PREM 19/719

MT

PART 3

~~SECRET~~

Confidential Filing

Inflation proofed pensions

Inquiring into the value of pensions

ECONOMIC POLICY

Part 1 : Jan 1980

Part 3 : July 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~15.7.81~~		~~25.2.82~~					
~~14.8.81~~		~~24.3.82~~					
~~5.10.81.~~		~~13.4.82~~					
~~29.10.81~~		~~14.4.82~~					
~~30-10-81~~		~~27.4.82~~					
~~1-12-81~~		~~19.5.82~~					
~~7-12-81.~~		~~20.5.82~~					
~~10-12-81~~		3.6.82					
12-2-82.							
		-ENDS-					

PREM 19/919

Dd 533270 5M 2/78 8362633 JET

PART 3 ends:-

CC (82) 31st concs minute 4 (LCA) of 3/6/82.

PART 4 begins:-

MCS to PM of 4/6/82

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(81)78 and Addendum	10.7.81
E(81) 24th Meeting, Minute	15.7.81
E(81) 119	24.11.81
C(81)58 & Corrigendum	7.12.81
LCA to CC(81)40th Conclusions, Min.4	10.12.81
LCA to PSP(O)(82) 2nd Meeting, Min2.	10.2.82
PSP(O)(82)7	12.2.82
C(82)14	19.4.82
LCA to CC(82) 31st Conclusions, Min.4	3.6.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OWayland Date 21 August 2012

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard, 4 February 1982, columns 547-612

Signed OWayland Date 21 August 2012

PREM Records Team

CONFIDENTIAL

cc Mr. Mount
Mr. Vereker

MR. SCHOLAR

Prime Minister (2)
You may like to see Alan Walters' commentary on the Chancellor's views. MES 21/5

INDEX-LINKED PENSIONS

1. I have seen the Chancellor's memorandum to the Prime Minister of 19 May. I readily concede that there may well be practical objections, which are quite overriding, to my suggestion of opting-out. But what concerns me is that the arguments put forward by the Chancellor are often inconsistent, sometimes contradicted by common observation, and occasionally illogical.

2. Let's begin with paragraph 2. My argument was simply that if we charged the public employers on a full actuarial basis the cost of indexed pensions, we should allow those who wished to contract out. Automatically the contractors-out would get pay which was the same as those who contract in, but the deduction would not be made for the pension scheme. But since employees and potential employees in the Civil Service would now have an opportunity which hitherto they lacked, one would expect that the public service package would, on the average, be more attractive to them. This would enable us to have lower gross wage rates in order to secure this same quantity and quality of labour. Therefore the gross pay cost would be lower. Therefore the cost of the public servants would be lower.

3. It is true that if there are a very large number opting out, then the cash costs today may increase somewhat. But this would be more than offset by the reduction in future obligations. The last sentence of paragraph 2 seems to imply that today's cash cost should be our sole criterion, whereas, in all other decisions, we assess in terms of the net present value. This decision also should be made in terms of net present value and not in terms of current cash outflow. I suspect a lot of our problems are caused by incurring large future obligations on public expenditure in order to reduce a small cash expense today, "mortgaging the future".

4. In paragraph 4 the Chancellor says that most people who would wish to opt out would be the young who would in fact go into the National Insurance scheme. This may well be true, especially if, as at present, the scheme is designed to tax the young for the benefit of the old. But then that is a problem of getting the scheme actuarily fair. In any case I think it is important for the young to be able to opt out.

/Many of them

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many of them would prefer to save in order to buy a house or some other asset, or to produce and nourish a young family. The perceived rate of return of the young on housing, family, etc, may be considerably greater than their appreciation of some distant pension income. The Chancellor's proposals preclude them using their savings in what they perceive to be the most desirable way. (Incidentally it is also one of our policies to develop home ownership and to encourage parental responsibility and family development.)

5. In paragraph 4 the Chancellor says that people might not abide by their agreements. There would be political pressure to pay off those who have opted out. But people who had opted out could buy indexed linked gilts. There is certainly no logical argument for saying that they should have a double compensation. The situation is quite different from that in the Seventies; now indexed gilts are available to all. Then they were not, and analagous arguments are quite misleading.

6. In paragraph 5 I think the Chancellor is wrong. The fact that one has an option to buy in or stay out, means that the contribution is simply the price of the indexed pension. If that price is fixed by the authorities at full actuarial value, then that is the supply price of an indexed pension. And the demand will adjust and take up that indexed pension accordingly. If, however, there is no choice, and one must take it up, then of course the indexed pension is a joint commitment with the job and the salary attached. Then the price is for the job, salary, pension combination and there is no separate price.

7. In summary, I find the Chancellor's detailed arguments largely unacceptable or irrelevant. But I do accept that practical difficulties, which I cannot foresee and which may well appear, could conceivably rule out the issue of optional take-up of pension. But I still believe that the fundamental proposition is correct: increasing the opportunities to workers will in general bring forward a larger supply or better quality for a given price. That still seems to me a good principle of employment or procurement.

AW

20 May 1982 ALAN WALTERS

Econ Pol

cc 5V.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

INDEX-LINKED PENSIONS

We discussed recently Alan Walters' suggestion that membership of index-linked pension schemes should be optional. I said that, while there were always attractions in principle in flexible arrangements, they were outweighed in this case by the practical difficulties.

