PO-CH/NL/0506

PART A

PO CH/NL/0506
PART. A

PO CH/NL/0506
PART. A

1989 BUDGET PUBLIC
SERVICE PENSIONS.

22.2.89

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

Pensions.

Public Service

Pensions

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: J D HINTON

DATE: 2 DECEMBER 1988

This is the second paper in the pensions series. The third (free-standing AVCs) will follow next week

1. MR KUCZYS

2. ~~MR CORLETT (seen in draft)~~

3. FINANCIAL SECRETARY

PERSONAL PENSIONS

1. The Chancellor asked at the meeting of 26 October for further work to be undertaken on ways of giving personal pensions an advantage over occupational schemes.

Background

2. At present there is a broad balance between occupational schemes and personal pensions for the majority of people. If contributions are started soon enough a personal pension can produce similar benefits to occupational schemes (see the illustration at Annex A). But each form of retirement saving tends to offer a better deal

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Loades - GAD
Mr Jenkins - Parliamentary Counsel

Mr Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Newstead
Mr Lusk
Mr Eason
Mr Kuczys
Miss Dougharty
Mr Hinton
Mr Gilbert
PS/IR

to different groups. So, for example, personal pension schemes tend to favour job changers, and occupational schemes are often better for stayers and high flyers.

3. The main variations come about because of the structural differences between personal and occupational pensions. In particular with personal pensions it is important to start contributions early. This is because shortfalls in contributions and lost investment growth cannot normally be made good. But with occupational schemes there is not this disadvantage. If an employer is willing to pay large contributions there is no obstacle to benefits for back service being fully pensioned. In an extreme case an employer could make a single payment at retirement to secure a two-thirds pension - and some (mainly smaller) employers do just this.

4. In order to help late starters in personal pensions, two special facilities are available. First, it is possible to count unused tax relief for up to six previous years against extra contributions made in a current year - this is known as "carry-forward". Second, the maximum personal pension contribution limits are graduated so that they increase with age. The limits are:

Age	Maximum % of earnings
50 or less	17.5
51 to 55	20
56 to 60	22.5
61 to 75	27.5

5. These special facilities give many people the opportunity to catch up with, or at least not fall too far behind, the benefits for a person who spends his career as a member of an occupational scheme. The main discrepancy is between the professional partner (who is subject to the normal personal pension contribution limits) and directors and other high earners who can often expect accelerated accrual of their occupational pensions.

Earnings caps

6. A prime feature of the core package which we have recommended is a tough cap on occupational pension and lump sum benefits based on earnings of £60,000 in order to limit the tax privileges enjoyed by very high earners. It is therefore necessary to consider whether this cap should be extended to personal pensions or whether the opportunity should be taken to counterbalance the advantage of accelerated accrual enjoyed by some occupational scheme members.

7. There are good reasons for narrowing the gap between personal and occupational pensions. Personal pensions, being money purchase, and wholly portable, avoid the cross subsidies found in final salary occupational schemes. And it could encourage some controlling directors and high earners to move across from the occupational regime. If Ministers consider this to be a goal worth aiming for, there would appear to be three main options:

(i) to do nothing - leave the personal pensions tax regime unchanged; but, if that was not thought possible,

(ii) to introduce a higher earnings cap than for occupational schemes; or

(iii) to have the same earnings cap, but increase the maximum percentage contribution limits.

Leave the personal pensions tax regime unchanged

8. There are some clear attractions to leaving the personal pensions tax regime unchanged. It would be the clearest possible signal of the Government's views towards retirement provision. And it could, for the very highly paid, swing the balance of advantage firmly towards personal pensions.

9. But it also has its drawbacks. In particular, it would be seen by the occupational pensions movement as a direct attack which could sour their attitude towards the other aspects of the core package for pensions. And it would produce inequalities between occupational schemes and money purchase personal pensions - for example, between the partners and employees of big law or accountancy firms - which would be difficult to justify. Ministers will wish to consider whether such a clear lack of symmetry between the occupational and personal pension tax regimes would be acceptable.

<u>A higher earnings cap</u>

10. If it was not thought possible to discriminate blatantly in favour of personal pensions schemes there are other possible approaches. One would be to set the earnings cap for personal pension contributions at a higher level than for occupational schemes.

11. The justification for this would be the basic structural differences between occupational and personal pensions. With occupational pensions, the tax privilege controls are applied to the <u>benefits</u> which may be paid and there is no minimum period for contributions. So, at the extreme, the whole cost of a maximum pension can be met by a single contribution at retirement. This is not possible with personal pensions - they are essentially a long term pensions savings vehicle.

12. Any alternative (ie higher) earnings limit for personal pensions would inevitably be arbitrary, in the sense that there is no arithmetically determined level at which it would compensate for the other advantages of occupational schemes. But if the purpose of the higher earnings limit is to compensate for the absence of accelerated accrual under the personal pension rules then the following example illustrates what might be needed to meet the more difficult cases (late arriver, high flyer).

Example

(i) The value of personal pension benefits in comparison with those under an occupational scheme depends critically on investment returns. Annex A shows the result on differing earnings assumptions of an investment return 3 per cent above real earnings growth.

(ii) The Annex shows, over a 20 year term, that personal pension benefits may be worth between 33 per cent and 50% of the maximum possible under accelerated accrual (ie pension of £6,570 or £10,240 compared with an occupational pension of £21,110).

(iii) So, using this as a crude example, for a personal pension to produce a pension of £40,000 per annum (the maximum under a tax privileged occupational scheme), the earnings limit might need to be raised to between £120,000 and £180,000 (compared to the £60,000 for occupational pensions).

13. Although a case could be made for having a higher earnings cap for personal pensions than for occupational schemes, the contrast between the two limits would look very awkward. And as only a handful of people have earnings in excess of the level implied by the cap, it would in the majority of cases be virtually meaningless. Furthermore it would do nothing to help the professional partner earning £60,000 or less to accrue an equivalent pension to an executive earning the same money.

Higher percentage limits

14. An alternative way of bridging the gap between personal pensions and occupational pensions would be to have the same earnings cap as for occupational pensions (£60,000) but to increase the allowable percentage contributions limits. This has the presentational (and real) advantage that it is

directed at the specific area where the personal pensions rules tend to be less favourable than the occupational pensions regime.

15. It is not possible to make realistic general comparisons between occupational and personal pensions. The outcome depends on a large number of unquantifiable factors such as investment returns, career patterns, ages at which contributions start, actuarial assumptions and so on. All that can be done is to look at particular career patterns and benefit packages and try and estimate what contributions would be required.

16. Annex A demonstrates that on certain assumptions personal pensions can produce benefits as good as those from final salary scheme. But the example in Annex A makes no allowance for career progression. Annex B therefore considers some illustrative contribution rates for particular career patterns to see what contribution rates might look like if account were to be taken of career movements.

17. Some work was done on this earlier this year with the help of the GAD in connection with Mr Byatt's proposal to switch to a contribution based tax regime for occupational pensions. The results of that work were included in Mr Corlett's submission to the Chancellor dated 8 July and are reflected in Annex B.

18. No firm conclusions as to a rate of contribution which would be generally appropriate to all people or career patterns can be drawn from these illustrated rates. But what the table does show is that the present personal pension limits look inadequate for people who can expect significant career progression (through promotion or job changing).

19. There are many combinations of contribution limit which could be substituted. But using those illustrated in the

table in Annex B as a starting point (coupled with a £60,000 earnings cap) a revised set of contribution limits could be:

OPTION A

Age	percentage limit	cash limit (ie percentage applied to £60,000)
up to 45	17.5% (no change)	£10,500
46 to 50	22.5%	£13,500
51 to 55	27.5%	£16,500
56 and over	35%	£21,000

20. An alternative would be a more graduated contribution scale (with more rounded figures). In the following table, the maximum contributions for those under age 35 have been reduced. This reflects the fact that the present 17.5 per cent limit is, perhaps, too high for those at younger ages (and indeed we believe that very few people in this age group actually contribute anything close to the maximum percentage).

OPTION B

Age	percentage limit	cash limit
up to 35	15%	£ 9,000
36 to 45	20%	£12,000
45 to 50	25%	£15,000
51 to 55	30%	£18,000
56 and over	35%	£21,000

21. These two options are just illustrative. Decisions are not required on any particular option now. It would, however, be useful to know the overall approach that Ministers would like to follow. Further work could then be done to develop a range of options. The cost of either option A or B above would depend on the number of people who

would take advantage of the higher limits for younger ages and how many people would be attracted across from occupational schemes. We estimate however that the cost in 1989/90 could be about £5 million — ie about the same as the yield, from occupational pensions, of the "core package" in the previous paper. AWK

Limit on lump sums

22. Introducing a cash cap on contributions to personal pensions would offer a new approach to the cap on the lump sum. The cap is at present set at £150,000 (in line with occupational scheme lump sums). But the problem is that it applies to each personal pension arrangement. Where a person has built up a series of personal pension arrangements with different providers, no one pension provider is in a position to check the overall situation and cut back the lump sum where necessary.

23. Annex 3 to Mr Corlett's pension paper of 17 October considered two options for dealing with this loophole. One would have applied the cap to aggregate personal pension benefits, if a way could be found. The second would, as a fall back, apply the cap on a "per scheme" or "per provider" basis instead of the present "per arrangement" rules. The first option looked impossible to enforce effectively and the second would, at best, only have a limited impact.

24. But with a monetary ceiling on contributions the question of controls on lump sum benefits can be looked at in a new light. Very high earners would have limited scope to pump very large amounts of money into a personal pension scheme. And as the normal limit on personal pension lump sums is expressed as a percentage (25 per cent) of the value of the member's benefits, the control on contributions is, arguably, a sufficient replacement for the present (£150,000) lump sum cap.

25. Having a control on funds going into personal pension schemes does not necessarily mean that lump sums could not exceed the proposed £90,000 ceiling on occupational scheme lump sums - much would depend on the investment return

achieved. But the personal pension fund would have to be more than £360,000 before a £90,000 lump sum could be paid.

26. In a contribution limited tax regime a "cash" cap on contributions fits better than a "cash" cap on benefits. On the other hand, without a corresponding ceiling on personal pension lump sums, unfavourable comparisons would inevitably be made by proponents of occupational pension schemes. If Ministers, therefore, consider that there should be both a contribution ceiling and a £90,000 lump sum cap it would, however, be possible to justify leaving the cap on its present "per arrangement" basis.

Transitional Matters

27. The one personal pension measure which might need transitional arrangements is any reduction in the £150,000 tax free lump sum cap (This problem will not arise if, by imposing a cash ceiling on contributions, it is considered that the lump sum cap is superfluous.)

28. The precedent for transitional measures is the way in which the 1987 changes were applied. These imposed the £150,000 lump sum cap only on new retirement annuity contracts (the forerunner of personal pensions). So if the lump sum cap was now to be reduced to £90,000 it would be logical to follow that approach.

29. On the other hand, personal pensions have been in existence for only a few months and it is most unlikely that anyone could yet claim an expectation to a £150,000 lump sum (which implies a total fund of £600,000), or even a £90,000 lump sum (which would require a total fund of £360,000). There is, for this reason, a strong case for not cluttering this new pensions regime with transitional arrangements which would be bound to be complex. In the circumstances, it might be worth trying to get by without any transitional provisions, but be prepared to act if, but only if, some genuinely hard case came to light.

30. If, however, it is considered that transitional measures are essential, their form would depend on decisions called for elsewhere in this note - for example, whether the cap should apply to each arrangement (as now) or whether it should operate on a "per scheme" or "per provider" basis. As people can have any number of personal pensions, however, it would be necessary in any event to prevent circumvention of the lower cap by transferring funds to a scheme or arrangement to which the higher (£150,000) cap applied.

Conclusion

31. This paper looks at a number of options for tilting the pension tax rules a bit more in favour of personal pensions. Three possibilities have been considered:

i. to leave the personal pensions tax regime alone (while tough measures are introduced for occupational pensions) (paragraphs 8-9);

ii. to have a higher earnings cap for personal pension contributions than for occupational pension benefits (paragraphs 10-13); or

iii. to increase the present percentage contribution limits (subject to a cash limit) (paragraphs 14-21).

32. Of these three options, (i) and (ii) appear to have more disadvantages than advantages. In particular they look too awkward in relation to a broad balance with occupational schemes. Option (iii) provides a more acceptable approach, offering controlling directors and high earners some real, but reasonable, encouragement to move across from occupational schemes. This is the approach we recommend. There is a number of possible contribution ranges and this submission covers just two - others could be constructed as necessary.

33. The introduction of a cash cap on contributions also paves the way for an alternative approach to the (present) £150,000 lump sum cap. With a cash cap on earnings of £60,000, do Ministers agree that:

i. the cap on personal pension lump sums can be removed altogether (which is what we recommend); or if not

ii. that the present rules which operate on a "per arrangement" basis can be left as they are; subject to

iii. the present £150,000 lump sum cap being brought into line with occupational schemes (£90,000).

JDHinton

J D HINTON

ANNEX A

COMPARISON OF BENEFITS FROM PERSONAL PENSION SCHEMES AND 'FINAL SALARY' OCCUPATIONAL PENSION SCHEMES

Assumptions

1. Maximum personal pension contributions are paid.

2. Contributor has starting salary of £10,000 per annum.

3. Prices constant, earnings increase by either 1.5 per cent per annum or 3 per cent per annum, real return on investments 3 per cent.

4. Retirement at 65.

	PERSONAL PENSION SCHEME		FINAL SALARY SCHEME*	
Earnings growth	1.5%	3%	1.5%	3%
Membership of scheme for:				
40 years	13,890	18,620	11,920	21,110
30 years	9,960	14,430	8,940	15,710
20 years	6,570	10,240	5,960	11,690

*Final salary scheme benefits are based on 1/60 final salary for each year of service. But where a scheme is willing to offer accelerated accrual, the maximum benefit relating to 40 years service can be obtained after 20 years service with the employer.

ANNEX B

ILLUSTRATIVE CONTRIBUTION RATES

Introduction

1. The attached table gives an indication of age related contribution rates for three civil service careers. The contribution rates are highly variable depending on the particular career pattern, funding method and actuarial basis used. For this reason they are purely illustrative; they do not represent the actual costs of civil service retirement benefits or of the occupational pensions sector as a whole.

Benefit Structure

2. The benefits valued are those available at retirement under the civil service pension scheme. These are:

   a. A pension of 1/80 of pensionable salary for each year of service (increasing each year in line with inflation).

   b. A lump sum of 3/80 of pensionable salary for each year of service.

   c. A widow's pension of 1/160 of pensionable salary for each year of service (increasing each year in line with inflation).

3. It should be noted that this is less valuable than the maximum approvable accrual rate of 1/60 pension and 1/90 widows pensions under normal tax rules (1/30 and 1/45 under the accelerated accrual rules).

Selected careers

4. Three illustrative careers have been selected. They have been constructed using the Autumn 1987 pay scales and specified ages at promotion. The entry age for careers 1 and 2 have been taken at 20, thus giving a full pension at age 60 for 40 years service. For career 3 entry is taken as age 24. No allowance has been made for death in service, ill health retirement or early leaving.

5. The selected careers are:

1. Enter as administrative officer and retire as executive officer.

2. Enter as executive officer and retire as senior executive officer.

3. Enter as an administrative trainee and retire as a Grade 5.

Actuarial Basis

6. Male demographic factors have been used. This is to concentrate on the effect of differences in careers. However the value of the package of personal pension plus dependent's pension is similar for both men and women. No allowance is made for death in service, ill-health retirement and early leaving.

7. A cautious basis - as used for the pension fund surpluses legislation - has been adopted (a less cautious basis would have produced lower contributions, as a greater proportion of ultimate cost would be met out of investment returns). The main elements of the actuarial basis are as follows:-

Rate of Interest	8.5%
Excess of Rate of Interest over rate of increase in pensions	3%
Excess of Rate of Interest over rate of increase in earnings	1.5%

Note that an additional allowance is made for increases in earnings arising from the specific career.

Funding Methods

8. To relate to the current earnings basis on which personal pension contributions are paid, the table has been developed using the Current Unit Funding Method. Under the current unit method a provision is made for each person based on past service and current salary increased to pension age at the same rate used to increase preserved pensions. That rate of increase could be the statutory 5% or related to the assumed rate of increase in prices. The age related contribution rate is that required to increase the provision at the beginning of the year to that needed at the end.

Typically, the contribution rate using this method will start low and increase rapidly towards retirement. A large increase will also occur if salary increases sharply (eg on promotion), this is to bring past service benefit up to the new level. The contribution rate will then tend to fall back once past service benefits have been funded before increasing its rising trend.

