Fund was to be wound up; and that the United Kingdom Government had agreed to contribute £39 million to keep the Fund in operation until 1993. This was in addition to £19 million provided since 1985 to support the Fund while its future was determined. Under these arrangements the Government have paid:

	£16.50m	in instalments from 1986 to 1988
	£ 2.36m	August 1988
	£ 0.60m	December 1988
	£38.60m	March 1989
Total	£58.06m	

2. The Government of Gibraltar had established the contributory Social Insurance Fund in 1955, with the intention that it should be self-financing, to provide for the payment of pensions and benefits to Gibraltarians and other nationals working in Gibraltar. Under the Gibraltar Constitution pensions are defined as a domestic matter and the Fund has been administered by the Gibraltar Government, the United Kingdom Government having no direct control over the Fund.

3. The main events leading to the Fund's financial difficulties and United Kingdom's payments were the closure of the border between Gibraltar and Spain in 1969, which had the effect that Spanish contributors were unable to collect their benefits and pay their contributions; substantial increases from 1973 in the benefits payable under the scheme to those beneficiaries resident in Gibraltar; the re-opening of the border with Spain in 1983; the refusal of the European Commission to agree a derogation in respect of Gibraltar; and Spain's accession to the European Community in 1986, which meant equality of treatment for all European Community nationals who had contributed to the Fund.

4. This Report sets out these events more fully, based on the National Audit Office's examination of the Foreign and Commonwealth Office's papers. The National Audit Office sought the views of the Governor of Gibraltar and the Government Actuary whose comments have been incorporated.

Closure of the border

5. In 1969, when Spain closed the border with Gibraltar, some 16,500 Spaniards had interests in the Fund on the basis of contributions paid whilst in employment in Gibraltar:

— 2,000 had been drawing pensions but as the majority resided in Spain they were unable to collect their entitlements (typically 50 pence to £1 a week);

— 4,500 were below pensionable age when their employment was terminated by the closure of the border; and

— 10,000 had previously terminated their employment but retained some possible future entitlement.

6. In 1970 the United Kingdom, acting on behalf of Gibraltar, explored with the Spanish Government various ways to continue the payments of pensions to Spanish pensioners not resident in Gibraltar. The Spanish Government were, however, unwilling to accept payment at the frontier or through Consulates or banks. The Foreign and Commonwealth Office suggested that Gibraltar should transfer part of the Fund, representing contributions made by Spanish workers and their employers, less benefits already paid, to the Spanish Government. However, the Foreign and Commonwealth Office told the National Audit Office that the Gibraltar Government were unable for many months to reach a consensus on this proposal. British Ministers considered whether, if it became necessary, the Governor should use his constitutional powers to force a solution against the wishes of the Gibraltar Government; but they concluded that to do so would lead to a political crisis.

7. In the event, the Foreign and Commonwealth Office persuaded Gibraltar to accept the option of transferring a due proportion of the Fund to Spain. However, the Spanish Government claimed that it was for the United Kingdom Government to provide a sum sufficient to meet the pensions of Spanish workers on the same basis as if they had continued in employment in Gibraltar and had maintained their contributions. The United Kingdom Government rejected this claim but suggested both sides produce estimates of the capital sum required for transferring this liability to the Spanish Government. While the Foreign and Commonwealth Office had figures available by 1972, Spain did not and no progress was made.

8. The Governor of Gibraltar is required to appoint an actuary to report every five years on the financial condition of the Social Insurance Fund and the adequacy of the contributions to support the benefits. The 1972 report (for the period 1 January 1966 to 31 December 1970) was made by the United Kingdom's Government Actuary. It observed that expenditure on benefits had fallen because most Spanish pensioners had been unable to collect their payments. The Actuary also pointed out that income had fallen because the number of contributors had decreased after the withdrawal of Spanish labour, which had not been fully replaced. On the assumption then pertaining that a proportion of the Fund would be transferred to the Spanish Government, the Actuary estimated that income from contributions would be adequate to meet the cost of benefits until 1992 and that, taking account of investment income, benefits would be met for sometime thereafter.