2. Clearly, somebody who opted out of the pension scheme would expect to be fully compensated in the form of higher pay. We should be pressed for the compensation to reflect not only his contribution as employee, but also the employer's contribution, on the grounds that it was just as much part of his remuneration, albeit deferred. If that were accepted, the pay increase for public servants opting out of their pension schemes could be some 15-20 per cent. On that basis, we could expect a great many people to opt out, particularly younger people. There would be a high public expenditure cost immediately, but the savings on pensions would not materialise for several decades.

3. There are other problems. For example, those who opted out of their occupational scheme would have to be contracted in to the State scheme, leading ultimately to higher expenditure from the National Insurance Fund. And many of those who opted out early in their careers would want to change their minds later. Generally

speaking, people's perceptions of the importance of pensions are directly related to their age. The main factor in determining the proportions who opted out would probably be the age composition of the workforce.

4. An alternative version would be to allow opting out of index-linking alone, which would raise a different set of problems. We would have no way of ensuring that future governments (stretching well into the next century) would in practice resist political pressure to increase the pensions of those who opted out of index-linking. If inflation were high, they might well be given ex gratia increases in some form, as happened before the present legislation. So the taxpayer could end up paying a good deal of the cost without benefiting from the contributions; and those who had paid contributions for index-linking throughout their careers would feel aggrieved, and would probably start demanding refunds.

5. A further practical problem is that our preferred scheme is infact a levy to ensure that, beyond whatever is the current private sector practice, every penny of the cost of index-linking will be automatically paid not by the taxpayer but by the employees in the schemes concerned. This means that it could hardly behave as a price in the conventional sense, reacting to supply and demand, because whatever the take-up it is difficult to see a convincing argument for levying more than 100 per cent.

6. These are all real difficulties, and I doubt whether we would gain much credit by including this suggestion in our response to the Scott Report. It might

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well encourage strong union pressures in favour of these or other similar options, which we would then wish to resist. I should therefore prefer not to pursue it.

7. A copy of this minute goes to Alan Walters, to whom Adam Ridley has mentioned my concerns.

G.H.

(G.H.)

19 May 1982

MAY 19[illegible]

A.08300

PRIME MINISTER

Index-Linked Pensions
(C(82)14)

BACKGROUND

At its meeting on 10 December 1981 (CC(81)40th conclusions, minute 4), Cabinet decided that there should be no change in the index-linking of benefits conferred by public sector pension schemes, and invited the Chancellor of the Exchequer to arrange for further studies to be made of the detailed effects on different public service groups of changes in the present system of pension contributions.

2. The memorandum, and the detailed report by the Official Committee on the Value of Pensions (VP) attached to it, take as their starting point the 'two-tier' system of contributions previously discussed by Cabinet. Under this, the generality of public servants would continue to pay a 'lower-tier' contribution of 5 per cent for manual workers and 6 per cent for non-manuals; a new 'upper-tier' contribution, based on the year-by-year cost of the pensions increase element of public service pensions, would be levied in addition. This would be of the order of 2¼ per cent of pensionable pay; the exact amount will probably need to be studied further.

3. The other main features of the Chancellor's proposals are as follows:

a. for the police, fire and prison services which have a lower retiring age, the existing lower-tier contribution will need to be increased and the new upper-tier contribution ought to be set at a higher rate; however the combined effect of these extra charges may be too severe and they may have to be modified;

b. the armed forces are to be excluded for the time being on the grounds that the existing notional contribution is adequate and that the necessary adjustments to the armed forces pay and pension arrangements could not be justified;

c. the judiciary should be dealt with by asking the Top Salaries Review Body to review the arrangements under which they take account of pensions in assessing judicial pay, (in his letter of 22 April the Lord Chancellor has pointed out that the judiciary, like the civil service and the armed forces, pay a notional contribution for their pensions);

d. the civil service pensions scheme should be made fully contributory with an offsetting adjustment to pay to compensate for the lower-tier contribution; in the case of the upper-tier any claim for offset will be resisted as far as possible in accordance with e. below;

e. there should be no assumption that pay will be adjusted to offset the special charge;

f. while the scheme cannot apply directly to the nationalised industries, each industry should be invited to review its level of employee contributions in the light of the charges proposed for the public services;

g. the next steps should be an early announcement on the lines of the draft at Annex C, followed by a Parliamentary debate in late May/early June, consultations in the summer, and final decisions in the autumn leading either to legislation (probably not before the 1983/84 session) or a Manifesto commitment for action early in the next Parliament.

MAIN ISSUES

General

4. The most important issue is whether Ministers feel that the Chancellor's general approach to the issue of index-linked pensions is feasible, justifiable, and politically advantageous.

Feasibility & Justification.