TABLE OF ILLUSTRATIVE AVERAGE CONTRIBUTION RATES FOR DIFFERENT CAREER PATTERNS

AGE RANGE	CAREER 1	CAREER 2	CAREER 3	MAXIMUM PERSONAL PENSION CONTRIBUTION RATE
20-25	8.6	9.5	9.2	17.5
26-30	10.5	13.3*	10.9	17.5
31-35	13.0	14.5	21.0*	17.5
36-40	29.7*	22.2	21.4	17.5
41-45	19.5	19.5	30.7*	17.5
46-50	23.9	23.9	32.7	17.5
51-55	29.1	29.1	27.8	20.0
56-60	34.7	34.7	33.1	22.5

* impact of promotion on contribution rate.

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: C W CORLETT
EXTN. 6614
FAX. 6766
13 January 1989

FST X has much to be said for it. I'd be grateful if you could look urgently @ what might be done to achieve this.

Ch, Worth seeing before overview.
AL
13/1

FINANCIAL SECRETARY

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

1. You may be interested in having a quick note of our meeting yesterday with the Occupational Pension Schemes Joint Working Group to discuss proposals they had put to us for changes to the pensions tax rules.

2. The Joint Working Group (JWG) is an umbrella organisation for the main pension bodies: the Association of Consulting Actuaries, the Association of British Insurers, the National Association of Pension Funds and the Society of Pension Consultants.

<u>Background</u>

3. Ministers were informed at a meeting last summer that a number of pension bodies were interested in exploring radical reform of the pensions regime. The Chancellor's

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cc Chancellor of the Exchequer	Sir A Battishill
Chief Secretary	Mr Isaac
Paymaster General	Mr Bush
Economic Secretary	Mr Lusk
Sir Peter Middleton	Mr Kuczys
Mr Scholar	Mr Hinton
Mr Byatt	Mr Cooke
Mr Culpin	PS/IR
Mrs Chaplin	Mr Corlett
Mr Tyrie	

views were that this should not be discouraged (we were then embarking on "Byatt" ourselves), and we have since had a couple of meetings with the JWG, as a result of which they have developed a package of ideas.

4. The JWG's main concerns have been:

- anomalies caused by having separate tax regimes for occupational and personal pensions;
- the complexities of the present limits - mainly benefit limits;
- the harsh treatment of excessive AVC benefits.

<u>Radical reform</u>

5. The JWG have gone over much the same ground as we did in our Byatt exercise, trying to integrate the benefit-based and contribution-based systems. You will be interested to know that they have reached the same conclusions as Ministers did - that there are insuperable problems in getting from where we are now to where we would like to be in an ideal world.

<u>Detailed proposals for simplification</u>

X 6. The JWG has focused principally on the need to reduce the administrative burden for pension schemes, and to do this mainly by relaxing benefit limit rules for people on smaller incomes. Thus they had in mind proposals such as removing the two-thirds final salary benefit limit for pensions below £15,000 a year, leaving it to individuals to declare pensions to the Revenue and to tax offices to tax any excess. They also proposed more flexibility in retirement ages and some changes to the way in which the tax free lump sum is calculated.

7. In general, the proposals are a genuine attempt to find simplifications without making the tax reliefs substantially more generous.

8. Their suggestion for relaxing their need to keep a close check on benefit limits in favour of passing the responsibility substantially to tax offices is not really workable. But we shall be giving the underlying objective a little more thought. If anything comes of this - and it may not - it would be likely to involve administrative, not further legislative, changes.

9. On the other hand, the Budget package will go a long way towards helping with their concerns. For example

- the proposal to allow refunds of excess AVCs (less a tax charge);

- the relaxation in benefit limits on early retirement (which will meet worries about the complexity of limits and flexibility in retirement ages);

- the simplifications of the lump sum calculation (even though not the same as the JWG's proposal).

Policy changes

10. The JWG had two main proposals here:

- contribution limits for personal pensions should be improved;

- the 10 year accelerated accrual facility should be re-introduced.

11. On the first, the provisional Budget package includes increased limits - though they will probably not be as generous as the JWG would like. On the second, the answer

will of course be the new facility to pay additional "top-up" benefits (though without tax privilege). (We have, on previous occasions, made it clear that the Chancellor is unlikely to want to reverse the 1987 measures.)

Conclusion

12. The JWG ought to be reasonably happy with much of the Budget package. But we propose meeting them shortly after the Budget to explain the package in detail and, in particular, how to a substantial extent it should meet their main concerns.

C W CORLETT

FROM: J M G TAYLOR
DATE: 16 January 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Byatt
Mr Culpin
Mrs Chaplin
Mr Tyrie

Sir A Battishill IR
Mr Isaac IR
Mr Corlett IR
PS/IR

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

The Chancellor has seen Mr Corlett's note of 13 January.

2. He has noted Mr Corlett's comment that the Joint Working Group has focused principally on the need to reduce the administrative burden for pension schemes and to do this mainly by relaxing benefit limit rules for people on smaller incomes (paragraph 6 of Mr Corlett's note). He has commented that this has much to be said for it. He would be grateful if the Financial Secretary would look urgently at what might be done to achieve this.

J M G TAYLOR

CHANCELLOR OF THE EXCHEQUER

Chancellor,

I realize this note may niggle a little but I do think that there is an important point here.

Could you possibly hang on to this or envelope it <u>direct</u> to me? My last note seems to have been seen

by more than Alex in the

private office! (only Jonathan)

Andrew. 10.ii.

PS Judith and I happen

to see eye to eye on this, a

far cry from the days of the

late Commander!

CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: J D HINTON

23 JANUARY 1989

This is for discussion at your meeting at 3pm on Wednesday.
6WB 23/1

1. MR CORLETT

2. FINANCIAL SECRETARY

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

1. The Chancellor has asked (Mr Taylor's note of 16 January) if the Financial Secretary could look at what might be done to ease the administrative burden of the present pension tax rules for people on smaller incomes. This request follows Mr Corlett's note of 13 January reporting on a meeting with the Occupational Pensions Joint Working Group.

The Joint Working Group proposal

2. The Joint Working Group's main proposal was to allow pension schemes to pay a pension (subject to the normal two thirds final salary limit) of up to £15,000 a year without taking account of retained benefits from previous employments. It would then be for the pensioner to declare his total retirement benefits from all pension schemes to his local tax office. If in aggregate the benefits exceeded the two-thirds limit, the excess would be taxed at a "penal" rate.

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Mr Scholar
Mr Byatt
Mr Culpin
Mrs Chaplin
Mr Tyrie
Sir A Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Lusk
Mr Kuczys
Mr Hinton
Mr Cooke
PS/IR

6001.

3. The Joint Working Group claimed that such a system would significantly ease scheme administration. At present each scheme has to ensure that the benefits it pays, taken together with benefits from previous employments, do not exceed tax approval limits.

4. We do, however, see a number of serious difficulties with this approach. In particular it is based on a misunderstanding of how the tax system works. For the system to be effective, far more people than now would have to complete annual tax returns. The extra work involved for tax offices in dealing with the extra tax returns, calculating the total benefits received in pension and lump sum form, and making assessments at a special rate of tax on the excess would be considerable. It certainly could not be accommodated within present (or projected) staff levels. For this reason we do not believe it to be workable.

Reasons for the proposals

5. In explaining the problems that schemes face at present, the Joint Working Group identified three main issues:

i. Monitoring and dealing with excess AVCs (whether paid in-scheme or to a free-standing AVC provider);

ii. the complication of the benefit limit formula where a person leaves service or retires before the scheme's normal retirement age - especially when transfer values have to be calculated; and

iii. the need to keep a record of retained benefits from previous jobs.

The Budget package

6. The Budget package will, however, go a long way towards resolving two of these problem areas. In particular:

i. The proposal to allow refunds of excess AVCs (less a tax charge) will remove a major area of concern to pension schemes. Now that this change has been agreed we are also looking for simplifications to the present rules governing the payment and monitoring of AVCs.

ii. The proposed relaxation in benefit limits for early leavers and early retirers (as well as the greater flexibility proposed for retirement ages) should also be a major help. For the future, benefit limits should be clear cut and simple to calculate.

Retained benefit rules

7. The one concern not addressed in the Budget package is retained benefits. Even here our present rules are designed to ease administration where small benefits only are involved. For example:

i. It is not necessary to record retained benefits, or take them into account, where the scheme gives no more than a 1/60th final salary pension for each year of service; and

ii. there is a de minimis rule for accelerated accrual cases which allows an employee to have a total pension of up to £1000 each year (or two thirds final salary, if less) regardless of length of service.

8. There may, however, be scope for further relaxing the retained benefit rules. For example, according to the most recent survey of pension schemes conducted by the GAD, the

average size of new pensions granted in 1983 to men in the private sector was about £1500 per year. This figure will clearly have grown, but it does indicate how small most pensions are in practice.

9. It should therefore be possible to raise the de minimis threshold. It has not been revalorised for many years and straight indexation would set the new figure at pensions of £3000 per annum - although it may be possible to go further than that. This on its own would not significantly help pension scheme administrators. But if it could safely be combined with a relaxation which also allowed retained benefits to be kept out of the calculation, there would be some worthwhile savings for schemes. Any change of this sort would not require legislation. It could be implemented through changes to tax approval practice.

Conclusion

10. The three measures described in this note -

- simpler rules for AVCs;
- simpler benefit limits rules; and
- an increased de minimis rule

should go a long way to meet the pensions industry's worries.

11. The first two measures are part of the Budget package and will be announced at that time.

12. We would prefer, however, not to reach a view on the level of the de minimis rule at this time. As we propose to meet the Joint Working Group shortly after the Budget to

explain the package in detail, there are advantages in raising this point with them. We could then gauge the real value of the relaxation once we have their reactions.

J D Hinton

J D HINTON

rc 1989/25.1.01

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 25 January 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Scholar
Mr Gilhooly
Mr Matthews
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill
Mr Isaac
Mr Painter
Mr Kuczys
(paras 1-19 only)

Thanks. Ch
Re ①, I wd be strongly inclined
to keep to £150,000; but we
can discuss @ next overview.
Re ②, will look further.
Re ③, Inheritance tax threshold
must be unchanged
Re ④, grateful for views of
FST.
N

BUDGET DETAILS

I should like to raise a few random points.

1

Pension lump sum limit

2. Can you confirm, for the avoidance of doubt, that there is no question of raising the existing lump sum limit of £150,000, for those who will continue to be affected by it? I don't see how we could do this at the same time as reducing the limit to £90,000 for new entrants to pension schemes; but there could be some slight awkwardness, and it might be prudent to smoke this out now.

3. As you know, the £150,000 limit applies to people joining pension schemes between 1987 and 1989. I do not know how many such people there are, but there could be up to two million.

4. The number affected will fall as people change jobs and so change pension schemes. It could fall below a million within 5-10 years, and is likely to be down to tens of thousands within 20-25 years.

5. The most sensible policy would probably be to freeze the £150,000 limit until the new £90,000 limit catches up with it. That could be around the year 2000, assuming you hold to your decision that the new limit should be indexed to prices.

6. The case for this is, briefly, as follows:

- it would seem unfair to people joining pension schemes now to raise the limit for those who joined earlier

- any increase would lock people further into their existing jobs

- the numbers affected by the £150,000 limit should decline quite rapidly

- it is always open to their employers to top up their lump sums with taxable ex gratia payments.

7. However, the Financial Secretary has pointed out in earlier meetings that the Government has given the impression that the £150,000 limit will be raised from time to time. I have looked up the words which would have to be eaten. They were said in the Finance Bill Committee in 1987.

8. The Financial Secretary said clearly that the lump sum limit "will not be indexed" (7 May, col. 115): "notwithstanding what happens to personal allowances, it is our general stance, in a time of low inflation and at a time when we intend that inflation should remain low, to resist general indexation provisions" (14 July, col. 1039). There can be no complaint there. Indeed, if the new lump sum limit is indexed, it will, in that one respect, be more generous than previous undertakings would suggest.

9. However, the Financial Secretary also said of the £150,000 limit: "we do not wish it to be eroded" (7 May, col 115). "We shall review and adjust it from time to time" (15 July, col 1148).

10. Sir William Clark asked for a specific commitment that the £150,000 limit "will not be altered downwards but only upwards" (15 July, col 1146). The reply was, again, that we "did not intent that it should be eroded" (col 1148).

11. We are safe against the bluntest charge that we are breaking faith by reducing the £150,000 limit, as such. It will be kept in place. But we are open to complaints from Sir William Clark, whose minor hobby horse this seems to have been, that we <u>are</u> allowing the £150,000 limit to be eroded.

12. The answer will presumably be that we are now in an entirely new world. The limits for tax relief no longer determine the sorts of pension funds anyone can operate.

13. This is a bit thin, because it has always been open to employers to top up lump sums with ex gratia payments. The limit on the tax free lump sum has <u>not</u> been a limit on the total lump sum anyone can in practice receive, whereas the limit on the tax-privileged pension <u>has</u> to all intents and purposes been a limit on the total pension.

14. But, frankly, freezing the £150,000 limit still looks a lesser evil than raising it.

15. You do not need to decide now whether to freeze the £150,000 limit until the new limit catches up with it (paragraph 5 above). But you do need to decide whether to freeze it in 1989. We did, of course, in 1988; there is no obvious pressure to do anything else; and I cannot believe that we would even be asking the question if our other proposals on pensions had not raised it implicitly. But since you have decided to index the new £90,000 limit, and the Government has said that the £150,000 limit will not be eroded, it seems better to ask the question explicitly than to leave it to be decided by default.

2

Personal pensions

16. Second question, prompted by Hamish McRae's piece on Saturday (attached): can we do anything more to allow people to run their own pension schemes?

17. As I understand it, thanks to Mr Kuczys, the position is roughly this.

(a) We could in principle let people run their own personal pensions. It would probably not require legislation, so would not technically be a Budget measure; but it could clearly help the presentation of the Budget if you were able to announce the opening up of new opportunities.

(b) People would have to run their pensions through a financial intermediary of some sort. They could take their own decisions about how much to invest, where to invest it, when to buy and sell, and so on; but they would have to get an intermediary to hold the investments, and to act on instructions.

Otherwise it would be next to impossible for the Revenue to police the scheme. The intermediaries would perform much the same function in this respect as plan managers in the case of PEPs.

(c) Banks, building societies, unit trusts and insurance companies are already allowed to provide personal pensions. In principle, the Revenue would be prepared to allow them to act as authorised intermediaries for people wanting to run their own pensions.

(d) However, the DTI would want the same opportunities to be open to other potential intermediaries, to ensure free competition. These are not at present approved by the Revenue to handle personal pensions; and there is no realistic chance that they could all be let in. The plain fact is that it would be too risky to entrust them with the policing of the very substantial amounts of tax relief at stake, without an unacceptable supervisory cost to the Revenue.

18. If we could do anything here to remove obstacles, it seems to me that it could be well worth while. There might not be many takers to start with; but it would clearly enlarge freedom of choice, and facilitate both individual responsibility and wider share ownership.

19. Do you want to give this a push, to see whether anything could be done at or around the time of the Budget? If so, you will want further advice: I have not yet explored the issue in detail, or consulted colleagues. One thought which occurs to me is that you <u>might</u> want a word with Lord Young. As I understand it, the provision of tax-privileged personal pensions is already limited to banks, building societies, unit trusts and insurance companies. <u>If</u> the only big objection to letting them manage personalised funds, for

those wanting to run their own pensions, is that this would entrench a competitive advantage, it is not obvious that it is overwhelming.

3

Inheritance tax

20. Could we freeze the inheritance tax threshold this year? We raised it last year by over 20 per cent, from £90,000 to £110,000. We only went that far to get a round number. Keeping that round number for one more year would save about £35 million in 1989-90 and £70 million in 1990-91.

21. As you know, my own view is that we have gone slightly too far in raising the inheritance tax threshold above the average house price. I would not put much weight on this, because it is all very marginal; but there is a good case for keeping some small tax on reasonably ordinary houses, and, apart from stamp duty, inheritance tax is about to be the only one left.

4

CGT Chattels relief

22. Freezing the inheritance tax threshold could, if you wish, be presented in the same breath as freezing the £5,000 annual exemption for CGT (though the main reason for that is slightly different) and abolishing the CGT deferral for gifts.

23. Given the decisions you have now made on these two CGT items, can we drop the Starter to raise the CGT exemption for chattels, from £3,000 per chattel to £5,000? I can't get worked up about this; but in a year when we are tightening up, it could look a bit odd to allow more relief just for chattels.