Increases in benefits

9. In 1973, the Gibraltar Government decided to increase pension and contribution rates for the first time since 1968. These increases were,

however, limited to those resident or insured in Gibraltar during the immediately preceding period. This stipulation effectively froze pensions due to Spaniards at the 1968 rates — although, with the border closed, they were unable to register their claims. On this basis the United Kingdom Government Actuary advised the Gibraltar Government that their estimates were of the right order and that there could be further savings arising from the residence qualification. The Foreign and Commonwealth Office saw no objection to the proposal: a residential requirement was not novel as increases in the United Kingdom's retirement pensions were not normally paid to those living abroad unless their country of residence had a reciprocal agreement to pay such pensions. They saw the obvious solution to the problem of paying pensions to Spaniards at that time as a lump sum payment to Spain, as this would not affect benefit rises and would allow the Spanish workers to be integrated into the Spanish pension system.

10. Pensions payable from the Social Insurance Fund were subsequently increased further. The Foreign and Commonwealth Office informed the National Audit Office that this was at a time of economic stagnation in Gibraltar when there was domestic pressure on the Gibraltar Government to raise, or at least maintain, living standards. By this time Spain had begun to show an interest in joining the European Community and in 1976 the Gibraltar Government realised that one effect of Spain's entry would be that, under existing Community Regulations, the higher rates of pensions would also apply to the Spanish. They sought the advice of the Department of Health and Social Security in London who confirmed that Community law would apply to Gibraltar.

11. In July 1977 an amending Ordinance introduced index-linked pensions related to earnings. (Index-linking pensions to earnings operated in the United Kingdom at that time but there remained differences compared with the United Kingdom scheme — for example, in Gibraltar contributions were allowable against tax and benefits were not taxable.) There is no record that the Gibraltar Government had sought actuarial advice or had consulted the Foreign and Commonwealth Office. Once the measure had been enacted, the only action which could have been taken would have been for the Foreign and Commonwealth Secretary to exercise his power of disallowance. Ministers decided not to do so.

The re-opening of the border and Spain's accession to the European Community

12. In 1977, the Foreign and Commonwealth Office consulted the Department of Health and Social Security about the possible implications of a Spanish entry into the European Community. The Department advised that contributions should be increased to ensure that the Fund was placed on a sound financial footing. This advice was passed on to the Gibraltar Government.

13. In his 1978 report (covering the period 1971 to 1975) the Government Actuary pointed out that expenditure was likely to exceed contributions almost immediately. He suggested that urgent consideration should be given to increasing the level of contributions, bearing in mind that the

longer the increase was postponed and the Fund allowed to diminish, the larger would be the increase ultimately required. The Foreign and Commonwealth Office emphasised to Gibraltar the importance of raising contributions.

14. In March 1978 the Foreign and Commonwealth Office began negotiations with Spain about a range of issues which, with the Gibraltar Government's agreement, included pensions. In a subsequent joint working group the Gibraltar Government accepted a legal and moral obligation to meet the cost of Spanish pensions and the possibility of a lump sum payment was again considered. In the event all these issues were subsumed into general discussions about normalising relations between the United Kingdom and Spain and the re-opening of the border with Gibraltar.

15. In June 1978 the Foreign and Commonwealth Office sent the Gibraltar Government the Department of Health and Social Security's estimate that the annual rate of payment from the Fund would increase from £1.5 million to about £4.3 million upon Spanish accession to the European Community. Later the Foreign and Commonwealth Office invited Gibraltar Ministers to comment on their 1979 paper which considered the implications for Gibraltar of Spanish accession to the European Community, including social security issues. At a meeting in 1979 with British officials from a number of departments, the Gibraltar Government decided to commission a report from the United Kingdom Government Actuary including estimates of the year by year cost of Spanish pensions.

16. In response to the Actuary's 1978 Report (paragraph 13 above), contribution rates were increased in January 1979 by significantly more than the increases in benefit rates. Nevertheless, the increased level of contributions was applicable only for the last two years of the quinquennium and in his 1982 Report the Actuary commented that income from contributions over the 5 year period to 31 March 1981 had been some £0.5 million lower than expenditure on benefits, the shortfall having been covered by receipts from investments. He went on to recommend that, from 1983, rates of contribution should be increased each year by a greater percentage than the increase in the rates of benefit, with a view to achieving contribution income by 1987 that would be sufficient to meet expenditure. In these circumstances the Fund could be expected to form a reasonable contingency reserve. The Actuary assumed that part of the existing Fund would be used to meet the pensions to Spaniards, which were not at that time being paid, at pre-1973 rates, and that only the balance of the Fund would be available for the costs of benefits for remaining members.

17. In practice the Gibraltar Government increased contribution rates by nearly double the target recommended by the Government Actuary. However, in making their calculations neither the Gibraltar Government nor the Actuary took account of Gibraltar's potential liability to increase benefits for Spanish workers — which the Actuary had estimated (paragraph 15) would cost £5.7 million per annum at 1982 benefit levels.