5. The following difficulties may be identified in discussion:

a. the proposals are not fully comprehensive and consistent; in particular:

they do not apply to the nationalised industries;

the armed forces have to be left out, partly on the grounds that their notional contribution for index-linking is adequate although this can be argued equally well for certain other groups such as the civil service;

the principle of paying the true cost of pensions is not to be applied with full rigour to those groups (police, fire and prisons) who are at present most markedly undercharged for their pensions;

in making the civil service scheme contributory, the 6 per cent lower-tier notional contribution is to be accepted as justifying automatic offset by increased pay but not the existing 2 per cent notional charge for index-linking;

b. the proposals will be difficult to negotiate and, as the report by the Official Committee on Public Service Pay concluded (Annex B to C(82)14), "increased contributions are in practice likely to be compensated, at least in part, by corresponding increases in pay";

c. although the proposals may arouse opposition among some of the groups affected, they may not satisfy that sector of public and Parliamentary opinion which is hostile to index-linked public service pensions, particularly if increases in contributions are, and are seen to be, offset by increased pay.

6. If Ministers are unconvinced by the Chancellor's general approach, there is no easy alternative. The Cabinet rejected action on benefits at its

meeting on 10 December 1981, not least because of statements made before the 1979 Election. It will also no doubt be argued that the Government cannot continue for much longer to resist a Parliamentary debate on index-linked pensions, and that it would be difficult in such a debate to give no clear indication of the Government's intentions. At the last Cabinet discussion some Ministers felt that the best way of holding the position would be to publish a Green Paper setting out all the facts in relation to pensions in the public sector, demonstrating both the extent to which certain groups were already contributing towards the cost of their pensions and the complexities and difficulties involved in various courses of action, and inviting comments. This might help to postpone the time when the Government had to take up a clear position until inflation was in single figures and the issue of index-linked pensions was to that extent less emotive and contentious. There must however be some doubt as to whether such tactics would work.

More detailed issues

7. If Ministers approve the Chancellor's general ~~approval~~ approach it will be necessary to go through the specific proposals about the treatment of particular groups, the implications for pay negotiations, and the proposed next steps summarised in paragraph 3 a. to g. above.

8. The precise timing of any announcement will need careful consideration in relation to public service pay negotiations in the current round. It is difficult to forecast how long it will be before a settlement is reached in the National Health Service. The hearing on the arbitration for schoolteachers in England and Wales is unlikely to take place until well into May. The local authority white-collar workers and the industrial civil service have settlements which are not effective until 1 July.

HANDLING

9. After the Chancellor of the Exchequer has introduced the paper you will wish to invite comments particularly from Ministers responsible for various public services, the Home Secretary (police, fire and prisons), the Secretary

of State for Defence (armed forces), the Secretary of State for Education and Science (teachers), the Secretary of State for the Environment (local authority employees) and the Secretary of State for Social Services (National Health Service). The Lord Privy Seal will have comments about the effect of the proposals on the Civil Service. The Secretary of State for Employment may have some general comments. The Lord President and the Chancellor of the Duchy of Lancaster will have views on the Parliamentary and political implications.

CONCLUSIONS

10. You will wish to reach conclusions on the following points:

i. whether the Chancellor's general approach of introducing a new special charge of around $2\frac{1}{4}$ per cent for index-linking is broadly acceptable;

ii. whether the lower-tier contributions for the police, fire and prison services should be increased, and there should be a higher special charge, subject to possible modification in the light of overall impact;

iii. whether the armed forces should be excluded for the time being;

iv. whether the scheme should cover all other public services including the judiciary and, indirectly, the universities and other public service bodies mainly financed from Government funds;

v. whether the Civil Service scheme should become fully contributory;

vi. whether there should be no assumption that adjustments will be made to pay to offset the special charges;

vii. whether the nationalised industries should each be invited to review its own level of employee contributions in the light of the changes proposed for the public services;

viii. whether there should be an early announcement on the lines of the draft statement at Annex C, and, if so, when;

ix. whether there should be a Parliamentary debate, consultations in the summer, and final decisions in the autumn;

x. whether the options of legislation during this Parliament or a Manifesto commitment for action in the next Parliament should be left open at this stage.

RA

ROBERT ARMSTRONG

19 May 1982

CONFIDENTIAL

PRIME MINISTER

CABINET 29 APRIL: INDEX LINKED PENSIONS

1. I support the general recommendations John Vereker makes in his memorandum of 26 April. But in addition to the points he makes, I think there are two other major considerations which are ignored in the Chancellor's memorandum.

2. First, there is no opportunity for any civil servant or other employee to opt out of an index-linked pension. Everyone has to have them, and pay for them, whether they need them or not, whether they want them or not.

3. But this, although bureaucratically tidy, must make Civil Service jobs less attractive on the average than if they had the option of contracting out. Consequently we shall pay more for our manpower than if we had a more flexible arrangement.

4. Of course, it may be argued that everyone would wish to contract in. But in that case we would know that the price of an indexed pension was too cheap. Thus allowing the option would give us a test of the value of that right to an indexed pension. If, for example 20% or 30% contract out, then we know that the price is probably about right If, on the other hand, only 1% contract out, then we know we are charging too little. It seems to me therefore that at the very least a wide variety of forms of contracting out should be open for consultation and discussion over the next few months.

5. Secondly, I believe that the Chancellor's memorandum doesn't take into account what we hope may be the approach to pay settlements after Megaw. In principle the value of an indexed pension will be reflected in the turnover rates, which we want to see becoming a main determinant of pay settlements. John Vereker is quite right in saying that the charge for an index linked pension will be bound to appear in the pay claim. And logically, using the turnover rates as an indicator of the market for labour, we would be on very slender ground if we tried to oppose such claims.