National insurance contributions

24. Finally, I have remembered a second precedent for charging employer but not employee NICs, in case we want one. (The first and obvious precedent is that this is what we do on earnings above the UEL.) Women over 60 and men over 65 pay no national insurance contributions; but their employers pay 10.45 per cent.

RC

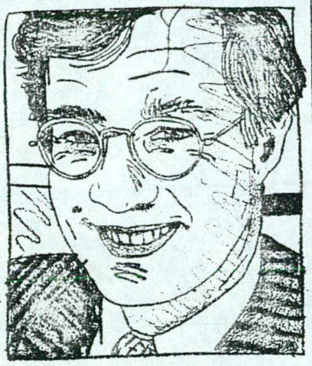
ROBERT CULPIN

Mr Culpin
90/1

The Guardian
FINANCIAL NEWS 9

An opportunity and an excuse to boost saving

Saturday Notebook



Hamish McRae

BUDGET time is looming. Well, not just yet, but this week we got the date of the Budget — March 14 — together with some economic indicators that suggest that it may not have to be such a restrictive budget after all.

It is going to be an extremely interesting Budget, not because there are going to be enormous tax changes, which there are not, but because it will be the first budget ever where money is not a problem.

A word of explanation. Budgets in essence have two quite different roles. They raise money for the Government to finance spending. And they are used as an instrument of economic policy to dampen down, or to boost economic demand.

This year money is coming out of the Treasury's ears, with something like £12 billion of public sector debt being repaid by the end of March. That would normally point to substantial tax cuts in the next year, because no one can seriously argue that the Government should take more in tax when it is already paying off the national debt at such a rate that it will disappear by the late 1990s.

But the Chancellor cannot cut taxes by much, because that would boost demand, increase inflationary pressures and threaten to increase further our trade deficit.

All would, however, become much easier if there was evidence that our economic growth were slowing of its own accord. In the last few days there have been some modest signs that that has been happening. We know that retail sales fell in December for the second month running. We saw a small fall in latest figures for the rate of growth in earnings. Industrial production also fell slightly.

If you add in the reports from the retailers that Christmas was pretty flat, it does look as though the rise of interest rates to 13 per cent has done the job of curbing the economy.

The trouble, as usual with economics, is that not all the evidence points in the same direction. This week also saw a record fall in unemployment, which, however welcome in itself, does not suggest a sluggish economy. And as reported today, both retail prices and consumer borrowing are still rising strongly.

The Chancellor will have another month's figures available before he has to commit himself to a budget, but the likelihood of these giving a much clearer picture is not that strong. Mr Lawson may well approach the Budget with the indicators pointing in different directions.

What will he do? In a nutshell he will try to give us some money back, but only in ways which will increase our saving rather than our spending.

In particular he will be looking at ways of increasing our saving to buy shares. There are two reasons for wanting to do this, a respectable one and a less respectable one.

The respectable reason for using the tax system to boost individual savings is that at the moment there are large incentives to save collectively by putting money into pension plans. If you need to encourage saving to stop Britons buying so many imported products, it would be logical and sensible to extend the devices used to encourage this institutional saving to ordinary individuals.

There are two main ways he can do this. One would be to extend or alter the tax relief on personal equity plans. These have been a resounding flop, with limited take-up in the first year and worse in the second.

Something has to be done to revive them, and just increasing the amount of money individuals can put in would hardly do that.

If, however, he were to allow people to put money into PEPs net of tax — that is, not pay income tax on money put into them — that would have a dramatic impact on take-up. It would be rather like the business expansion schemes, which have been a considerable success.

The other way of getting people to save more by buying shares would be to allow people to run their own pension schemes.

Given the poor investment performance of many financial institutions, not to mention the lavish "incentives" they give their door-to-door sales staff to encourage people to take out pension schemes, there would be an obvious attraction in allowing people to invest their own savings.

In the US there is a system of individual retirement accounts, where people do set aside money net of tax in this way. There is no reason why such a system could not be introduced here.

The less respectable reason for finding some way of boosting savings by encouraging investment in shares is that the Government needs a strong share market during the next year. Why? For the very simple reason that it has to sell the largest privatisation issue ever: the electricity industry.

As we saw in the case of British Steel, issues can be got away simply by pricing the issue cheaply enough. But that did not stop the steel shares dropping below the issue price for some weeks after the shares hit the market. The issue did the minimum thing required of it, in that it not only sold the issue, but it revived personal interest in share sales after the BP flop.

So while somehow the electricity industry will be sold, it will be infinitely easier to sell it on a buoyant market. The Government cannot control share prices, but it can, by its tax policy, have an influence on them, and this Budget is the ideal opportunity to do so.

The upshot of all this is that the very strong position of the public finances of the country will give both an opportunity and an excuse for the Chancellor to change the whole balance between individual investment and group investment.

He has tried to do this before, but then he wanted to reduce the financial advantages of the pension funds.

He was defeated by effective lobbying on their part. At that stage money was tight and there was no need to encourage savings.

Now he can achieve the same end of fiscal neutrality without taking away the special tax breaks of the pension funds, simply by extending these to individuals.

The message to all will be: provided you save the money rather than spend it, you can have it back.

2/6

Robert 02.25.1.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

PPS ~

Broadly content - but I sh[ould] be grateful if the FST would let me know how long ago the minimum rule was 8% @ £1,000; + what would be equivalent now (60% ...

Ch/ agree FST? 26/1

FROM: FINANCIAL SECRETARY

DATE: 26 January 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Corlett) IR
Mr Hinton)
PS/IR

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

You asked me to look at what might be done to ease the administrative burden of the present pension tax rules for people on smaller incomes. I have now discussed Mr Hinton's note of 23 January with officials.

Our proposals for the Budget will certainly help ease the situation in two areas:-

- refunding excess AVCs (with a tax charge) will remove a major area of concern;

- the relaxation of the benefit limits for early leavers and retirers will make the rules simpler to understand and calculate.

There remains the chore of having to keep a record of retained benefits from previous employments. The Occupational Pensions Joint Working Group suggested allowing pension schemes simply to pay pensions up to £15,000 a year without any regard to previous jobs. But that would mean a lot of additional administrative work for the Revenue since they would now have to ensure that total benefits did not exceed the two thirds limit. A better option would be to use the Revenue's discretionary powers in this area and raise the existing de minimis rules for pensions within the two thirds final salary limit from the existing £1000 per year regardless of length of service to at least £3000. This, combined with the fact that schemes giving a pension of no more than 1/60 final salary for each year of service do not have to record retained benefits or take them into account unless AVCs are being paid, would produce worthwhile savings.

Such a move would not require legislation. We could therefore implement it after the Budget following discussions with the Joint Working Group. I recommend we go ahead on that basis.

NL

NORMAN LAMONT

cst.rj/docs/26.1.4

BUDGET CONFIDENTIAL

FROM: A G TYRIE

DATE: 26 January 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mrs Chaplin
Mr Call

NB: –

BUDGET DETAILS

I saw Robert's note of 25 January.

2. On inheritance tax you know my general view that there is a good case for taxing it. But now that IHT has a hole blown in the middle of it by the abolition of CTT I can't see much point in rubbing our people up the wrong way by freezing the threshold.

3. This would undo the rise of 20% last year. We didn't do that just to get a 'round number', as Robert suggests. We did it because house prices are dragging more and more "ordinary folk" into IHT. Since we took that decision house prices have probably risen 30-40%, (although less where house prices were already high), so the case for indexation remains strong.

4. On CGT chattels relief I think the reasons for raising this to £5,000 are also strong:

- An increase in the exemption will probably increase the yield. How can this be, you might ask? It is because farmers write down CGT losses on their tractors and combines.

- You don't lose any revenue off the big items because of the withdrawal taper.

- We are keeping up with revalorisation (should be about £4,500), last done in 1982.

- Chasing small amounts is quite a hassle. It would certainly be a simplification for tax payers.

A G TYRIE

FROM: J M G TAYLOR
DATE: 26 January 1989

MR CULPIN

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Gilhooly
Mr Matthews
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Kuczys
(paras 1-19 only)

BUDGET DETAILS

The Chancellor was grateful for your note of 25 January.

2. On your first question, he would be strongly inclined to keep the existing lump sum limit at £150,000; but this can be discussed at the next overview meeting.

3. He thinks it is well worth pushing whether we can do anything more to allow people to run their own pension schemes. He would be grateful if you could take this forward.

4. On your third question, he thinks that the inheritance tax threshold <u>must</u> be revalorised.

5. On your fourth question - whether we can drop the starter to raise the CGT exemption for chattels from £3,000 to £5,000- he would be grateful for the views of the Financial Secretary.

J M G TAYLOR

FROM: J M G TAYLOR
DATE: 27 January 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Corlett - IR
Mr Hinton - IR
PS/IR

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

The Chancellor has seen the Financial Secretary's note of 26 January.

2. He is broadly content with the Financial Secretary's conclusion that we should use the Revenue's discretionary powers and raise the existing de minimis rules for pensions within the two-thirds final salary limit from £1,000 to (at least) £3,000 a year. But he would be grateful if the Financial Secretary would let him know how long ago the de minimis limit was set at £1,000; and what would be the revalorised equivalent now (both in terms of price revalorisation and earnings revalorisation).

J M G TAYLOR

chex.ps/jmt.41 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 27 January 1989

MR TYRIE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mrs Chaplin
Mr Call

BUDGET DETAILS

The Chancellor has seen and noted your minute of 26 January.

J M G TAYLOR

chex.ps/jmt.44 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 27 January 1989

bf. 3/1

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Corlett - IR
Mr Hinton - IR
PS/IR

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

The Chancellor has seen the Financial Secretary's note of 26 January.

2. He is broadly content with the Financial Secretary's conclusion that we should use the Revenue's discretionary powers and raise the existing de minimis rules for pensions within the two-thirds final salary limit from £1,000 to (at least) £3,000 a year. But he would be grateful if the Financial Secretary would let him know how long ago the de minimis limit was set at £1,000; and what would be the revalorised equivalent now (both in terms of price revalorisation and earnings revalorisation).

J M G TAYLOR

Robert 03.30.1.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

	FROM:	R C M SATCHWELL
	DATE;	30 January 1989
PS/CHANCELLOR	cc	PS/Chief Secretary PS/Paymaster General PS/Economic Secretary Mr Culpin Mrs Chaplin Mr Tyrie Mr Call

Ch/ Agree 'X'? OK –
AS 30/1

BUDGET DETAILS

The Financial Secretary has seen Mr Culpin's minute of 25 January and yours and Mr Tyrie's of 26 January.

The Financial Secretary very much agrees with Mr Tyrie on IHT. The flat rate of 40% looks quite harsh on modest estates, particularly when the Government has done so much for businesess.

The Financial Secretary agrees with Mr Culpin about freezing the £150,000 limit on the pension lump sum. He would be prepared to live with any necessary "eating of (his own) words". He also favours removing obstacles so that people can run their own pension schemes; it would fit in well with one of the themes of the budget, namely wider share ownership and savings.

X Finally, on the chattels exemption, he does not believe tightening up in this area would be worthwhile (i.e. he would raise the limit to £5,000).

R.C.M.S.

R C M SATCHWELL
Private Secretary

FROM: J M G TAYLOR
DATE: 31 January 1989

PMP

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Call

BUDGET DETAILS

The Chancellor has seen the Financial Secretary's note of 30 January.

2. He is content to keep the Starter to raise the CGT exemption for chattels from £3,000 per chattel to £5,000.

J M G TAYLOR

BUDGET CONFIDENTIAL

Inland Revenue

Capital and
Valuation Division
Somerset House

From: D Y Pitts

Date: 31 January 1989

pmp

(Missed the boat)

FINANCIAL SECRETARY

BUDGET DETAILS: CGT: CHATTELS EXEMPTION

1. The Chancellor (Mr Taylor's minute of 26 January) seeks your views on whether you can drop the starter to raise the CGT exemption for chattels from £3,000 to £5,000 (Mr Michael's minute of 20 October 1988).

2. You can. Raising the exemption would save some chores, but I cannot say dropping it would have significant ill consequences.

3. But in isolation there seems no point in doing so. Albeit a minor matter, it is possibly unique in being a lollipop with no cost: possibly even a yield: because it would also disallow some small losses on selling off plant and machinery. It is already drafted. It takes 4 lines of Bill space. It will probably be uncontroversial. It is 7 years since it was last raised. You and the Chancellor both supported it firmly (minutes of 24 October).

---

cc Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Gilhooly
Mr Matthews
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call
Sir A Battishill
Mr Painter
Mr Isaac
Mr Pitts
Mr Bush
Mr Cayley
Mr Hamilton
PS/IR

4. Mr Culpin's reason for now suggesting dropping it is that it could look a bit odd to allow more relief for chattels in a year when you are tightening up - by which I assume he means not across the taxes, but on the CGT annual exemption and gifts relief. I had not seen the latter as part of a general CGT tightening up; each measure has its particular justification. I should rather imagine that - if anything - you might welcome something which (although it cuts both ways) shows in its beneficial aspect that you are not in fact simply out to be tough on CGT. But it is very much a matter for political judgement.

DP.

D Y PITTS

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FST
Chancellor
we will look for statutory criteria to raise this limit to £5,000. (see exp 3(ii))
M.

FROM: J D HINTON

DATE: 1 FEBRUARY 1989

1. MR CORLETT

The original figure of £3000 mentioned in our earlier note is consistent with price revalorisation since publication of the £1000 figure in 1975. But if in the event you wanted to go higher, an alternative revalorisation formula should be readily available.
GWC 1/2

2. FINANCIAL SECRETARY

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

1. The Chancellor has asked (Mr Taylor's note of 27 January) in relation to the existing de minimis rules for pensions:

i. how long ago the de minimis limit was set at £1000; and

ii. what its revalorised equivalent would be now (in terms of both prices and earnings).

2. The present limit was first published as part of the Revenue's practice on the approval of pension schemes in mid-1975. Its present value, in terms of prices revalorisation is £3200 (at December 1988). Our estimate of present value by reference to male average earnings is about £4800.

---

cc	PS/Chancellor	Sir A Battishill
	PS/Chief Secretary	Mr Isaac
	PS/Paymaster General	Mr Corlett
	PS/Economic Secretary	Mr Lusk
	Sir P Middleton	Mr Kuczys
	Mr Byatt	Miss Dougharty
	Mr Scholar	Mr Hinton
	Mr Culpin	Mr Cooke
	Mrs Chaplin	PS/IR
	Mr Tyrie	Mr Bush

3. In addition, we should point out that although this limit was published in 1975, it had been introduced internally as a working rule in November 1972. If that date is used for revalorisation the £1000 limit becomes:

i. £4930 (if uprated by prices to December 1988); or

ii. £6350 (if increased in line with male average earnings).

4. These figures suggest that it should be possible to go further than £3000 when revising this limit. The exact figure could depend upon the pensions industry's reactions when we meet them after the Budget. More importantly, we would like their views on whether the de minimis limit - whatever figure is chosen - is in the most helpful form at present.

JDHinton

J D HINTON

FROM: J M G TAYLOR
DATE: 6 February 1989

PMP

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Chaplin
Mr Tyrie

Sir A M W Battishill - IR
Mr Isaac - IR
Mr Corlett - IR
Mr Hinton - IR

PENSIONS TAX REFORM: VIEWS OF THE INDUSTRY

The Chancellor has seen Mr Hinton's note of 1 February.

2. He has commented that, clearly, we will wish to give serious consideration to raising this de minimis limit to £5,000. (He notes particularly that if the November 1972 date is used as a basis for revalorisation, the £1,000 limit becomes £4,930.)

JT

J M G TAYLOR

psp.bh/draft8.2

BUDGET CONFIDENTIAL

FROM: J DIXON
DATE: 8 FEBRUARY 1989

15.2.89

1. **MR L HARRIS**
2. **CHANCELLOR**

cc: Treasury

Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Riley
Mr P Sedgwick
Mr Gilhooly
Mr MacPherson
Miss J C Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Inland Revenue

Sir A Battishill
Mr Beighton
Mr Isaac
Mr Painter
Mr G Bush
Mr Corlett
Mr Kuczys

Customs and Excise

Mr Jefferson Smith

Ch, We are fixing up a meeting with Ld Mackay. (No need to have a meeting with Mr Clarke, I think, despite 'X' – consultants are no different from anyone else, while judges are, of course, sui generis: they need primary legislation).