18. In May 1983, the border was partly opened and Spanish workers who had previously contributed to the Fund were able to receive benefits but only at the 1968 rates. In September 1983, the United Kingdom Government, acting on behalf of the Gibraltar Government, sought a derogation from the European Commission to the Spanish Treaty of Accession to allow a staged increase in payments to Spanish pensioners. The Commission ruled that Gibraltar could not be treated as a special case and was obliged, from the date of Spain's entry into the Community, to ensure that a pension paid to a Spaniard was equivalent to that paid to a Gibraltarian with an equal contribution record.

19. In August 1984 the Gibraltar Government asked the United Kingdom for financial support to meet the commitment to Spanish pensioners from 1 January 1986, the date when Spain would formally join the European Community. During the protracted negotiations which followed the Foreign and Commonwealth Office recognised the United Kingdom's responsibility to ensure Gibraltar's adherence to Community law. However the Department continued to make it clear that responsibility for payments to Spanish pensioners rested with Gibraltar. By December 1985 Spanish entry was imminent but the Gibraltar Government had not made appropriate provision. British Ministers, in order to ensure that Gibraltar complied with Community law, decided as a matter of policy to grant £16.5 million towards the estimated £21 million required to pay Spanish workers at the enhanced rates between 1986 and 1988. The grant was conditional on Gibraltar's participation in a joint examination of the extent of the Social Insurance Fund's liability and how its financial difficulties might be resolved. In August 1988, the United Kingdom provided a further £2.36 million followed by £0.6 million in December 1988.

20. The Foreign and Commonwealth Office's Diplomatic Wing had no provision for such payments within their Votes. As the reasonable needs of Dependent Territories remain a first charge on the Aid Programme, the Treasury agreed that all this expenditure should be charged to the Overseas Development Administration Overseas Aid Vote (Class II, Vote 5).

Dissolution of the Fund

21. The United Kingdom and Gibraltar Governments duly set up a Joint Study Group to determine the sum necessary to fund pensions at full rates to all eligible beneficiaries from 1 January 1986. The Group was also required to assess the capacity of the Gibraltar economy to contribute towards the cost of pensions after 1988, taking into account the financial and economic circumstances of the territory; and to consider other ways of funding.

22. On the basis of estimates made by the United Kingdom Government Actuary, the Study Group concluded that over the period 1989 to 2026 the Fund would require between £257 million and £289 million at 1988 prices (not discounted to show the present value of future payments) to meet the Spanish liability alone. They assessed the likely impact of different growth assumptions on the Gibraltar economy and concluded that the full liability for paying Spanish pensions would consume about 7 per cent of the

territory's Gross National Product. The Group also predicted that if contributions were increased only in line with earnings, the deficit on the non-Spanish pension liability to 2026 would amount to £136 million (at 1988 prices, undiscounted) and that its cost would exceed contribution income by 1997.

23. The Government Actuary's 1988 report (for the period 1981 to 1985) concluded that contributions at present rates in relation to average earnings would not be adequate to support benefits linked to earnings. He stated that, if the United Kingdom or Gibraltar Governments met the cost of payments to Spanish nationals after 1988, contributions would be sufficient to meet expenditure at least until the end of 1993, provided that they were increased by the same percentage as benefits. If there were no Governmental support, by 1992 contributions would need to be doubled compared with 1988.

24. The Foreign and Commonwealth Office therefore began negotiations with the Gibraltar Government to identify how the pension arrangements could be made financially viable. In 1988, the Gibraltar Government agreed to consider replacing the Social Insurance Fund with a new fund with contribution and benefit rates similar to those of the United Kingdom's National Insurance Fund. This would have brought the scheme into better balance by introducing a significant increase in contributions and a reduction in future pensions. However the Foreign and Commonwealth Office's papers indicated that this solution proved unacceptable to Gibraltar because they were not prepared to contribute to the Spanish liability and the United Kingdom Government were not prepared to underwrite the scheme unconditionally. The cost of benefits under such a scheme were tentatively estimated at £40 million–£60 million. The Foreign and Commonwealth Office told the National Audit Office that, as alternative proposals acceptable to Gibraltar would have been more expensive, detailed costings were not undertaken.