Conclusion

6. I suggest, therefore, that, in addition to John Vereker's recommendations, you also suggest that the issue of opting out

/should be

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should be investigated first on the grounds that such variety in wage employment conditions can only reduce the cost of labour, secondly that it will increase the choice available to candidates, at no cost to the Exchequer, and thirdly that it will enable us to monitor the take-up of indexed pension arrangements and so judge the perceived value of those rights to the employees.

AW

27 April 1982 ALAN WALTERS

cc Chancellor of Exchequer

cc Mr. Hoskyns
Mr. Walters

PRIME MINISTER

Cabinet 29 April: Index linked pensions

The Chancellor's paper C(82)14 is almost identical to the paper he sought your authority to circulate before the Budget, and which you said should be delayed because of the possible effect on the pay round of his proposed announcement. The principal change he has made is to keep, in paragraph 14, a much more open mind on the timetable for legislation - before, he had said there was a strong case for going for implementation by 31 March 1983. Nonetheless, he proposes to announce that the new scheme "should come into effect in the course of 1984" (Annex C), and I believe that our objections to that still stand:

(i) Pay implications

The Chancellor is of course right to say that the whole scheme is designed to answer the charge that public servants pay too little for index linking, so that we cannot concede automatic pay increases to meet the new charge. But, as the report of the Official Group on Public Service Pay makes clear, seeking increased contributions will inevitably complicate pay bargaining across the board; and, in the case of the civil servants, will widely be regarded as totally unjustified, because civil servants believe that their pay is already reduced by the full 8½% proposed (although since the suspension of pay research that reduction has been only notional). So all the groups affected will argue for offsetting pay increases: to some extent that is bound to result in higher pay settlements than would otherwise have been the case. And the proposed 2½% special charge will be much harder to lose in pay bargaining in low single figures than it would have been with settlements running over 20%.

(ii) Technicalities

The method recommended by the Chancellor, on the basis of the Official Group's work, is probably the best available in this highly technical area. It is certainly the one which will be most easily saleable as fair, because of the clear relationship it establishes between the benefits of indexation and payment for

/ it;

it; and I am sure it is right to make the "fast accrual" services pay more. But the arguments for excluding the Armed Forces are unconvincing. As paragraph 27 of the Offical Report makes clear, that is bound to increase the resistance of other groups to the Government's proposals, and leave the Armed Forces open to the criticism, however unjustified, that they are still receiving non-contributory pensions. The Armed Forces should be included.

(iii) Consultation

Your reaction to the Chancellor's earlier proposal was that it would be best to publish a Report, possibly in the form of a Green Paper, exposing all the facts and complexities, with a view to a wide-ranging public debate over the Summer. The Chancellor's proposed oral statement goes very much further than that, by indicating firm decisions on the part of the Government as to action on increased contributions and a firm timetable leading up to legislation coming into effect in 1984. So he would be setting out specific proposals, not starting a consultative process. Given that this is a most unlikely candidate for pre-election legislation - John Hoskyns drew your attention earlier to the large numbers of voters involved - that risks getting the worst of all worlds: the fear of higher contributions will put greater pressure on pay, but the benefits of increased contributions would not be achieved in the present Parliament.

(iv) Nationalised industries

Ministers agreed in December that officials should work on the assumption that the scheme would not extend to the nationalised industries, and the reasons for that decision still stand: it would be virtually impossible to implement any proposals. But this remains highly unsatisfactory, because in the public sector as a whole it is the nationalised industries whose pay settlements bear least relation to job security, market factors and affordability, and it is the public services where we have greatest success in holding pay down. From that point of view, increasing pension contributions in the public services but not the nationalised industries is a move in the wrong direction.

/ (v)

(v) Public Perception

Public and media perception is not at present running at all strongly on index linked pensions, principally because of the improved prospects for inflation. Resentment of index linking is a product of inflation itself. The fact that inflation from next year on should be firmly settled into single figures is a factor to take into account in deciding whether it is necessary to grasp this nettle at all.

Conclusion

So I recommend you stay with your original proposal , and:

(i) Endorse as the Government's preference the detailed scheme proposed (paragraph 15c of the Chancellor's paper), but with the inclusion of the Armed Forces; but

(ii) Amend the Chancellor's proposed statement to replace references to Government decisions and proposals by preferences subject to the outcome of consultation; and

(iii) Delete from the Chancellor's proposed statement the suggested timetable, and indicate instead an intention to publish a consultative document in the summer, on the basis of which the Government would subsequently decide whether legislation was justified.

John Vereker

26 April 1982

MT.

c/ JV

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

26 April 1982

(2)

Prime Minister

MLS 27/4

Dear Peter

INDEX-LINKED PENSIONS

The Lord President of the Council has now seen the Chancellor of the Exchequer's minute of 8 April.

The Lord President agrees with the Chancellor that it will be necessary to arrange a Parliamentary debate on this subject before too long. Indeed, Sir William Clark again pressed for such a debate during Business Questions last Thursday. The Lord President also believes that the announcement of the Government's conclusions in broad terms by means of an oral statement should be made at least three to four weeks before a debate is arranged. Members of Parliament will need at least this much time to consider the Government's proposals. It follows that, if the debate is to take place in June, as the Chancellor proposes, it will be necessary to make the announcement of the Government's views before the Whitsun recess.