PENSIONS REFORM: MEETING WITH THE LORD CHANCELLOR

You wish to discuss with Lord Mackay several points arising out of the tax and pensions proposals, and asked for a briefing note.

2. The issues you wish to raise are:

(a) the effect on the proposed cap on lump sums arising from pay above £60,000 per year upon the judiciary; and

(b) the need for legislative action by LCD.

In addition, you could broach the sensitive matter of the accrual rate of the judiciary, which is inconsistent with Finance Act 1987 provisions in giving senior judges a half pay pension and lump sum after 15 years.

psp.bh/draft8.2

BUDGET CONFIDETNIAL

3. The issue of accrual rates is not an easy one for Lord Mackay, because it is highly valued by the judiciary, and a worsening at the present time would not help Lord Mackay in his legal reforms. You might, therefore, prefer not to press it at this time, or if you do, only in a very low key way. The general justification for this very fast accrual rate is that members of the Bar gaining judicial appointment are appointed late in life, and often suffer a large drop in earnings. The previous Lord Chancellor rejected the idea of new judicial appointees having to accept a 20 year accrual rate, even though the full impact of a change would not work through for 15 years or so. There is scope to offer a sweetener by increasing judges' lump sums from 1 up to 1½ times final salary.

4. We have now reappraised the numbers of those in the public services that would be hit by the cap at various salary levels. Since almost 900 NHS consultants would eventually be affected at £60,000, you may wish to consider warning Mr Clarke as well. In that case, legislation would not be necessary, but NHS scheme rules would need to be changed. However, the effect of the Budget change is much less severe for the newly appointed consultants, since most doctors are already in the existing NHS pension scheme and hence would not be caught by the cap, when appointed as a consultant after Budget Day.

X/

5. A speaking note is attached, which assumes you will wish to include the question of the accrual rate in your discussion with Lord Mackay.

J. D.

J DIXON
Superannuation Division

psp.bh/speak15.2.

BUDGET CONFIDETNIAL

SPEAKING NOTE

BUDGET CHANGE: LUMP SUMS

1. Wish to inform you in good time about proposed change in this year's budget, affecting judges among many others. Proposing to bring in a cap limiting tax privileged occupational pension schemes to those which provide pensions and lump sums derived from salaries up to £60,000 pa. Employers wishing to provide pensions and lump sums above the £60,000 cap will have to arrange separate top-up schemes which will not attract tax relief. Relevance of this to majority of public service schemes, including the judicial scheme, is that lump sums derived from the slice of income above £60,000 will be taxed on receipt. Change will apply only to those joining a scheme after Budget day; it will not affect existing scheme members.

2. As an example, a new judge appointed after Budget Day on a salary of £80,000 will receive benefits from two schemes. When he retires, the lump sum from the main judicial scheme will be tax free, as now. But the lump sum from the top-up scheme will be taxed. If he serves the full 15 or 20 years and gets maximum lump sum benefits, £60,000 would be tax free and £20,000 would be subject to tax (of £8,000). (For convenience, the example is in today's money, since the arrangements will be index-linked.)

3. Finance Act can override private sector scheme rules, but not the rules of most statutory public service schemes. They will require separate amendment. The Judicial Pensions Act 1981

probably needs amending to give effect to Budget change, which is why I need to consult you now. Would like to give a firm commitment during Budget debate that you will legislate as soon as possible to bring judges scheme into line with the private sector and the rest of the public services.

4. Although only new judicial appointments made after Budget day will be affected, some 160 judges will be affected ultimately. (See Annex A for details.) Change will bite on about 50,000 people in private sector. The other main public service group affected is some 900 NHS consultants, although some senior officials in central and local government will also be caught.

TOP-UP SCHEME

5. Will need to consider whether your department should set up a top-up pension scheme for judges earning more than £60,000. This is what the private sector and other public service schemes are likely to do. There would be presentational merit if the judges' scheme followed suit. New top-up scheme would be unfunded, and judges would not contribute to it.

FAST ACCRUAL IN THE JUDICIAL SCHEME

6. Necessary amendment to Judicial Pensions Act 1981 could be made for the above in the proposed Judicial Pensions Bill or County Courts Bill next session. At same time, opportunity could be taken to remove an embarrassing anomaly in the judicial pensions scheme.

7. 1987 Finance Act outlawed pension schemes giving maximum pension benefits in less than 20 years. All other private sector and public service schemes now reflect this. But the judges scheme still provides many judges with half pay pension and lump sum equal to a year's salary after 15 years service (compared with, for example, the Civil Service which provides a half pay pension and a lump sum 1½ times salary after 40 years reckonable service).

8. Main justification for favourable judicial scheme is that many judges take a drop in salary on appointment from the bar, and start their judicial careers late. But difficult to defend continuing difference between judges and the population at large, where the fastest accrual rate now permitted gives a half pay pension in 20 years. Even 20 year accrual rate is very favourable.

9. Solution might be for future judicial appointees to be given an accrual rate of 20 years in exchange for an increase in the maximum lump sum from 1 up to 1½ times annual salary. This might be further explored in discussions already planned between Treasury officials, your officials and others about a number of possible tidying-up changes to the judicial pensions scheme. The improvement in the lump sum might be greater than the new tax liability (see Annex B). Recognise, however, that it would take some judges an extra 5 years to accrue full pension. But they would be in same position as population at large - and there is greater opportunity now (eg through personal pensions) for judges to have made pension provision during earlier years at the Bar.

CONCLUSION

10. Grateful if you would urgently consider including provisions in the proposed Judicial Pensions or County Courts Bill, to:

(i) give effect for the judges to the Budget changes, and provide a separate top-up scheme for the judiciary; and

(ii) change judges' 15 year accrual rate to 20 years in line with the Finance Act 1987 with, perhaps, an improvement in their maximum lump sum (as a measure of compensation).

ANNEX A

TSRB GROUPS

		Current Salary £ wef (1.10.88)	Number in post	Pay bill £m (excl ERNICs & superannuation)
JUDICIARY				
Lord Chief Justice	Grp1	85,250	1	0.09
Lords of Appeal Master of the Rolls Lord President of the Court of Session Lord Chief Justice (Northern Ireland)	Grp2	78,750	13	1.02
Lord Justice Clerk Lord Justice of Appeal Lord Justices of Appeal (Northern Ireland) President of Family Division Vice Chancellor Inner House Judges of the Court of Session	Grp3	75,750	39	2.95
High Court Judges Judges of the Court of Session Puisne Judges (Northern Ireland)	Grp4	68,500	103	7.06
London Official Referees	Grp4a	59,700	6	0.35
Chairman, Scottish Land Court and President, Lands Tribunal (Scotland) Official Referees Vice Chancellor of the County Palatine of Lancaster Senior Circuit Judges Recorder of Liverpool Recorder of Manchester Recorder of Belfast Chief Social Security Commissioners England), Wales and Scotland and Northern Ireland Presidents, Industrial Tribunals (England and Wales, Scotland and Northern Ireland) Judge Advocate General President Social Security Appeal Tribunals and Medical Appeal Tribunals (England, Wales, and Scotland) County Court Judges (Northern Ireland) Chairman, Criminal Injuries Compensation Board Presidents, Lands Tribunal (England and Wales and Northern Ireland	Grp5	50,900	24	1.22

ANNEX B

Examples of accrual rates and lump sum taxation: salary £80,000

		Total Lump Sum £	Tax free element £	Taxed element £
A.	15 years' service (under present accrual rate, and present lump sum rate of 1 times pay)	80,000	60,000	20,000 at 40% = £8,000

Total lump sum received = £72,000

Thus the effect of the tax change is a loss of £8,000.

		Total Lump Sum £	Tax free element £	Taxed element £
B.	20 years' service (under proposed accrual rate, with lump sum at 1½ times pay)	120,000	60,000	60,000 at 40% = £24,000

Total lump sums received = £96,000

Thus the effect of a change in the lump sum rate is that a larger lump sum is received than in A, but 5 more years' service is required.

		Total Lump Sum £	Tax free element £	Taxed element £
C.	20 years' service (proposed accrual rate, with lump sum at 1¼ times pay)	100,000	60,000	40,000 at 40% = £16,000

Total lump sums received = £74,000

An outcome very close to A.

PERSONAL AND BUDGET CONFIDENTIAL

FROM: A G TYRIE
DATE: 10th February 1989
cc: Mrs Chaplin

CHANCELLOR

TYRIE 10/2

PUBLIC SECTOR PENSIONS

May I dissent again from the decisions we have taken on public sector schemes in conjunction with the "Chaplin/Isaac" package?

2. As Terry Burns pointed out, the Chaplin package is very radical. In practice, it removes virtually any incentive to provide pensions above the £60,000 cap. Whether companies decide to pay for a bit more in the course of their employees' working life or give them a "golden goodbye" on retirement is neither here nor there: both would be allowable against CT and both would be taxed as income in the hands of the recipient.

3. In the long run, the Chaplin scheme would bring some transparency to occupational schemes and reduce the cross-subsidisation within them considerably. Those benefits would be denied public sector schemes with the provisional decisions we have taken.

4. At the moment, as I understand it, the Civil Service scheme shadows relief available through occupational schemes, even though it is unfunded. So, in principle, any tightening of occupational schemes should be mirrored to the public sector.

5. It is agreed that the lump sum should be taxed in both the public and private sectors. The question is, what, if any, reduction in public sector benefit should civil service accept as an offset to removal of tax privileges above the £60,000 cap? Tom Luce and co say "none" and that, in some indeterminate way, the TSRB could take the removal of tax privileges "into account". I don't believe they would do that for a moment. But, setting that to one side, what is the "excess" benefit in the public sector scheme?

6. It seems to me that there are three ways of expressing the size of the benefits of Civil Service schemes:

(i) <u>The read across to personal pensions plans</u>
Actuarial, a person in the private sector with an identical earnings profile as a permanent secretary (starting at £10,000 rising to £70,000) over a lifetime would need an annuity of about £600,000 to pay for an indexed link pension. To obtain that someone in the private sector would have to save about 40% of his salary each year throughout his life, with income tax relief on the full 40%.

This demonstrates the sheer size of the benefit. I have based this on a 3% real rate of return. If the real rate of return were less than that, say a little over 2%, (as it was in the early 1980s) the private sector chap would have to put by around 50% of his salary to obtain the same pension!

(ii) <u>The read across to occupational schemes</u>
With a cap at £60,000 and a final salary of £70,000, it can be argued that salaries should be reduced by the tax relief notionally given for those earnings above the cap, that is £1,600.

[This is calculated at follows: for the man on £70,000 who would notionally require a 40% contribution to fund his pension, the excess contribution is £4,000, ie .4 (70,000 - 60,000). Given that he is a top rate tax payer, the value of the tax relief will be 40% of £4,000 = £1,600. Of course, to arrive at this I have had to draw in a money purchase scheme assumption.]

(iii) "<u>Pay as you go</u>"
It could be argued that the Civil Service is being put on a level playing field by the Chaplin scheme in that both would now be "pay as you go" above the cap. In that case I cannot see how one can avoid

calculating the "golden goodbye" required to buy the annuity which would provide the top up for the Civil Servant between the cap, of £60,000, and his salary of, say, £70,000.

7. I cannot think of any way of looking at this which does not lead to the conclusion that <u>either</u> top Civil Servants must take a cut in salary and/or pensions <u>or</u> we must accept that whereas we are increasing taxation for private sector pensions we are not doing so for the public sector.

8. Of course tampering with all this would cause a riot in the upper echelons of Whitehall. But I think the politics are not at all to our disadvantage. The Government took a lot of flak when it implemented the TSRB report three or four years ago and increased top Civil Service salaries substantially. The announcement that we were not going to let them avoid the consequence of a tightening in the tax treatment of private sector pensions would probably be met with nods of approval from the media and Parliament.

9. This all may look like a rather academic discussion about a few hundred top Civil Servants. But the whole point of the pensions' reform is that, as the gap between earnings and prices widens, more and more people would be affected by the cap. So, as I mentioned in my earlier note, we are taking decisions about the treatment of very large numbers of Civil Service pensions over the coming decades.

10. If we are ever going to get labour mobility at the top end between the public and private sectors I think we have got to grasp this nettle. Why can we not say, for example, that Civil Servants will not henceforth automatically receive pensions above the cap but may receive discretionary pay rises (or acquire an entitlement to "golden goodbyes" at 60) <u>on merit</u>. If we need these civil servants we must be prepared to pay for them. On the flip side, top Civil Servants say they want equivalence with the private sector labour market; they would be getting it. The door to the removal of job security

and cross-fertilization of Whitehall and the private sector would be open.

11. I don't think there is anything in the least unfair about this sort of suggestion. For some reason we still treat Civil Service remuneration like a constitutional question. Of course, top officials would claim that such discretionary power gave politicians the scope to make appointments/awards on political grounds and would therefore prejudice the independence of Civil Service. I think that's hog wash. Nobody disputes the right of the Prime Minister to appoint who she wants to the Permanent Secretary jobs. I can't see how these discretionary awards at the top would add to that sort of power.

pp RJ.

A G TYRIE

cst.rj/docs/15.2.4

PERSONAL AND BUDGET CONFIDENTIAL

[The one I am allowed to see!]

FROM: A G TYRIE
DATE: 15 February 1989
cc: Mrs Chaplin

CHANCELLOR

Thanks. I shd like official advice on the mechanics of the PPP top-up proposal with the public service pensions problem

TYRIE 5/2

PUBLIC SECTOR PENSIONS AND A PPP TOP-UP

If you did the PPP top-up what consequences would this have for the approach I suggested in my earlier note?

2. Civil Servants can't take advantage of accelerated accrual but they can buy added years. The problem for them is that, even if they bought added years, they wouldn't be able to get out of their scheme until they were 60, so they couldn't contribute to a PPP while still in the Civil Service. There would be clear non-comparability with the private sector.

why not?

3. So if we were to do the package, with the PPP top-up, I think we would need to change the Civil Service rules to enable Civil Servants to buy added years and close down their "notional" schemes before retirement. (I have not consulted superannuation to check that this, in practice, could be done, but I can't see why not!) This would enable them to open a PPP for their remaining years. It would give them parity with private sector.

4. Of course, as with the private sector, the cap would bite deep at the top end in years to come. But, with the option of a PPP available, which puts them on all fours with the private sector, I see every reason for sticking to the suggestion that the only compensation should be <u>selective</u> pay awards to top

Civil Servants to help them set up PPPs. This is what the private sector will do: they will only offer accelerated accrual/PPP packages to the staff they really wanted to keep. For the rest, many big companies, I suspect, will be quite happy to see the entitlement of some of the highly paid dead wood "salary capped".

5. Selectivity is the key. Without that the door would stay closed and all the opportunities for long term Civil Service reform to which I alluded in my earlier note. In any case, I can't imagine there will be a queue of Ministers wanting to go to the despatch box to announce a blanket pay rise for top Civil Servants, particularly if it's in compensation for a pensions reform that many perceived to be severe on the private sector!

AGT.

A G TYRIE

FROM: J M G TAYLOR
DATE: 15 February 1989

MR MACPHERSON

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Harris
Mr Gilhooly
Mr Matthews
Mrs Chaplin
Mr Tyrie

Mr Isaac - IR
Mr Corlett - IR
Mr Kuczys - IR

PENSION LIMITS

The Chancellor has seen your note of 14 February, noting that under the proposed new regime an employee has the additional option of leaving his employer's scheme and taking out a tax-privileged personal pension.

2. He has commented: "Well spotted". He thinks this is a most important point. We must take credit for this, and present it as an integral part of the overall package.

J M G TAYLOR

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: J D HINTON

DATE: 15 FEBRUARY 1989

Note at end

1. MR KUCZYS ✓ 15/2

2. MR ISAAC 15.2

3. FINANCIAL SECRETARY ✓

PERSONAL PENSIONS

1. As part of the Budget pensions package, personal pensions are to be given a boost through increased maximum percentage contribution limits (subject to an earnings cap). My submission of 2 December suggested some options for the new limits and these were discussed at a meeting on 9 December. But, although you then agreed the broad outline of the personal pensions measures, there are three issues still open. They are:

Not attached, in the interests of brevity!

i. What the new contribution limits should be.

ii. At what level the earnings cap should be set.

---

cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir T Burns
Dame Anne Mueller
Mr Scholar
Mr Culpin
Mr Harris
Mr Riley
Mr Gilhooly
Mr Dixon
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill
Mr Isaac
Mr Bush
Mr Corlett
Mr Newstead
Mr Lusk
Mr Eason
Mr Kuczys
Miss Dougharty
Mr Hinton
Mr Cooke
Mr Gilbert
PS/IR

iii. Whether these changes should be extended to the old retirement annuity tax regime.