25. A joint decision was therefore made to wind up the Social Insurance Fund. The Minister of State for Foreign and Commonwealth Affairs informed the House of Commons on 7 December 1988 that the state of the Fund was such that it was no longer financially viable. However, in order to minimise the hardship to pensioners, the United Kingdom and Gibraltar Governments agreed to continue to provide pensions to all beneficiaries at existing cash levels for a further five years. At the end of that period the Fund would be dissolved and any balance paid out to past and present contributors in proportion to the level and timing of their contributions. Legal advice provided to the United Kingdom Government confirmed that this met Community law. Gibraltar residents, regardless of nationality, whose income subsequently fell below a certain level would, subject to a needs assessment, be eligible for support through Gibraltar's existing Social Assistance Scheme.

26. The United Kingdom Government agreed to meet the estimated Spanish pension liability until 1993, estimated to be some £48.4 million at 1988 prices. They also agreed to meet lump sum payments due to Spanish pensioners in 1994 which were provisionally estimated at a further £7 million, pending the verification of eligible claimants.

27. In January 1989 the Treasury agreed to the lump sum payment of £38.6 million to meet the shortfall of £48.4 million. They considered a single payment cheaper as it could be invested on behalf of the Fund, thereby reducing the cost to the Exchequer. Parliament approved the expenditure in a Supplementary Estimate to the Overseas Development Administration's Superannuation Vote (Class II, Vote 6, 1988–89); as such it was not part of the Aid Programme. In July 1989, the ambit of the Vote was extended to cover this expenditure.

28. The Crown Agents were appointed to manage the grant as managers of the Gibraltar Social Insurance Fund. The grant has been placed in a special account under the control of their wholly owned subsidiary, Crown Agents Asset Management Limited. The Gibraltar Government will make monthly claims on this account and will provide annual audited statements that drawings on the grant are in accordance with the agreed terms.

Conclusions

29. The financial support provided by the United Kingdom Government to make good the shortfall in the Gibraltar Social Insurance Fund arose essentially because between 1973 and 1988 the Gibraltar Government did not make adequate provision to meet the liability to Spanish pensioners. It was not until 1989 that a solution was found. By this time the United Kingdom Government had committed £58 million to ensure that Gibraltar conformed to European Community law.

30. Primary responsibility for the Social Insurance Fund lies with the Gibraltar Government since it is essentially a domestic matter. And, in the Foreign and Commonwealth Office's view, their attempts to solve the problem on Gibraltar's behalf did not remove the Gibraltar Government's responsibility to make contingency plans to pay the Spanish pensions.

31. The Foreign and Commonwealth Office told the National Audit Office that it had been the policy of successive British Governments to give Dependent Territories a large measure of self-government. In practice their power to intervene in domestic matters, as defined in the Constitution, were limited and could have entailed political penalties. The United Kingdom's powers in Gibraltar are limited to the broad rights under the Constitution: the Governor may withhold his assent to a bill; in certain circumstances (for example to maintain financial and economic stability) he may force a bill through the House of Assembly; and the Foreign and Commonwealth Secetary may disallow a law.

32. In the Foreign Office's view, however, the only real power was that of persuasion. They also pointed to the sensitive state of relations between the United Kingdom, Spain and Gibraltar, and to Gibraltar's consequently difficult economic circumstances (partially offset by United Kingdom aid, some £72 million over the last decade). These difficulties were compounded by Spain's application to join the European Community.

33. The Foreign and Commonwealth Office emphasised that they had taken several steps to devise a solution:

— seeking to negotiate a settlement with Spain in 1970 (paragraph 6)

— warning Gibraltar repeatedly between 1977 and 1979 of the consequences of Spain's accession and the need to raise contributions (paragraphs 13–15)

— re-opening negotiations with Spain in 1978 about a lump sum payment (paragraph 14)

— seeking a derogation from the Treaty of Accession in 1983 (paragraph 18).

British Ministers had twice considered using their general powers to intervene but had decided not to do so for fear of provoking a constitutional crisis: first in 1970 (paragraph 6) to force Gibraltar to negotiate with Spain over a lump sum payment from the Fund — although in the event persuasion was sufficient; second in 1977 (paragraph 11) to oppose Gibraltar's decision to increase benefits substantially, and to index-link them, without making an equivalent provision for contributions, without taking account of all potential liabilities and without seeking actuarial advice.

34. In 1986, the position changed because the United Kingdom became responsible, as a matter of European Community law, for ensuring equal treatment in Gibraltar of all beneficiaries of the Fund who were European Community nationals. The Foreign and Commonwealth Office stated that at that point they had set up the Joint Study Group (paragraphs 17, 19 and 20); and this had led to the agreement to wind up the Fund in 1993.