I am copying this letter to Mike Pattison (No 10), Michael Pownall (House of Lords) and David Wright (Cabinet Office).

Yours ever
Nick Huxtable

N P M HUXTABLE
Private Secretary

Peter Jenkins Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London SW1P 3AG

CONFIDENTIAL

FROM:

THE RT. HON. LORD HAILSHAM OF ST. MARYLEBONE, C.H., F.R.S., D.C.L.

c/c JV

LORD CHANCELLOR

HOUSE OF LORDS,
SW1A 0PW

CONFIDENTIAL

22nd April, 1982

(2)

The Right Honourable
Sir Geoffrey Howe, QC MP
Chancellor of the Exchequer

Prime Minister

MCS 23/4

My dear Geoffrey: **Index-linked Pensions**

Your paper C(82)14 on index-linked pensions includes, in paragraph 8, a table of existing and proposed levels of contribution. The judiciary are shown as paying 3 or 4% at present, increasing with the special charge to $5\frac{1}{4}$ or $6\frac{1}{4}$%. The figures shown for the other groups are all much higher. I must point out, however, that this is not a true comparison. The figures given for the judiciary relate only to widows' and children's pensions. The main judicial schemes are non-contributory. The TSRB takes the superannuation arrangements into account in making its recommendations and in that way a notional contribution is exacted in respect of basic benefits.

This comes out in the report by officials, but is not immediately apparent from the table. I am therefore circulating this note because I would not wish colleagues to be misled into thinking that the judiciary pay less for their pensions than others in the public service.

I am copying this to the Prime Minister, other members of the Cabinet and Sir Robert Armstrong.

Yrs:

Q.

CONFIDENTIAL

File

cc: LPO
LPS
CWO
CO

DSS

Econ
Pol

10 DOWNING STREET

From the Private Secretary

13 April 1982

bc: Mr. Vereker

INDEX LINKED PENSIONS

The Prime Minister has seen the Chancellor's minute of 8 April on the above subject. She is content that the Chancellor should now circulate his paper to colleagues for discussion in Cabinet.

I am sending copies of this letter to David Heyhoe (Lord President's Office), Jim Buckley (Lord Privy Seal's Office), Murdo Maclean (Chief Whip's Office) and to David Wright (Cabinet Office).

M. A. PATTISON

John Kerr, Esq.,
HM Treasury.

DS

CONFIDENTIAL

① QC JV

Prime Minister

Agree to the Chancellor circulating this paper to E, so that there would be a discussion about whether to announce these decisions in May/June?

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

I agree that. There should be a discussion. There will be some difficulty - I believe in getting the Chancellor's view endorsed. MS.

8/4

INDEX-LINKED PENSIONS

When we last discussed this on 25 February you decided against an announcement in my Budget Statement and suggested that we might consider the possibility of an announcement in the late summer or autumn, which would be least inconvenient on the pay front. You thought it would be useful to expose all the arguments in a published document, perhaps a Green Paper: it might also be necessary to arrange for a debate in Parliament later on.

2. Since then, pressure has continued from many of our supporters to give a early indication of our conclusions. Francis Pym recently wrote to me to say that, in his judgement, there was no prospect of avoiding a fairly early Parliamentary debate. The new leader of the House will be under growing pressure to arrange this, which is likely to increase in the coming weeks, especially as we approach the time for decisions on MPs' pay and allowances.

3. Against this background I do not think we can now hope to postpone any indication of our views until the autumn. A debate with no clear indication of our intentions would be badly received by our supporters, both in the House and in the country. Similarly, if we published an inconclusive Green Paper, we should earn no credit with the opponents of index-linking, while, because of the continued uncertainty, causing widespread concern to the pensioners and public service unions. There are, therefore, in my view good political arguments for resolving this question once and for all well

before the run-up to an Election. I have discussed this with Janet Young, who has also encountered considerable pressure around the country for an early Government decision. This comes not only from those opposed to index-linking but from others who are anxious to see an end to the present uncertainty.

4. The best timing for a debate would be towards the end of May or early June - after decisions on the civil service pay arbitration and before the report of the Megaw Inquiry. This could still run into difficulties over the teachers' or nurses' pay negotiations, if they had not been settled by then, but it would be difficult to hold off the pressures much beyond mid-June. The debate would, I think, need to be preceded by an oral statement giving an indication of our conclusions in fairly broad terms. This could be backed by a written document, placed in the Library of the House, explaining the proposals in greater detail.

5. Beyond that, we are firmly committed to consult the various interests on any proposed changes and we could, as you had in mind, undertake this during the summer - perhaps on the basis of a White Paper or formal consultation document. We could decide which in the light of the debate. This timetable would pave the way for final decisions in the autumn as you suggested, and on the assumption (which we may wish to reconsider) that no place can now be found in the 1982-83 legislative programme, it would lead either to legislation early in the 1983-84 session (with a view to implementation in the course of 1984), or to a firm Manifesto commitment for action early in the next Parliament. We need not close the options on this question for some time.