The Contributions limits

2. Personal pensions, being money purchase arrangements, generally give the best results if used for long term savings: the sooner you start contributing the better the pension. The present normal contribution limit (17.5% of earnings) was set with this in mind. If a person contributes regularly at or near this level when he is young, there is every prospect of achieving a pension as good as one from a normal final salary occupational scheme.

3. But, in practice, this does not often happen. It is tempting for the young to not worry about retirement. So it tends to be only those who are in occupational schemes who have full contribution histories. For those not in employer schemes, substantial contributions are often not started until mid-career. By then it may already be too late to achieve a good pension. There is little that can be done about this - people have different priorities depending on factors such as their age, income and health.

4. But where the tax regime can help is by giving the late starter some leeway to catch-up. First, there are special rules which allow people to pay extra contributions in respect of unused tax relief from the previous six years (this is known as carry-forward). Second, the maximum personal pension contribution rates are graduated according to age. The present contribution limits were set only in 1987 - before then the maximum depended on the person's date of birth. For illustrative purposes the table below shows both the present age related limits and (in brackets) what the pre-1987 limits would have allowed for those people who are now within the respective age bands.

Age	Maximum percentage of earnings	
50 or less	17.5	(17.5)
51-55	20	(17.5)
56-60	22.5	(20)
61-75	27.5	(20 for those born in 1916 or later; 21 for those born in 1915)

5. Although the improved contribution limits introduced in 1987 for those aged over 50 and the special carry-forward rules help, they do not fully redress the disadvantage caused by inadequate contributions in earlier years. Nor can a personal pension match the very generous accelerated accrual rules (which allow for a two-thirds final salary pension after 20 years service) which many senior executives in occupational schemes enjoy.

6. But there is scope to go some way further to bridge the gap between personal pension benefits and those from the best occupational schemes. You agreed in December that improving the contribution limits (within an earnings cap) is the best approach.

7. Annex B to my submission of 2 December included some illustrative contribution rates for particular career patterns to see what personal pension contribution rates might look like if accounts were to be taken of career movements - a copy of that Annex is attached for ease of reference.

8. The illustrative contribution rates do not in themselves represent any real guide to what personal pension contribution rates should be. There are too many variables such as investment returns, career patterns, actuarial basis etc. They do, however, show that there is scope to increase maximum percentage limits in order to "level-up" personal pensions with their occupational counterparts.

The options

9. This submission offers, in ascending order of generosity, four options for the new contribution limit. These options are not, of course, exhaustive and other combinations of limits can be considered if Ministers wish.

OPTION A

Age	Percentage limit
up to 45	17.5
46-50	22.5
51-55	27.5
56 and over	35

Analysis: This is the least generous of the four options. It makes no change for those below age 46, but thereafter it represents a considerable improvement giving increases ranging from 27% to 55% over the present maxima.

Its cost in the first few years could be about £5 million (which, set against the yield from the £60,000 cap on occupational pensions, would produce an overall balanced package).

OPTION B

Age	Percentage limit
up to 35	15
36 45	20
46-50	25
51-55	30
56 and over	35

Analysis: This has a more graduated scale (and rounder figures) than Option A. The contributions for those under age 35 have been reduced (from 17.5%) because at younger ages the present limit is perhaps too high if the maximum allowed is contributed over a full career. But, if a reduction in rates looked presentationally difficult, the 17.5% base limit could be retained. The cost of this option would also be in the order of £5 million, in the early years - again producing a balanced package overall.

OPTION C

Age	Percentage limit
up to 35	20
36-45	25
46-50	30
56 and over	40

Analysis: This is a much more generous option. For example at age 56 it represents a increase of more than 75% over the existing contribution limit at that age. And, by pushing the improvements down the age range, it would increase the chances of people being able to compensate for an inadequate contribution history early in their careers. This option carries a significantly higher cost, perhaps £15 million in the first full year (so the overall pensions package would have a cost of £10 million).

OPTION D

Age	Percentage limit
up to 30	25
31-40	35
41-50	45
51 and over	50

Analysis: This option is taken from the Budget representations by the Inter-Professional Committee on Retirement Benefits for the Self-employed. It represents their view of what would be required for the self-employed to match 20 year accelerated accrual for occupational schemes. (But even then these very high percentage limits would be too low without other changes they call for. In particular the Committee link their proposed contribution rates with an extension to the carry-forward rules so that people would not be restricted to the 6 "in-date" tax years as now but would be able to carry-forward unused relief over the whole of their career). The cost of this option is around £25 million in the first full year, producing a £20 million cost for the whole pensions package.

10. None of these options (even that suggested by the Inter Professional Committee) could enable personal pension holders to stand in exactly the same shoes as those in the best top-hat final salary scheme with its 20 year accelerated accrual rules. But all of the options represent a big improvement over what is possible now.

11. Of these options, C and D have the disadvantage of allowing the high paid to shelter a very large part of their profits from income tax and they would also turn the overall pensions package into one with a considerable cost. There

are other ways in which the self-employed, in particular, can save for their retirement, eg many have the value of their businesses, and former partners can be paid annuities direct from the partnership in addition to a personal pension. So options C and D look unnecessarily expensive. Options A or B therefore look the more practical choice. Of the two, Option B with its more graduated approach extending further down the age range is preferable (but, if you wished to avoid any presentational problems, with a 17.5% contribution limit rather than the more rounded 15%). We therefore recommend Option B modified so as to keep the 17.5 per cent limit for younger contributors.

The earnings cap

12. Ministers have decided that there should be an earnings cap on personal pension contributions, but it is an open issue where that cap should be set. This is a difficult issue. For occupational schemes the benefit cap will be imposed on earnings of £60,000. The question then is what limit is appropriate for personal pensions?

13. The first point to emphasise is that the personal pensions limit will not prescribe what benefits may be paid. It simply limits the money going into a scheme - the benefits which emerge then depend on how well the scheme investments have performed and annuity rates on retirement.

14. There is no clearly appropriate level at which the cap should be set. It does not have to bite at the same earnings as its occupational scheme equivalent. If it were set at a different level, there is no arithmetically determined level at which the cap would compensate for the other advantages of occupational schemes enjoy. But, on the strength of an admittedly crude example, the submission of 2 December showed that [on certain assumptions] the limit might need to be raised to between £120,000 and £180,000.

15. A difference of this magnitude over the £60,000 occupational pension limit would be very difficult to present - especially as there can be no arithmetical justification for it. It would also weaken the case for removing the £150,000 cap on personal pensions lump sums (which is an unnecessary limit if the personal pensions earnings cap is set at £60,000).

16. The earnings cap - whether for occupational pension benefits or personal pension contributions - is an arbitrary figure. There is no particular magic about it in either context. And, as no clear case can be made for different caps it will be easier to justify a single (£60,000) earnings cap which applies uniformly for the purposes of all tax privileged pension arrangements. We recommend accordingly.

The retirement annuity rules

17. The one issue not considered up to now is whether the new personal pension rules should be extended also to the old retirement annuity contracts. With the advent of personal pensions, retirement annuities are a closed class - no new contracts can now be taken out.

18. There are two options - either keep the two tax regimes in line or leave the retirement annuity code unaltered. To bring the two tax regimes into line would mean introducing corresponding provisions such as the £60,000 earnings cap on contributions and the higher percentage contribution limits (as well as the removal of the £150,000 limit on tax-free lump sums). If it were considered essential to keep the two regimes in line the changes required to the retirement annuity rules would be straightforward and would mirror those for personal pensions. They would add, perhaps, a further page to the Finance Bill.

19. On the other hand, it would be possible to do nothing to retirement annuities and allow them to wither away over time as an obsolete form of retirement provision. This

would mean leaving them with rather lower percentage contribution limits but no earnings cap. In practice very few people with retirement annuity contracts are likely to have earnings in excess of £60,000, so the lower contribution limit will be the most important factor in encouraging people to switch to personal pensions. This should help shorten the transitional period.

20. Such an approach might be criticised. But none will be disadvantaged as personal pensions provide a modern, more flexible, alternative. The case for leaving things as they stand would be that retirement annuities are a closed class and in view of the alternatives available there is no need to extend any of the Budget changes to them. This would be a perfectly defensible approach. And it makes sense to allow them to wither away. But if severe pressure is brought to bear to update them, that could be considered at a later stage of the Bill. <u>We therefore recommend that no changes be made to the retirement annuities tax regime</u>.

JDHinton

J D HINTON

In summary, we recommend:

i. the <u>cap</u> on contributions should be set at the <u>same</u> (£60,000) earnings level as for occupational schemes;

ii. the <u>percentage contribution limits</u> should be as in <u>Option B modified</u> (which keeps the cost to £5m but leaves no-one worse off); and

iii. the improvements should <u>not</u> extend to old <u>retirement annuities</u>.

You may want to discuss this with us.

[signature]

ANNEX B

ILLUSTRATIVE CONTRIBUTION RATES

Introduction

1. The attached table gives an indication of age related contribution rates for three civil service careers. The contribution rates are highly variable depending on the particular career pattern, funding method and actuarial basis used. For this reason they are purely illustrative; they do not represent the actual costs of civil service retirement benefits or of the occupational pensions sector as a whole.

Benefit Structure

2. The benefits valued are those available at retirement under the civil service pension scheme. These are:

a. A pension of 1/80 of pensionable salary for each year of service (increasing each year in line with inflation).

b. A lump sum of 3/80 of pensionable salary for each year of service.

c. A widow's pension of 1/160 of pensionable salary for each year of service (increasing each year in line with inflation).

3. It should be noted that this is less valuable than the maximum approvable accrual rate of 1/60 pension and 1/90 widows pensions under normal tax rules (1/30 and 1/45 under the accelerated accrual rules).

4000.

Selected careers

4. Three illustrative careers have been selected. They have been constructed using the Autumn 1987 pay scales and specified ages at promotion. The entry age for careers 1 and 2 have been taken at 20, thus giving a full pension at age 60 for 40 years service. For career 3 entry is taken as age 24. No allowance has been made for death in service, ill health retirement or early leaving.

5. The selected careers are:

1. Enter as administrative officer and retire as executive officer.

2. Enter as executive officer and retire as senior executive officer.

3. Enter as an administrative trainee and retire as a Grade 5.

Actuarial Basis

6. Male demographic factors have been used. This is to concentrate on the effect of differences in careers. However the value of the package of personal pension plus dependent's pension is similar for both men and women. No allowance is made for death in service, ill-health retirement and early leaving.

7. A cautious basis - as used for the pension fund surpluses legislation - has been adopted (a less cautious basis would have produced lower contributions, as a greater proportion of ultimate cost would be met out of investment returns). The main elements of the actuarial basis are as follows:-

Rate of Interest	8.5%
Excess of Rate of Interest over rate of increase in pensions	3%
Excess of Rate of Interest over rate of increase in earnings	1.5%

Note that an additional allowance is made for increases in earnings arising from the specific career.

Funding Methods

8. To relate to the current earnings basis on which personal pension contributions are paid, the table has been developed using the Current Unit Funding Method. Under the current unit method a provision is made for each person based on past service and current salary increased to pension age at the same rate used to increase preserved pensions. That rate of increase could be the statutory 5% or related to the assumed rate of increase in prices. The age related contribution rate is that required to increase the provision at the beginning of the year to that needed at the end.

Typically, the contribution rate using this method will start low and increase rapidly towards retirement. A large increase will also occur if salary increases sharply (eg on promotion), this is to bring past service benefit up to the new level. The contribution rate will then tend to fall back once past service benefits have been funded before increasing its rising trend.

4000.

TABLE OF ILLUSTRATIVE AVERAGE CONTRIBUTION RATES FOR DIFFERENT CAREER PATTERNS

AGE RANGE	CAREER 1	CAREER 2	CAREER 3	MAXIMUM PERSONAL PENSION CONTRIBUTION RATE
20-25	8.6	9.5	9.2	17.5
26-30	10.5	13.3*	10.9	17.5
31-35	13.0	14.5	21.0*	17.5
36-40	29.7*	22.2	21.4	17.5
41-45	19.5	19.5	30.7*	17.5
46-50	23.9	23.9	32.7	17.5
51-55	29.1	29.1	27.8	20.0
56-60	34.7	34.7	33.1	22.5

* impact of promotion on contribution rate.

CHANCELLOR OF THE EXCHEQUER

AJC

Thanks. I thought this must have orig- from you. M

L,

As it happens, the idea known as the 'Culpin wheeze' came to me during the last overview and I asked Messrs. Kuczys and Macpherson to think about. I should have known that the sticky-fingered bearded wonder would hear about it and filch it! (Andrew is furious about this!)

Having claimed authorship

I would like to support it, but as I set out in the note, it is not all upside.

Andrew.

—

BUDGET CONFIDENTIAL

FROM: N I MACPHERSON
DATE: 14 February 1989

Note at end

RC 14/2

1. MR CULPIN

2. CHANCELLOR

cc: Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Harris
Mr Gilhooly
Mr Matthews
Mrs Chaplin
Mr Tyrie

Mr Isaac)
Mr Corlett)IR
Mr Kuczys)

Well spotted. This is a most important point. We must take credit for this, & present it as an integral part of the overall package. N.

PENSION LIMITS

At yesterday's Overview, you were concerned that the top-up regime might lead to growth in pay-as-you-go. You also wondered whether the earnings limits might be on the low side (but concluded that they were not). We have discovered a loophole which could alleviate both these problems.

2. So far we have been assuming that as soon as an employee's earnings approach £60,000 p.a. he will begin to negotiate a non-privileged top up. However, he has another option. He can leave his employer's scheme and take out a tax privileged personal pension.

3. Take the example of someone in a fast accrual final salary scheme. At the age of 50, he has accrued a full pension on earnings of £60,000. Under the new regime, his tax privileged pension from the final salary scheme cannot increase. He can therefore leave the scheme, have his accrued rights uprated in line with prices, and take out a personal pension. A personal pension will give him relief on contributions of 27.5 per cent of earnings (up to £16,500 per annum), rising to 35 per cent (up to £21,000) when he is 56. (Assumes Option A, Hinton 2 December). By retirement at 65, his personal pension could give him benefits of £35,000 p.a. on top of his final salary pension of £40,000 p.a, even if his salary remained unchanged at £60,000. No non-privileged fund would be necessary.

4. Employers should welcome a personal pension top up because it will secure a funded pension at a lower cost: employees may be more easily persuaded to contribute, since there will be no schedule E charge, and there will be tax free build up within the fund.

5. Of course, the example above is an extreme case. Most employees will not be in a fast accrual scheme, and it may pay them to stay in their final salary scheme in order to clock up 40 years service and hence a pension of two thirds of final salary. This will be particularly true of someone whose earnings cross £60,000 late in their career. Others may prefer the security of the final salary promise, particularly if the employer is prepared to foot the bill in the form of a pay as you go scheme. It will also be of little consolation to the Ralph Halperns, since they will be hit by the cash limit on personal pension contributions.

6. However, the personal pension route does show that the regime is not quite as restrictive as we, in FP at least, originally thought.

7. The Revenue are inclined not to close off this route, except for controlling directors who could clearly exploit it by manipulating their salaries. We tend to agree. In logic, it is perhaps inconsistent and overgenerous to allow some high earners a "double dip" in this way. But the personal pension regime involves ceilings on the amount of tax relief, and so the scope for exploitation will be limited. A major objective is to shift people into money purchase schemes, particularly personal pensions. There is also concern about a possible drift towards pay-as-you-go. Personal pension top-ups score on both counts. Rather than leaving it to the industry to work it out for themselves, it may be best to make its availability clear from the start.

8. If however you do want to prevent high paid employees from taking advantage of this dodge, then the Revenue will have to devise some new rules.

9. To sum up, there is an inconsistency here. On balance we suggest it is not so serious that anything need be done about it, but you should be aware of the point.

N. I. Macpherson

N I MACPHERSON

Mr Kuczys thinks this analysis is probably right: the rules do allow someone earning £60,000 to amass a total pension of (say) £75,000, with full tax relief. I suggest you either outlaw this or take credit for it.

RC

ROBERT CULPIN

FROM: J M G TAYLOR
DATE: 15 February 1989

MR MACPHERSON

cc PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Harris
Mr Gilhooly
Mr Matthews
Mrs Chaplin
Mr Tyrie

Mr Isaac - IR
Mr Corlett - IR
Mr Kuczys - IR

PENSION LIMITS

The Chancellor has seen your note of 14 February, noting that under the proposed new regime an employee has the additional option of leaving his employer's scheme and taking out a tax-privileged personal pension.

2. He has commented: "Well spotted". He thinks this is a most important point. We must take credit for this, and present it as an integral part of the overall package.

J M G TAYLOR

cst.rj/docs/15.2.3

BUDGET CONFIDENTIAL

FROM: A G TYRIE

DATE: 15 February 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Macpherson
Mrs Chaplin
Mr Call

Mr Isaac
Mr Kuczys

TYRIE 15/2

Thanks - Is X really the case? Pse pursue urgently.

A PPP TOP UP?

Advantages

The main advantages are:

- Above the cap, this wheeze would force very high earners into money purchase schemes. So you would be able to point out that the Halpern-type abuse of occupational schemes had been stopped; henceforth the fiscal privileges accorded those earning over £60,000 would be limited to the combined value of the occupational pension cap and the new PPP limits.

- At the same time the cap would not appear so draconian: you would have attenuated the radicalism which made everyone hesitate ten days ago.

- You would also be retaining the main prize of the reform: deregulation and simplification, reducing the Revenue policing role etc.

2. Some of the other advantages of the reform would remain, but in a watered down form. For example, there would not be one lump sum limit but two: the £90,000 cap, plus the 25% by value PPP lump sum limit. People would be able to take two lump sums. You would also have reduced the downward pressure on cross subsidisation brought about by the cap - to the extent that people opted for accelerated accrual to get into PPPs.

<u>Would PPP top ups be taken up</u>?

3. I think that they could become quite attractive. Anybody who found himself earning substantially over £60,000 would find it worthwhile calculating, with his employer, how to extract the maximum level of fiscal privilege at any given level of salary. Various packages are possible.

4. Take a man aged 50 who has been with ICI all his life, who has clocked up 30 years service, and has reached a salary of £60,000. He is then promoted to the Board, carrying a salary of £90,000. Under the new rules the company could suggest that he forgo part of the £30,000 increase in salary and take accelerated accrual (on the 20/30ths basis) which would enable him to reach 40/60ths equivalence, i.e. the maximum allowable pension of £40,000, at age 55. The company

would demand exactly the amount of salary forgone which made them indifferent whether the individual went for accelerated accrual or not.

5. For the remaining five years the individual could be promised his full £90,000 salary, which he could use, if he wanted, to fund a PPP. With the proposed 35% PPP contributions limit for those aged 56 and over he would be able to put the whole of the £30,000 into the PPP until retirement.

6. This would, I think, maximise fiscal privilege. Unless the chap thought he was likely to die on the job he would be best off with this route!

7. Alternatively, he could close down the occupational scheme at 30/60ths, (giving a pension entitlement of only £30,000) and either take the £30,000 pay rise as taxed salary or use the maximum permitted amount of it for a PPP. He would do this only if his personal discount rate was lower than the actuaries'.

8. It would not be long before actuaries were able to tell companies exactly which combination provided the maximum fiscal privilege for each individual. Only special circumstances or a spendthrift attitude would lead individuals not to follow this advice.

Disadvantages

9. So now the disadvantages are becoming apparent:

- The PPP top-up would mean that the pensions package would not force high earners into unprivileged pension top-ups. The "excess" above the cap would often not be cashed out.

- As mentioned above, two lump sum limits would be created and people could obtain the benefit of their combined value. So we would have created a loop hole in the reduction in the lump sum limit.

??X Tony Kuczys tells me that it would be well nigh impossible to impose a limit on the combined value of the lump sums, i.e. to say that no more than £90,000 could be taken out as a lump sum, no matter the source. At least, we could only do it by putting back some of the red-tape the reform is designed to snip.

- It would enable the opposition and others to claim that: "Under the Tories it's a case of one pension for ordinary folk and two schemes for the very rich". Small businessmen would also be excluded from having two schemes.

- In the decades ahead, the incentive for wealthy people to make sure they had an occupational scheme and collect the benefits of cross subsidisation, would remain quite strong. Paradoxically, if we were to block the PPP loop hole we might well force more people into exclusively final salary schemes in the long run.

So is the PPP wheeze worth doing?

10. I don't like the idea of increasing the scope for lump sum relief, even if, at first, it would be available to only a small number of people. On the other hand, the PPP wheeze would provide a way round the charge that, in a budget that was meant to be for savings, you had succeeded only in severely curtailing the saving incentive for top earners.

11. Overall, if we were able to impose a combined lump sum limit I would be keen on the PPP wheeze, I would definitely do it; but because we can't I am much less enthusiastic.

pp A G TYRIE

ppg.jg/harris/14.2.89.1

BUDGET CONFIDENTIAL

FROM: L J HARRIS

DATE: 15 FEBRUARY 1989

approved by Sir Peter Middleton

1. SIR PETER MIDDLETON

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Kelly
Mr Luce
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Customs and Excise

Mr Unwin
Mr Jefferson Smith
Mr P R H Allen

Inland Revenue

Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke
PS/IR

Thanks. 2. As Mr Harris pts out, option (2) would bring the public services into line with the proposals for private sector; there [illegible] for which [illegible] strong case [illegible]

HARRIS 5/2

PUBLIC SERVICE PENSIONS

This note discusses the options for dealing with the public service pensions of the those above the £60,000 earnings cap which forms part of the occupational pensions proposals which were provisionally agreed at your last overview meeting. The objective is to devise arrangements which do not appear to be unduly favourable to the public services in terms either of the tax reliefs or benefits provided, but which equally do not look overly punitive, or create uncertainty which damages the prospects of attracting senior people to public service appointments or recruiting candidates with potential for top management posts in the public services in the future.

This is surely wrong. With price indexation & 2½% growth in real earnings it would catch everyone at principal level within 40 years.

BACKGROUND

2. In comparing private and public sector scenarios, a number of general considerations need to be borne in mind. First, the public service population which will eventually be subject to the new regime is relatively small - only about 1200 people, including about 900 NHS consultants and about 160 judges currently earning more than £60,000 a year (these figures have been revised upwards from those quoted in earlier papers, on the basis of new information supplied by departments). This compares with an estimated 50,000 in the private sector. Second, existing members of public service schemes will not be affected and the turnover of senior staff in the public services tends to be less than in the private sector, so it could well be nearly 40 years before all those with salaries above the cap will be covered (though the cap will bite much more quickly on newly appointed board members, other outside appointees, and the judges). Third, the pension schemes covering the great majority of public servants offer slower accrual rates than the best private sector schemes, offset perhaps by less generous private sector inflation proofing arrangements. The Civil Service Pension Scheme, for example, provides a pension of half final salary, plus a lump sum of three times the annual pension, after 40 years' service, while many private sector schemes provide the equivalent after 20 years.

3. The Finance Act cannot override the rules of the statutory public service schemes. But the proposed change would confine tax relief to "relevant" statutory schemes (ie existing schemes and, for future employees, to those limiting benefits to salaries of less than £60,000. To conform with this, the public service schemes would need to be amended. Procedurally, this would involve:

(i) in the case of the Civil Service, scheme amendments laid before Parliament;

(ii) in the case of local government, teachers and health service employees, regulations subject to negative resolution procedure;

(iii) in the case of the armed forces, amendment of the prerogative warrants;

(iv) in the case of the judges, primary legislation to amend the Judicial Pensions Act 1981. (The Lord Chancellor has a suitable vehicle in the 1989-90 legislative programme approved by QL).

Similar action would be needed to provide for top-up schemes above the cap.

OPTIONS

4. The rest of this paper sets out the possible options for the public services. The options are essentially no different than for the private sector.

5. Option 1. Cap, with no top-up. This would effectively limit public service pensions for new entrants to the maximum generated by their schemes from a final salary of £60,000. After 40 years, a Grade 1 Permanent Secretary would receive a pension of £30,000 a year (in 1989 values) and a lump sum of £90,000, compared with present figures of £34,250 and £102,750 respectively. There are two possible ways of presenting this option:

(i) as a permanent change deliberately designed to put a ceiling on all public service pensions, regardless of length of service or final salary. This would represent a marked worsening of terms of service which would impact on recruitment and be seen in some quarters (rightly or wrongly) as a further signal of the Government's low regard of the public services relative to the private sector; or

(ii) as a holding measure, subject to review in the light of private sector practice, the state of the labour market, and recommendations by the TSRB. This would avoid the public services appearing to lead the private sector into particular kinds of top-up schemes, but would leave a considerable degree of uncertainty to bedevil the recruitment market (Particularly for judges and public board members). It would lay the Government open to the charge of not having thought the proposals through properly, even in relation to its own employees.

6. Under either approach, the Government would be free to make compensating pay adjustments for those caught by the cap, either on an individually negotiated basis for key staff, or across the board. This would lead to at least two rates of pay, one for those with reserved rights from pre-amendment schemes and others for entrants post-amendment. Those involved would have the option of investing part of their increased salaries in appropriate forms of savings, though it is doubtful whether that could, at any realistic level of increase in salary and saving, offset the loss compared with the benefits available under existing schemes. The precise level of pay increase would depend on (a) the state of the labour market and (b) the extent to which the notional contributions to pensions above the cap was taken into account (but bearing in mind the high degree of cross-subsidisation at the top end of final salary schemes).

7. Option 2. Cap with top-up. This would bring the public services into line with the Isaac-Chaplin proposals, but could be seen as giving a lead to the private sector in the direction of top-up schemes. There should be no legal or administrative difficulty about establishing public service top-up schemes. Two variants might be considered:

(i) Unfunded. Employees would continue to contribute to, and receive benefits from, top-up schemes at the same rates as for main scheme benefits. Top-up pensions would be taxed (as at present), and the top-up lump sum would also attract tax. (The local government scheme, is funded and may be expected to follow the same pattern as the similar private sector schemes);

(ii) Money Purchase. Employees' and employers' contributions at existing rates on earnings over £60,000 would go into top-up schemes could be designed as money purchase arrangements, with the tax consequences described in Mr Kuczys' note of 9 February. Again, it is doubtful whether a scheme of this kind could close the gap between the value of existing benefits and of those available under capped arrangements - even with substantially higher employers' contributions to make up for the loss of tax advantage.

The top-up arrangements could be applied to all staff with salaries over £60,000, or be made available only for key staff on a selective basis.

8. As with Option 1, there might still be pressure for compensating salary adjustments. Under Option 2(ii), as Mr Kuczys has already pointed out, employees might well prefer to be paid the total amount of the employers' and employees' contributions as salary to be invested at their discretion.

9. Option 3. Cap with top-up and grossed up lump sum. This would be the same as Option 2(i), but with the lump sum grossed up at the higher tax rate to leave the recipients the same net benefit as now. This would dispose of the case for salary adjustments, but could well be attacked as feather-bedding senior public servants.

Indeed

10. Option 4. A higher cap. You decided at the last overview meeting to go for a cap of £60,000, though without finally closing the door to a possible concession. Raising the cap to £75,000 would exclude over 1100 of the 1200 public servants who would eventually be caught, including all but 3 civil servants; taking it to £100,000 would exclude all but those on individually negotiated contracts, who are, in any case, dealt with on an ad hoc basis. To choose the level of the cap to resolve the public service problem would clearly be to allow the tail to wag the dog; but if you are minded to look at the limit again anyway, this is an angle worth bearing in mind.

CONCLUSIONS

11. Option 4 would dispose of the public service problem very neatly, but it is only worth going for if you saw advantages on other grounds in setting the cap at around £100,000 final salary.

12. The choice between the other main options and their variants largely depends on whether you want to be able to present the changes as being broadly neutral in their effect on the public services, or whether you wish to impose some worsening of the public service terms for new entrants.

? 13. Strict neutrality would be achieved by Option 3. If detriment is acceptable, or indeed desirable, then Option 1(i) is the one to go for, with Option 1(ii) as a fallback if a rigid cap proved unsustainable (though the position on any concession to buy out actual or prospective detriment would need to be resolved before the next TSRB round). Option 2(i), or Option 2(ii) with its rather more risky outcome for the individual, both entail an element of detriment.

14. It remains to be seen how private sector employers will react: it seems likely that they will go for something on the lines of Option 3 or 2(i) (ie to introduce top-up schemes, with or without grossing up). If you decide to go down this path, you need not commit yourself in the Budget, although the form of public service top-up schemes will need to be finalised very shortly thereafter in the light of the immediate private sector reaction.

Leonard Harris

L J HARRIS

BUDGET CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

A good point: spoke [illegible] [illegible] and briefed them.

behind.

FROM: A J G ISAAC
16 February 1989

CHANCELLOR OF THE EXCHEQUER

PENSIONS REFORM: MEETING WITH THE LORD CHANCELLOR

1. We have just seen the brief from Treasury Superannuation Division dated 8 February (some mistake?) for your meeting with the Lord Chancellor on the new tax and pensions proposals.

---

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Kelly
Mr Harris
Mr Luce
Mr Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Unwin)
Mr Jefferson Smith) C&E
Mr P R H Allen)

Sir A Battishill
Mr Isaac
Mr Painter
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke
PS/IR

2. With respect, we wonder if it poses an unnecessarily sharp dilemma over accrual rates (paragraphs 2 and 3 of the covering note from Superannuation Division, paragraphs 6 to 9 of the Speaking Note).

3. As we explained in the papers for the last Overview, the new regime will open up a new option for the Lord Chancellor, and other employers who may be worried by the 1987 changes on "fast accrual". Under present law, employers cannot offer faster than 20 year accrual because they can offer no pension provision (privileged or unprivileged) in excess of the so-called Revenue limit. The whole point of decoupling is that, in future, employers will be able to offer more favourable provisions, if they wish, but the top-up payments will not attract any tax privilege.

4. It follows that, if he wishes, the Lord Chancellor will be able to retain the fast accrual* for judges, very much as he has now. The excess amount attributable to "fast accrual" would not be tax privileged. It will have to come out of a top-up scheme, not the judges' main scheme. In practice, the only difference is that the resulting part of the lump sum will not be tax free in respect of future service.

5. Of course, we understand why, for public expenditure reasons, the Treasury might prefer to get rid of the judges' very fast accrual altogether, rather than merely transferring it to a separate top-up scheme. But, after the Budget, that will no longer follow from the tax rules.

ACI

A J G ISAAC

---

*and similarly with the associated problem with judges' "retained benefits" chex.pj/jc/16.2.2

CHAPLIN 16/2

BUDGET CONFIDENTIAL AND PERSONAL

FROM: MRS JUDITH CHAPLIN
16th February 1989

CHANCELLOR

AA [illegible]

PUBLIC SERVICE PENSIONS

I think there is more to this issue than just whether and how public service top-up pensions are provided.

2. The change does give an opportunity to start to reduce the enormous cost of indexed pensions. I remember the discussion of whether or not it would be possible to remove the indexation from civil service pensions before the last Election as inflation was relatively low then and it might have been easier. To remove the indexing in general would obviously be more difficult now, but this might be a way of starting that change.

3. As you know, I think the benefit of an indexed pension is very much undervalued when public sector pay vis-a-vis private sector pay is discussed. The Review Bodies, in my opinion, take far too little account of it.

4. All these issues are politically very sensitive. It does not seem appropriate to discuss them first in a large meeting such as the Overview meeting. Could we discuss this either at Prayers or after Prayers tomorrow morning?

JC

JUDITH CHAPLIN

Ch

I very much agree with Judith on handling (though not substance!). Take off overview agenda? One scheme (apart from adding NICs) could be a request for a note from Leonard Harris setting out ~~all~~ the funding & contribution arrangements for all the various existing public sector schemes – something conspicuously lacking from his note

AA

cst.rj/docs/16.2.ew.

PERSONAL AND BUDGET CONFIDENTIAL

Please hang on to this!

FROM: A G TYRIE
DATE: 16 FEBRUARY 1989

CHANCELLOR

cc Mrs Chaplin

TYRIE 16/2

PUBLIC SERVICE PENSIONS

I have just seen Mr Harris' note, together with Peter Middleton's comment. This note is very much my initial reaction and I need more time to think about it.

2. Taking the options in reverse order, option 4 is clearly a case of the tail wagging the dog. Raising the limit substantially would emasculate the whole package.

3. Option 3 would ensure that the package got a bad reception. It would look outrageously generous. Those in the private sector, who had just seen their fiscal privilege curtailed, would wail about this "blatant special treatment".

4. We would also be ending any notional comparability with the private sector. The notion may already be fragile: this would shatter it.