6. In conclusion, therefore, the strong pressure for a Parliamentary debate does, I believe, mean that we must now give some fairly early indication of our proposals. We cannot hope to delay this till the autumn and the best time for a debate would be at the end of May or early June. The

debate could be preceded by a statement in fairly general terms, and followed by a consultative exercise through the summer. We could emphasise that while we had made proposals in general terms, we were still open to receive representations, and we need not, therefore, be committed to final decisions until the autumn.

7. I should like to put these suggestions to our Cabinet colleagues and I attach at Annex A a revised draft of the paper I showed you in February. The substance remains the same, but the sections on timing and presentation have been revised to reflect the proposals in this minute. A draft of the proposed statement is of Annex B.

8. I am sending copies of this to John Biffen, Janet Young and Michael Jopling, and to Sir Robert Armstrong.

(G.H.)

8 April 1982

CONFIDENTIAL

DRAFT PAPER FOR CABINET

INDEX-LINKED PENSIONS

Introduction

It is now 14 months since the publication of the Scott Report and we are coming under increasing and understandable pressure to announce our conclusions. At Cabinet on 10th December (CC(81)40th Meeting, Item 4), we agreed in principle not to legislate to remove or reduce the inflation-proofing of public service pensions. Instead, we asked for further work on a new system of employee contributions. Essentially, public servants would pay, in addition to their present contributions (described in these papers as the lower tier) a new special charge (the upper tier) towards the current cost of index-linking. We accepted that the scheme could not extend directly to the nationalised industries because of the legislative difficulty of bringing their contribution rates within Government control.

The Official Report

2. Officials have now completed this further work and their report is at Annex A. It is detailed, but that is inevitable given its scope and the complex legal and financial structures involved. I am satisfied that the basic concept of our preferred option is sound; and that the technical difficulties can beovercome. There is, indeed, considerable attraction (except for the people affected) in a course in which public servants would be seen to pay for the additional cost of full index-linking, as compared with private sector practices. And it must be right in principle.

3. The report distinguishes between the services where full pensions are earned over 40 years ("normal accrual") and those where pensions are earned more quickly and are payable from an earlier age ("fast accrual"). Fast accrual is much more valuable and the benefit of index-linking is correspondigly greater. I endorse the general view of officials that these better benefits should be paid for at a somewhat higher rate. But we must also recognise that the advantages of earlier retirement stem partly from the fitness requirements of the jobs concerned - in the police, fire and prison services, for example, and the armed forces.

Points for decision

4. On the main issues posed in paras 4-6 of the official report and para 4 of the Chairman's note, my views are as follows:-

a. Police, Fire and Prison Services - lower tier contributions

I would accept the Official Committee's recommendation that the lower-tier contributions for these services should in principle be increased. I doubt whether in practice it is realistic to aim at a single, uniform, contribution and it will probably be unavoidable that we negotiate rates tailored to the circumstances of each service. We should, however, aim to ensure that the treatment of the various services is consistent and avoid unnecessarily fine distinctions between them. (Similar considerations apply to the NHS Mental Health Officers.)

b. Calculation of the special charge

Though it will complicate the scheme, I agree that the special charge should be calculated separately for the normal and fast accrual services. If there were a single charge for all, those in the normal schemes would claim that they were being required to subsidise the more costly inflation-proofing of the others. However, for the fast accrual schemes, the combined impact of increases in both tiers would be very severe. We may need to modify the higher special charge on the grounds that earlier retirement is imposed in these services.

c. The Armed Forces. It is desirable in principle that the scheme should have the widest possible coverage and that the Armed Forces should not appear to be getting specially favoured treatment. This argues for including them. On the other hand, the present pension deduction for the Armed Forces - increased last year to 11 per cent (equivalent to 13 or 14 per cent in a contributory scheme) - is unlikely to be criticised as inadequate. And although the method of calculation is different, the result is in line with what is proposed for the other fast accrual services. A change would require major adjustments to the Armed Forces pay and pension arrangements. On the balance of these arguments I would suggest that the Armed Forces should be excluded from the new scheme - at least for the time being.

5. For the normal accrual services - civil service, NHS teachers and local government - I agree that the lower tier contribution should be 5 per cent (manuals) and 6 per cent (non-manuals) with a uniform special charge estimated at 2¼ per cent.

6. I would endorse the other recommendations in para 4 of the Report. In particular, I see it as an integral part of the proposals that the Civil Service scheme should become fully contributory, with an upward adjustment to pay to compensate for the lower tier contribution. The effect would be financially neutral. I would propose to enter into consultation with the Civil Service unions on the precise amendments needed to the pension scheme avoiding, so far as possible, "windfall" benefits for those about to retire. Arrangements equivalent to the special charge must clearly apply in the universities and other public service bodies mainly financed from public funds. It would also be right to invite the Top Salaries Review Body to review, in the light of the proposed changes, the arrangements under which they take account of pensions in assessing judicial pay.

7. I shall consider further the effect of the increases in contributions on the Inland Revenue limit that employee contributions should not exceed 15 per cent of pay in schemes qualifying for tax-relief. My present view is that this limit should continue to apply to those who have yet entered into contracts to pay additional voluntary contributions but be waived for those with contracts existing at the date of

announcement, to the extent - and only to the extent - that thenew arrangements would take them over the limit.