5. Option 2 is more realistic ground. It is possible to imagine a notional stock of cash which the Government would normally have paid each year in pensions over the £60,000 cap. If there were no top-up whatsoever, the Government would be taking this money from top civil servants. Likewise, in the private sector, employers who took advantage of the new cap to stop paying anything above it would also, in some sense, be saving.

6. The public sector should lose the equivalent of the fiscal privilege which the private sector has forgone, not the total amount of pension above the cap.

7. That would leave the public sector with reduced benefits, a variant of option 2ii. It would mean ruling out option 1 which could be perceived as too harsh.

8. I think the differences between Options 2i and 2ii probably merely reflect the debate we had in the last Overview about whether the private sector would cash out top-ups or arrange schemes for their employees.

9. Incidentally, no-one has raised the point that civil servants, by retiring early, get five more years' pension than most of their private sector equivalents. Perhaps with the demographic changes taking place we should take a look at this 'early retirement'!

10. There then remains the question of whether this money should be distributed selectively to recruit and retain particular individuals, or should be distributed to everyone. You know my views on that. If awards were made on a selective basis, in the long run, it would become very much easier to recruit high level people into the civil service from other walks of life, and vice versa. There would then be scope for the erosion of some of the rigidity and perceived insularity of the civil service.

11. Another idea, which I have not yet fully thought through, has occurred to me. If the top echelons of the civil service want true comparability with the private sector and if, in the long run, it is Government policy to get as many people as possible into money purchase, why not change the presentation of the public sector scheme into a "notional PPP", rather than a notional occupational scheme?

12. To do this we would need to publish the gross salary that would be required for an individual to buy equivalent mandarin pension entitlements through a PPP. It's not easy to calculate the exact figures, but this would probably 'increase' mandarins' notional pay by around 40 per cent. We could claim that the public sector was leading the way towards PPPs. We would also be making the public sector scheme much more transparent, and comparability with the private sector much easier.

13. Furthermore, at a public expenditure cost, you could permit those over the cap to close down their pension before retirement and receive their gross salary, making their own arrangements. This approach might sit nicely with the PPP top-up wheeze on which I minuted earlier today.

14. As for Sir Peter's note, with a few annotations, it could slot very nicely into Jim Hacker's memoirs.

15. All-in-all, the pensions package throws up an excellent opportunity to take civil service pensions and ultimately recruitment, out of the dark ages. I haven't yet decided exactly how I would turn the light on!

AGT.

A G TYRIE

CHANCELLOR OF THE EXCHEQUER

Ch

I deliberately did not invite Andrew Tyrie to this. I have explained this to him & he seemed to accept it.

AT

pso.jt/Middleton/2.16.2

BUDGET CONFIDENTIAL

PEM 16/2

From: SIR PETER MIDDLETON

Date: 16 February 1989

CHANCELLOR cc

Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr L Harris
Mr Sedgwick
Mr C Kelly
Mr Luce
Mr J Dixon
Mr McIntyre
Mr Matthews
Mr Gilhooly
Mr Riley
Mr MacPherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Customs and Excise
Mr Unwin
Mr Jefferson-Smith
Mr P R H Allen

Inland Revenue
Sir A Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Corlett
Mr Bush
Mr Lusk
Mr Davenport
Mr Kuczys
Mr H Thompson
Mr Keelty
Mr Hinton
Mr Cooke

I will discuss with Peter on Monday

PUBLIC SERVICE PENSIONS

Kuczys says not so

There are two separate decisions to be taken. First, what is the tax relieved position to be? I understand the legislation will be drafted so that all schemes - statutory or otherwise - will be caught by the legislation in the Finance Bill. Second, what should be done about pensions for senior people over and above the new limits?. All employers will face this issue. They will all be under pressure to decide quickly. Senior recruitment is affected immediately and of course the new arrangements will affect the expectations of the high fliers who everyone is trying to attract. So far as the Government is concerned, it would also look pretty incompetent to say we had not yet thought about how to tackle such an obvious matter as the consequences for public sector pensions.

2. The first choice to be made is about the level of pension provision. Do we want to make it better or worse or leave it much the same? My own very strong view is that it would be most ill-advised to use this as a cover to reduce public sector pensions at the top. Top salaries are already pretty well out of line with their counterparts in the private sector; see the recent TSRB report. And I am very anxious that nothing should be done to make the problems of recruiting good people more difficult. Though there is a case for enhancement, it would be undesirable in my view to do it in conjunction with a change in taxation.

3. Second, it was being asked at your meeting whether the consequences could not be dealt with on an individual basis. Presumably this means telling different people at different times in their career that they can expect different amounts of pension. I can just about see this working - with a good deal of extra staff cost. But I greatly doubt whether we could manage without something much more structured in the Civil Service and the NHS.

4. I think therefore that we have to decide between the alternatives in Mr Harris' note. As you will gather, I am strongly against any detriment in pension entitlements in the public sector at present. So my vote goes for option 3. The same effect could be achieved without a top up pension but a substantially enhanced lump sum if you wished, so that the individual had a choice of buying an annuity or taking the money. What ever way is chosen, the enhanced pensions and/or lump sums would of course be taxable.

5. This will be seen as an important issue by departments, by the Health Service and by local Government (though the numbers there seem pretty small). I hope you will consult colleagues about it - and indeed about any consequentials in pension arrangements which arise. We shall, I think, have to consult the unions also as it affects terms and conditions of service.

p.p.

P E MIDDLETON

Robert's views
(new type-face for anonymity!?)

CULP IN 17/2

PUBLIC SERVICE PENSIONS: SUMMARY

Potential problems: retention, recruitment.

Retention can't be problem: existing staff not affected.

Recruitment:

- *judges : acknowledged special case*
- *Hardcastles: one-off already*
- *20/30 year olds: not pension fixated.*

Need consult:

- *offer PMG to meet unions on/after Budget day*
- *? refer to TSRB*

Line:

- *public sector to follow exactly same rules as private*
- *behave as good employer*
- *full and open consultation: taking initiative in offering.*

PUBLIC SERVICE PENSIONS

The issues are of substance and timing.

Mr Harris' note (paragraph 2) makes clear that at full maturity (which is decades away) only around 1200 public service posts would be affected at present earnings and lump sum cap levels.

(ie with no real earnings growth (patently unrealistic – I hope!))

- *900 NHS consultants*
- *160 judges*
- *about 150 senior civil servants, military and local authority employees; (? any Ministers - Lord Chancellor - Prime Minister? Mr Speaker?).*

No present incumbents affected, so no retention problem created.

In short-term, most posts will be filled by promotion of people already in the relevant pension scheme.

Recruits from outside going directly into these posts can be dealt with presumably by special appointment arrangements (except for judges). Subject to checking direct recruitment at these levels probably only matters for CS and Local Authorities.
(Query: Any problem about NHS consultants whose income may come from more than one employer - eg NHS hospital and private sector hospital?)

So only immediate problem is over recruitment down the line, in practice at Grade 7 and below. Difficulty is to judge what impact, how serious, if decisions not announced very quickly after Budget.

- *Do we need announcement in Budget Week?*

- *While FB is going through House?*

- *End July?*

- *Later?*

***Advantages** in delaying a bit are:*

(a) *means we do not lead private sector (but does it matter if we do? They will only follow us if it suits them);*

(b) *we can find out how others eg Local Authorities plan to deal;*

(c) *gives time to consult with staff interests;*

(d) *could, if desirable, ask TSRB, DDRB to do quick supplementary report. (Very unattractive);*

(e) *would not look as if public service employers had an inside track to Budget Secrets;*

(f) *gives time to consider Option 3 fully. It has real disadvantage that grossing up looks like a wheeze to escape the effects of the Budget. Delay might make this more palatable (especially if private sector goes that route). And gives time to make sure that other Options not real runners.*

*The **disadvantage** of delay is*

- *effect on recruitment at and below Grade 7. How long can an announcement be delayed until problems begin (eg when is next Grade 7 direct entry recruitment round)? Will the problems be severe if delay is, say, to end of July?*

BUDGET CONFIDENTIAL

FROM: J. ANSON
17th February, 1989.

CHIEF SECRETARY

c.c. Chancellor
Sir P. Middleton
Dame Anne Mueller
Mr. Scholar
Mr. L. J. Harris
Mr. Call

PROPOSED PENSION CAP: PUBLIC EXPENDITURE IMPLICATIONS

You asked this morning about the possible public expenditure consequences of the tax changes being discussed on pensions.

2. I had asked Mr. Harris to keep me in touch with the likely public expenditure implications of the emerging proposals. I attach the note which he sent me earlier this week. As you will see, while he cannot make a precise estimate, he judges that it will be very small indeed. As existing scheme members will have reserved rights, it will anyway build up very slowly.

3. Mr. Harris's note assumes that no immediate action would be taken to top up the public service schemes in order to respond to the labour market. But even if this were not so, and action was taken to gross up the taxable payments (as in Option 3) the effect on public expenditure would still be small. The group of posts concerned has a total salary bill of the order of £100 million; and the problem will only arise (a) after new entrants have joined the public service schemes and (b) as and when these people reach one of those posts and then retire.

4. There would of course be more impact - although still over a very long timescale - if the "cap" were not indexed. But the current scorecard assumption is that it would be.

CL

John Anson felt unable to do a 'personal view'! But Terry tells me John supported him at second Secretaries in criticising Peter's proposals. (Anne Mueller supported Peter, Nigel Wicks kept quietish)

AA

JA

J. ANSON

ppg.jg/harris/13.2.89.1

BUDGET CONFIDENTIAL

FROM: L J HARRIS
DATE: 13 FEBRUARY 1989

MR ANSON

cc Mr Dixon

PROPOSED PENSION CAP: PUBLIC EXPENDITURE IMPLICATIONS

You asked me some weeks ago to keep an eye on the public expenditure implications of the Chancellor's emerging proposals for capping tax-privileged occupational pension schemes. As you will have seen, the Chancellor is now firming up on the so-called Isacc-Chaplin option of limiting the privileged schemes to those providing pensions and lump sums generated by incomes of not more than £60,000. Any employer who wishes to provide pensions above that limit will have to set up a separate top-up scheme, and will be encouraged to do so by means of pay-as-you-go arrangements, under which the employer will get a tax deduction as he pays out to the pension, and the pensioner will be taxed as he receives it. This is the simplest option, and avoids awkward gaps between public and private sector practice. Funded top-up schemes will still be possible, but employees would receive no relief on their contributions, and would in addition be taxed on the employer contribution as a benefit in kind. The build-up in the fund would be taxed, but the capital drawings from the fund would be tax-free; the normal rules would apply if the capital were used to buy an annuity.

2. We cannot make any precise estimate of the likely effect of these proposals on public expenditure, but it will be very small indeed. We shall lay amendments to the PCSPS on or very shortly after Budget Day to impose the £60,000 cap, and arrange for the Secretaries of State in charge of the other public service schemes to do likewise. We shall then sit back and wait for some months to see what the private sector does before deciding whether setting up public service top-up schemes is likely to be needed to respond to the needs of the labour market. Given that existing scheme members will have reserved rights, the full effects of the cap on the public services will not be felt for some 30 years, and then only for the 530* people earning more than £60,000 in 1989 values. The first people to be affected will be outsiders brought in from other pension schemes, who can be dealt with

* Now put at 1200 — see Harris 15/2/89

J A.

n an individual contractual basis, and the judges, for whom separate primary legislation will be needed to make the budget changes bite on them. The Lord Chancellor will no doubt argue for some compensation for the judges as the price for agreeing to bring forward legislation - for example, we might offer a higher pensions multiplier and some form of top-up in return for the imposing of the cap and a move from a 15 to a 20 year accrual rate - but, again, the cost will be small and will, in this case, fall on the Consolidated Fund.

3. Independently of the Budget proposals, we are looking yet again at the implications of moving to a contributory (but not funded) basis for the PCSPS. That would clearly have more substantial public expenditure implications, and we shall be handling that to a longer-time scale than the Budget.

C Genovardi

pp L J HARRIS

CHANCELLOR OF THE EXCHEQUER

17.ii.

Chancellor.

This is a slightly less rushed assessment of the Harris note. Nonetheless, I completed it too late to copy round to others but will distribute it to Ministers and advisers before the 10.00am meeting. If you would rather I _didn't_ circulate it, please tell the Private Office to leave a note to that effect on my desk, first thing on Monday.

As for content, this note sets out more clearly the radical option. I think I've also found a workable and justifiable variant of Option 2.

By the way, Judith is in good spirits (although in some pain) and is determined to give her threepennyworth on public sector pensions on Monday!! Andrew.

PERSONAL AND BUDGET CONFIDENTIAL

FROM: A G TYRIE
DATE: 17 February 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mrs Chaplin
Mr Call

TYRIE 17/2

PUBLIC SERVICE PENSIONS

This comments on Mr Harris' note.

2. Taking the options in reverse order, Option 4 is clearly a case of the tale wagging the dog. Raising the limit substantially would emasculate the whole package.

3. Option 3 would ensure that the whole package got a bad reception. It would look outrageously generous. Those in the private sector, who had just seen their fiscal privilege curtailed, would wail about this "blatant special treatment". We would also be ending notional comparability with the private sector. The notion may already be fragile: this would shatter it.

4. Option 2 taxes the lump sum but does nothing to compensate for the tax we would be imposing on the private sector on the notional contributions (and rollup) above the cap. So it does not go far enough.

5. On the other hand, Option 1 goes too far. It doesn't just tax the lump sum and the notional salary contributions above the cap, it stops all remuneration at all above the cap!

6. <u>Option 1</u> is also offered in "holding operation" form (1 (ii)). I don't like this for two reasons. First, I don't think we could rely on the TSRB to sort it all out. Secondly, I don't think it is politically sustainable to ask the private sector to make quick adjustments to a new scheme but at the same time announce that we, in the public sector, required more time to think about how to react. This would look incompetent.

7. A variant of <u>Option 2</u>, let's call it 2 (iii), could provide an accurate read across from the private sector package.

8. The logic goes as follows: the public sector should lose the equivalent of the fiscal privilege which the private sector has forgone, both on the lump sum and on the notional contributions above the cap, not the total amount of the pension above the cap, as Option 1 would do. Therefore we should reduce the top ups in Option 2 by the amount of the fiscal privilege forgone by the private sector on their notional contributions, as well as their lump sum, but not more.

9. This would definitely be a justifiable and equitable package. It would of course mean a reduction in the entitlement for public sector pensions - there is no getting round that.

10. The money purchase approach (Option 2 (ii)) has clear advantages over the unfunded approach (Option 2 (ii)) because of its transparency. So I would rather see Option 2 (iii) on a money purchase basis, too.

11. I think that there is at least one other distinct approach worth looking at, not explored in Mr Harris' note, which I will call Option 5.

12. This would be to permit Civil Servants to close down their schemes when they hit the cap and cash out the full value of the pension entitlement forgone as salary. The pension entitlement forgone would, of course, include a deduction to take account of the new fiscal regime above the cap. If Civil Servants wished we could, of course, offer a money purchase scheme set up on their behalf.

13. This would increase mandarins' gross pay by 35%-45%.

14. There would be some clear advantages:

- The public sector would be leading they way into money purchase schemes, which we favour, and away from final salary schemes, which we don't.

- There would be a dramatic increase in transparency at the top end in the public sector. There would be genuine comparability with the private sector. Labour mobility into and out of the Civil Service at the top end would become much easier. Such a reform would, in short, be a key building block in a long term reform of the Civil Service, removing one of the two key obstacles (the other being job security) and putting top Civil Servants on all fours with the private sector.

- This approach would sit well with your provisional decision to retain the money purchase loop hole above the cap in private sector schemes. You would have to permit the public sector to buy added years and close down their schemes before the age of 60, which at present (I understand) they are not permitted to do.

- (At the very least, in the next week or two this approach would force Civil Servants to face up to the true cost of their benefits. It would therefore be a useful negotiating ploy!)

There would also be some disadvantages:

- There would be an increase in public expenditure. At first this would not be great, because only a thousand or so people would be involved. In fact one would only be bringing forward public expenditure because you would be cashing out pension entitlement earlier, as salary.

  In practice you could try and save some money in the long run. This is because you might not need to offer Civil Servants the full 35%-40% value of the pension forgone.

- The Civil Services' average contribution rate, I am told, is 18% That would be a useful starting point in negotiations. On the other hand, that approach would probably lead the TSRB to recommend higher pay, so much of the gains would be eroded.

- You would have to explain what would appear to be "massive pay rises" for mandarins.

<u>Conclusion</u>

15. I think the right approach is something along the lines of Option 2 (iii) or, more radically, Option 5. Both carry some public expenditure cost. Both move in the direction of transparency with the private sector. Both would enhance labour mobility, (Option 5 to a large degree) in the long run.