8. The special charge as estimated in the official report must be regarded as provisional, pending a proper review before implementation. However, the most likely overall effect of these proposals can be summarised as follows:-

	Total Contributions per cent	
	Existing	Proposed
Teachers) Local Government) NHS) Other bodies)	5 manual 6 non-manual	7¼ manual 8¼ non-manual
Civil Service	Total effective contribution approximately 8 (equivalent to 8½ per cent in a contributory scheme)*	7¼ manual 8¼ non-manual
MPs	6	8¼
Police, fire and) prison services)	6¾ - 8	10-13 depending on negotiations
Judiciary	3 or 4	5¼ or 6¼, plus TSRB pay adjustment
Armed Forces	Continued pay adjustment equivalent to 13 or 14 per cent in a contributory scheme	

The gross public expenditure savings of these changes - that is, the additional income from employee contributions, assuming no offset in higher pay - would be about £535 million a year.

* reflecting the fact that pensions would be slightly larger being based on higher gross pay.

Implications for pay

10. The key question for decision is whether in this Parliament we are going to insist that public servants should pay more for index-linked pensions. To impose a higher contribution would not be easy at any time. It will be particularly difficult at a time when most public servants are being asked to accept increases in pay which are near or below the increase in the cost of living. We must, therefore, expect our proposals to be vigorously resisted by the unions, even if the basic shape of the scheme is a fair one.

11. The Official Committee on Public Service Pay have pointedout (Annex B) that the introduction of the special charge will lead to claims of varying strengths for compensatory adjustments to pay. However, the whole scheme is designed to answer the charge that public servants pay too little for index-linking. Its purpose would be lost if we conceded automatic pay increases to meet the new charge. So too would the savings in public expenditure. In my view, we should say there can be no assumption that pay will be increased to offset the special charge. We should then resist claims for offsets so far as possible.

12. These difficulties are, of course, inherent in any proposal to increase the contributions for index-linking over the next two years. The problem will not go away; and my judgement is that public concern about index-linking will increase if we are successful in holding down pay while pensions increase in line with prices. If we are to meet this concern,

the only alternative to a genuine increase in contributions would be to cease full index-linking. We have rejected that course for other reasons. It might, however, help to secure the acceptance of the special charge if, during the process of consultation, we pointed to this as the alternative.

Announcement and implementation

13. The Official Committee on Public Service Pay have recommended against an announcement before the completion of the remaining public service pay settlements - the Civil Service, the NHS and schoolteachers - and it is clearly important not to prejudice their outcome. On the other hand, the matter has now run on for well over a year and we are being widely criticised for dragging our feet. There are, in my view, good political arguments for resolving this thorny question once-and-for-all, well before the run up to an election. In particular, the former Leader of the House has faced growing pressure in the House to arrange a fairly early Parliamentary debate and, in his judgement, there is no prospect that this can be avoided.

14. The best timing for a debate would be towards the end of May or early June, after decisions on the Civil Service pay arbitration and before the report of the Megaw Inquiry. This could still run us into difficulties over the teachers' or nurses' pay negotiations, if they had not been settled by then, but it would be difficult to hold off the pressures much beyond mid-June. A debate with no clear indication of our intentions would be badly received by our supporters, both in the House and in the country. It would therefore need to

be preceded by an Oral Statement giving an indication of our conclusio-s in fairly broad terms. (A possible draft is at Annex C.) This could be backed by a written document, placed in the Library of the House, explaining the proposals in greater detail.

15. Beyond that, we are firmly committed to consult the various interests on any proposed changes and we could undertake this during the summer - perhaps on the basis of a White Paper or formal consultation document. We could make it clear that while we had made proposals in general terms, we were still open to representations, and we need not, therefore, be committed to final decisions until the autumn. On the assumption (which we may wish to re-consider) that no place can now be found in the 1982-83 legislative programme, this timetable could lead either to legislation early in the 1983-84 session (with a view to implementation in the course of 1984), or to a firm Manifesto commitment for action early in the next Parliament. We need not close the options on this for some time.

Recommendations

16. I ask my colleagues to agree, therefore:-

a. that in readiness for a Parliamentary debate in late May or early June, I should announce our intention to introduce a two-tier system of contributions on the general lines of our preferred options (see thedraft statement at Annex C);

b. that in thelight of the debate we should consult interested bodies with a view to reaching final decisions this autumn;

c. on the detail of the scheme,

i. that the normal accrual schemes should be treated as proposed in paragraph 5 above and pay a special charge of around $2\frac{1}{4}$ per cent;

ii. that for the police, fire and prison services, contributions for pension benefits should be reviewed as proposed in para 4a above; that the special charge should be set at a higher rate; but that the overall impact of these changes may need to be modified (para 4b);

iii. that the scheme should exclude the Armed Forces, but that it should embrace all the other public services, including the judiciary and, indirectly, the universities and other public service bodies mainly financed from Government funds;

iv. that the civil service scheme should become fully contributory and that the other recommendations in paragraph 4 of the official report should be accepted;

v. that there should be no assumption that adjustments will be made to pay to offset the special charge; and

d. that while the scheme cannot apply directly to the nationalised industries we should invite each industry to review its own level of employee contributions in the light of the changes proposed for the public services.