16. Two further points are worth bearing in mind. First, I don't think we should take into account the problems of recruitment. I find the idea that potential Grade 7s look up Permanent Secretaries' pensions packages before joining the Civil Service quite farcical. If anything, a more flexible approach at the top end is more likely to encourage youngsters and tempt more 30 year olds to stay.

17. Secondly, I would introduce an element of selectivity to any top up scheme we introduce. The Civil Service is one of the last bastions of blanket pay awards. Sooner or later it has to go. This would be a tentative step in that direction.

AGT.

A G TYRIE

chex.ps/jmt/56 BUDGET CONFIDENTIAL

Df. 24/2

FROM: J M G TAYLOR
DATE: 20 February 1989

MR ISAAC - Inland Revenue

cc Mr L Harris
Mr Dixon

Mr Kuczys - IR

PENSIONS REFORM: MEETING WITH THE LORD CHANCELLOR

The Chancellor was grateful for your note of 16 February. He would be grateful if the "speaking note" enclosed with Mr Dixon's minute of 8 February could be amended to reflect the points you make; perhaps Mr Kuczys and Mr Dixon could arrange for this to be done.

J M G TAYLOR

FROM: A C S ALLAN
DATE: 20 February 1989

MR McINTYRE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Byatt
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Mace - IR
PS/IR

BILATERAL WITH MR MOORE: 16 FEBRUARY

The Chancellor was grateful for your minute of 15 February. At the bilateral the following points were covered:

(i) the Chancellor explained what he planned on the pensioners' earnings rule. The next stage is for you to consult DoS officials urgently;

(ii) the Chancellor told Mr Moore that the issue of widows who have lost out as a result of the April 1988 reforms was for the public expenditure survey, not the Budget. Mr Moore accepted this;

(iii) on the procedure for future discussions about NICs, the Chancellor said there were clear disadvantages in having a joint Treasury and DoS working party to look at NIC reform. The Chancellor would have no objection to Mr Moore commissioning work from his officials, and if something promising emerged, coming to see him to discuss it. Equally, the Chancellor might want to commission work from Treasury officials, and if appropriate discuss it with Mr Moore. Mr Moore accepted this approach;

(iv) Mr Moore said he would be writing soon about equal State pension age. There was no discussion of the substance.

ACSA

A C S ALLAN

chex.ps/jmt/56 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 20 February 1989

MR ISAAC - Inland Revenue

cc Mr L Harris
Mr Dixon

Mr Kuczys - IR

PENSIONS REFORM: MEETING WITH THE LORD CHANCELLOR

The Chancellor was grateful for your note of 16 February. He would be grateful if the "speaking note" enclosed with Mr Dixon's minute of 8 February could be amended to reflect the points you make; perhaps Mr Kuczys and Mr Dixon could arrange for this to be done.

J M G TAYLOR

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS

21 FEBRUARY 1989

Having read this note, which I requested & for which I am grateful, I am driven to conclude (despite my hasty reaction recorded on Mr Taylor's note of 15/2) that, subject to the FST's views, we should proceed as per para 25(a). Mr Isaac's note is telling. N.

1. MR ISAAC .(notes at end).

2. PS/CHANCELLOR (Mr Allan)

PENSION LIMITS

1. You asked for a further note, following Mr Macpherson's minute of 14 February, Mr Taylor's of 15 February and Mr Tyrie's (entitled "A PPP Top Up?") of 15 February.

2. This note, therefore:

- looks again at what the "Tyrie/Macpherson wheeze" involves;
- why the Budget changes make it possible;
- who can take advantage of it;
- the arguments for and against allowing it (or taking credit for it); and
- what could be done to stop it (if that is what Ministers were to decide).

---

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call
Sir A Battishill
Mr Isaac
Mr Corlett
Mr Bush
Mr Lusk
Mr Kuczys
Mr Hinton
PS/IR

3. We should, at the outset, distinguish two quite different circumstances:

a. where an employee actually retires from one employment, and then takes another (pensionable) job; and

b. where the employee stays with the same employer and merely leaves the pension scheme.

In case a. something similar to the "Tyrie/Macpherson wheeze" is possible now. For example, a policeman joining the Force at age 20 and retiring at 50 can draw a full two-thirds pension, thanks to the (automatic) accelerated accrual in the police pension scheme. He may then set up in business (perhaps making use of his lump sum) and enjoy another 15 years of working life, paying contributions to a (tax privileged) personal pension scheme.

4. We have never seen that as particularly objectionable - and, indeed, any attempt to prevent it would raise a storm of protest from the Police Federation, Chief Constables, the Home Secretary et al. Similar opportunities exist for some other public service groups, including the armed forces, who also have fast accrual and early normal retirement ages, reflecting the nature of their work.

5. Of course, most policemen's earnings do not get anywhere near £60,000. But it is also possible for a Permanent Secretary to retire at 60 with a full pension, to take up another appointment, and to have his earnings from that pensioned (with tax privilege). The new employer will not be able to offer accelerated accrual - just the normal 1/60th rate. But, in a world where tax privilege will be capped at £60,000, it will mean that (if his earnings are high enough) he will have a combined pension at 65 of £45,000 (£40,000 from the civil service scheme and £5,000 from the final employer) quite apart from any non-privileged "top-up".

6. The Tyrie/Macpherson proposal takes some of these ideas, but applies them in case b. (where the employee does not change employment, but leaves the employer's pension scheme).

What the wheeze involves

7. The idea is very clearly explained in Mr Macpherson's note. A key employee passes the £60,000 earnings limit mid-way through his career. So long as he has at least 20 years' service, and he is at least 50, the proposed new tax rules will allow him a full pension of £40,000 (payable at retirement, but uprated meanwhile in line with price inflation). He now leaves the employer's scheme and takes out a personal pension. If he (or his employer) puts in the maximum possible contributions, then he can build up, by retirement, a second tax-privileged pension almost as great as the first. He thus obtains very nearly twice the normal "ration" of tax-privileged pension before he even needs to consider a non-privileged top-up arrangement.

?

8. The key features which need to be present before something like this becomes possible are:

a. the employee's earnings rise to £60,000 relatively early on in his career;

b. the employer is prepared to offer the fastest possible rate of accrual, not late on in a career to encourage a senior employee to switch company, but right from the outset in the expectation that the employee will leave the scheme as soon as he has accrued the maximum possible benefits;

c. the employer is then prepared to preserve the real value of the pension, over 20 years or so, even if inflation were to rise above 5 per cent (the level up to which he has to revalorise an early leaver's benefit); and

d. (unless the employee is prepared to take a reduction in disposable income) the employer is ready to pay similar sums into a personal pension for the next 20 years or so, or to pay the employee more so that he can make the contributions.

9. As we saw last year in work on the Byatt proposal, accelerated accrual is expensive requiring contributions of the order of two-thirds annual salary or more. So the whole package described above requires a very substantial commitment by the employer. And, once the employee has switched to a personal pension, the employer no longer has the same hold on him which continued membership of the company scheme provides. So the employer may not play ball except for someone very influential in the company, who is unlikely to leave for another employer.

What the Budget changes do

10. The proposed changes make this wheeze worthwhile in two ways:

1. For new members (or new schemes) they produce the result that the maximum tax-privileged occupational pension (from a single scheme) will be £40,000. At present there is no limit.

2. They also make personal pensions more attractive, through increases in the percentage contribution limits.

But much more importantly it is the simplifications proposed in the tax rules which could make the proposal possible.

11. At present, not only is the wheeze less attractive than it will be: it simply will not work. The present Revenue rules build on the concept of a "normal retirement age". We will not generally approve for tax purposes a scheme with a normal retirement age (for men) below 60.* If an employee

*The police scheme, being statutory, is not approved by us - and its special rules are justified by the nature of police work.

leaves the scheme before the normal retirement age (NRA), he can have benefits accrued at the normal (1/60th) rate in full (so, if he has 20 years' service, he can have a pension of 20/60ths, or one-third final salary).

12. But, if there has been any acceleration of accrual, then benefits must be cut back, by applying the fraction:

$$\frac{\text{years of actual service}}{\text{potential service to NRA}}$$

So if the employee has had 20 years' service out of a potential 40, the benefits resulting from accelerated accrual will be halved. Instead of 20/30ths, he is only allowed 10/30ths - the same one-third pension he would have been due with normal accrual. The effect is that, at present, accelerated accrual is generally only available for (and, indeed, was intended for) someone joining a scheme late in his career and then staying until normal retirement age.

13. Application of this cutting back can prove quite complex for pension schemes to administer - and to explain to scheme members. It is the subject of frequent representations from the pensions industry. We would therefore like to sweep it away, and substitute a simple rule that retirement with a full two-thirds pension will be allowed at any time after age 50, provided the employee has at least 20 years' service. The concept of "normal retirement age" would disappear as far as most individuals are concerned. Amongst other things, this simplification would largely solve the problem (which the Chancellor has come across in a constituency context) of an employer who wants to retire senior employees, on a full pension, at (say) age 55.

14. When we proposed this simplification (which the Financial Secretary has agreed) we had in mind employees who genuinely <u>retire</u> from their employment. Of course, they

might subsequently take another job and build up additional pension rights. In that case, they too might secure a total pension of more than £40,000. Our view was that this was unobjectionable: it does little more than give private sector schemes the same opportunities now open to public sector groups (like the police) with fast accrual.

15. However, the issue is less clear-cut where the employee merely leaves his pension scheme, not his job. We always envisaged the need for some protection against controlling directors, who would be able to exploit it. Beyond that, however, we did not originally see any need for action - if only because we think very few will be able to grasp the opportunity.

16. The possibility of ending up with total tax privileged pension of more than £40,000 also needs to be seen against the background of what is theoretically possible in the personal pension world. To take an extreme example (as Mr Macpherson did), someone whose earnings are at or above £60,000 throughout a 40 year working life, and who contributes the maximum possible amount to a personal pension, might be able to end up with a (tax privileged) pension well in excess of £40,000 - if his investments do reasonably well. With the higher contribution limits we have proposed, a pension of £90,000 would not be impossible.

Who can take advantage of the wheeze

17. As described in Mr Macpherson's note, the employee does not change jobs, just pensions. Is this objectionable? Partly, the answer depends on how many people would be able to use the device, and who they are.

18. In order to benefit from the Tyrie-Macpherson idea, you must first be an employee. "Double-dipping" will not be available to the self-employed, who will be restricted to one ration of privileged personal pension. Even if they contribute up to the new, more generous, percentage limits,

they will be doing exceptionally well to match the performance of an accelerated accrual final salary scheme.

19. Next, you need to be a high earner: the proposal is only worthwhile if your earnings pass £60,000 well <u>before</u> retirement.

20. Most importantly, you will need to be a favoured employee, for whom your employer is prepared to offer exceptional terms. Paragraph 8 above gives an idea of what commitment is involved on the employer's part. It seems likely that the only employees who could benefit from this are those who, while not "controlling directors" in the the strict sense, have enormous influence over the companies for which they work.

21. Because of the expense of funding for accelerated accrual, the employee could not pay for the same result out of his own pocket (which is, I think, what Mr Tyrie would like to see). There is a 15 per cent of earnings limit on employee contributions to tax privileged occupational schemes. And while the employee can arrange to "sacrifice" salary in return for employer contributions to the scheme, there is no point in doing so if the resulting salary is taken below £60,000. We might, therefore, be looking at a reduction <u>from</u> £120,000 or so <u>to</u> £60,000 - and this in the <u>earlier</u> part of the employee's career.

22. All in all, this looks likely to remain a device for the favoured few.

<u>Arguments for and against proposal</u>

23. The arguments <u>for</u> allowing the wheeze to work (and indeed to take credit for it) are:

1. It will make imposition of the £60,000 cap less draconian.

2. Personal pensions will receive a boost from high-paid employees, who would otherwise be unlikely to leave the security of their final salary schemes.

3. Legislating to prevent it will detract from the simplicity of the proposed rule for early leavers.

4. It is no worse than the case where someone actually retires with a full pension, and then takes another job. This is common among policemen and the armed forces (who have accelerated accrual schemes) and even top civil servants (who do not). Equally, someone making the maximum possible contributions to a personal pension could do even better than Mr Macpherson's hypothetical example.

5. At most, it allows a double ration of tax relief: there is no more to be had after that (compared with unlimited relief now).

6. (Not something to take credit for) Very few will be able to take advantage of it, so the cost will be negligible.

24. The arguments against are:

1. It depends entirely on employer co-operation. Only the most favoured employees will benefit. The self-employed (except in the exceptional case described in paragraph 16) cannot do anything equivalent.

2. It does not involve a genuine switch to personal pensions and money purchase, since the whole point is to extract the maximum possible from a final salary occupational scheme first, and only then start a personal pension.

3. It may be seen as undermining the whole intention of the £60,000 cap.

How the device might be stopped

25. We have been giving some thought to how the result might be prevented, if that is what Ministers wanted. Inevitably that will mean less simple rules than we had hoped for. But we see two possible approaches:

a. a requirement that the employee must actually leave service with the employer to benefit from the new simpler rule for early leavers/retirers; or

b. a rule that the benefits from the personal pension, in these circumstances, must be taken into account in arriving at the maximum benefits allowed from the occupational scheme.

The effect of b. would be to limit the combined benefits to a pension of £40,000. In Mr Macpherson's example, where the personal pension produced £35,000, the occupational scheme would only be able to pay £5,000.

26. We can develop these ideas further if Ministers wish. Our initial view is that a. (preventing the idea from working unless the employee actually leaves service) looks the better option - and probably would not need primary legislation.

Conclusion

27. It is possible now to have a two-thirds final salary pension from one employment, and then to build up further (tax privileged) pension from a different employment. After the Budget, that will offer a way of obtaining a total tax privileged pension greater than £40,000. We do not see any need to prevent that - particularly since a personal pension alone could (on some extreme assumptions) produce the same result.

28. The position is different where, as Mr Macpherson proposes, the employee stays with the same employer. This was not the case we had in mind in simplifying the early retirement rules. There may be a case for blocking this manipulation, by requiring the employee actually to change employers. If Ministers agree with this, we think it could be done without primary legislation.

A W KUCZYS

I would add only one point to Mr. Kuczys's para 24 ("points against"). If this wheeze is not blocked, it is likely to be publicised by the professional press, and it risks being seen as a pretty artificial device for tax planning by a very few very highly paid people. The thing could have a rather uncomfortable "feel". Most of us would recommend focussing the relief, as always intended, on retirement – not just leaving the pension scheme.

21.2

FINANCIAL SECRETARY TO THE TREASURY

FROM: FINANCIAL SECRETARY
DATE: 21 February 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Scholar
Mr Culpin
Mr Harris
Mr Riley
Mr Dixon
Mr Gilhooly
Mr McIntyre
Mr MacPherson
Mr Speedy
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Isaac)
Mr Kuczys) IR
Mr Hinton)
PS/IR

Ch/ Agree FST?
21/2

Content

PERSONAL PENSIONS

I have discussed Mr Hinton's minute of 15 February with officials.

I agree with the Revenue that option B offers the best set of percentage limits for the amount of contributions someone may make to a personal pension. It might have been neater to have 5% steps all the way up from 15% for those aged less than 35 to 35% for those aged 56 and over. However, that would mean reducing the limit for those under 35 from the present 17.5%. There can only be a handful of young people bumping up against the existing limits. But I'm sure the Labour Party would manage to find them in time for Committee Stage. I therefore recommend we keep the existing 17.5% limit for this age group.

I also recommend we have a parallel earnings limit for personal pensions of £60,000. There is nothing scientific in this; I simply find it difficult to justify having something different. I would also leave the existing retirement annuity rules unchanged. If we are forced to move from this (administratively easier) position, then we can always do so at Committee Stage.

R.C.M.S.

pp **NORMAN LAMONT**

FROM: J M G TAYLOR
DATE: 22 February 1989

pmp

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Isaac - IR
Mr Corlett - IR
Mr Bush - IR
Mr Kuczys - IR
PS/IR

PENSION LIMITS

The Chancellor has seen and was grateful for Mr Kuczys' note of 21 February.

2. In the light of that note, and of Mr Isaac's manuscript comment, he has been reflecting further on this matter. He is driven to conclude that, subject to the Financial Secretary's views, we should proceed along the lines of Mr Kuczys' paragraph 25(a). - ie we should seek to stop the device by imposing a requirement that the employee must actually leave service with the employer to benefit from the new simpler rule for early leavers/retirers.

J M G TAYLOR