CONFIDENTIAL

Draft Oral Statement

The Government has completed its review of the arrangements for increasing public service pensions in the light of the Scott Report and I should like to announce our broad conclusions and proposals for change.

2. First, we have decided that the right course is to seek adequate contributions from public service employee for their pension benefits rather than to seek to reduce the real value of those benefits. This decision is fully in line with the approach to these matters which we put forward at the last election. The principle underlying our proposals will be that public service employees, rather than the taxpayer, should bear the full cost of the extra benefits they enjoy as compared to private sector practice.

3. For the Civil Service we would propose to replace the present mixture of salary reductions and widow's contributions by a fully contributory scheme. Contributions to the other public service schemes will be reviewed. In addition to these changes, a special charge will be levied on all employees, in schemes covered by the Pensions (Increase) Act. It will be set at the level necessary to recover in full the extra cost of index-linking in excess of average private sector practice.

4. This new charge is provisionally estimated to be about 2¼ per cent of pay for most public servants and about 3 per cent for members of schemes in which full pensions accrue

over less than 40 years, such as the police, fire and prison services. As a result most non-manual public servants will pay a pension contribution of at least 8¼ per cent of salary. Members of the armed forces pay for their pensions under separate arrangements based on the recommendation of the Review Body on Armed Forces Pay; their contributions were increased to an adequate level last year and they will be excluded from our proposals. Subject to the necessary legislation receiving the approval of Parliament, we intend that the new scheme should come into effect in the course of 1984.

5. My rt. hon. friend, the Leader of the House, will be arranging for a full debate in the fairly near future. To assist in this, I shall be placing in the Library of the House a background document setting out our proposals in rather greater detail. Following the debate we shall, as we have promised, consult fully on our proposals with organisations representing public service employers, employees and pensioners, with a view to reaching final decisions later this year.

6. Finally, the House would, I know, wish me to express our thanks to Sir Bernard Scott and his Committee for the informative report which they produced last year. Although our proposals go beyond the issues set out in the Scott Committee's terms of reference, their report was a useful starting point for the Government's own review. It has helped to improve the quality of public discussion on this very difficult question.

CONFIDENTIAL

Econ Pol

MR. HOSKYNS

cc Mr. Scholar
Mr. Walters

Public Sector Pensions

A month having passed since Michael Scholar wrote round conveying the Prime Minister's decision not to have an announcement about public service pensions in the Budget statement, I have checked with the Treasury/CSD how they envisage carrying matters forward. You will recall that the Prime Minister said, entirely in line with our own thinking, that she would prefer to have an exploratory Green Paper, a Parliamentary Debate, and decisions much later on.

The Treasury have interpreted this (rightly, in my view) as an indication that the Government are not anxious to announce what are bound to be politically highly unpopular decisions on pensions during the rest of this Parliament; and the Treasury are also conscious of the tendency for public anxiety about index linking to die down when inflation is in single figures. The importance of this issue may therefore be transient; and the immediate problem is the fact that the Government has still not reacted to the Scott Report.

The Chancellor is likely to minute the Prime Minister about all this before Easter, following an internal meeting of Treasury Ministers, and I understand that he is being advised to suggest fairly early publication of a full Green Paper explaining all the complexities and giving an initial preference for the Government's own approach. The paper would indicate the need for a long consultation process, and might well imply that any legislation would wait until the next Parliament. Since that is almost entirely the scenario I suggested in the last paragraph of my note to you of 29 January, you will not be surprised to know that I agree with it.

J. M. M. VEREKER

24 March 1982

CONFIDENTIAL

Econ Pol

Ref. A07625

MR WHITMORE

The Chancellor of the Exchequer has sent me a copy of his minute of 23 February to the Prime Minister on index-linked pensions.

2. We can, of course, accommodate this subject at Cabinet on 4 March, if the Prime Minister so decides. But I have to say that I think that we need to consider very carefully the timing of an announcement on the lines suggested by the Chancellor of the Exchequer, not only in relation to his Budget but also in relation to current pay negotiations. The arguments for keeping clear of the current round of pay negotiations in the Civil Service, the NHS and the school teachers seem to me to be very strong.

RTA

ROBERT ARMSTRONG

25 February 1982

Sir R Armstrong

The Prime Minister and Chancellor discussed this morning and agreed not to make an announcement in the Budget or to circulate an immediate paper for Cabinet - but to produce a discussion (Green?) paper and go for a day's debate on these highly complex matters, with a view to postponing any announcement to the autumn when the pay round pressure would be less intense. (I mentioned to Mr Gregson this morning.)

MLS 25/2

file   MK

bc: J. Vereker.

10 DOWNING STREET

From the Private Secretary

25 February 1982

Index-Linked Pensions

The Prime Minister discussed with the Chancellor this morning the Chancellor's minute of 23 February about follow-up action on the Scott Report on index-linked pensions.

The Prime Minister said that she was concerned about the effect on the current pay round of an announcement on the lines envisaged by the Chancellor in the Budget Statement. The matter was a complex and difficult one, and it seemed unlikely that agreement would be reached in the course of one further discussion by colleagues. She would prefer to expose all the facts and complexities in a published report (perhaps a Green Paper?). It might prove desirable to arrange for a day's debate in Parliament later on. This process might lead to a decision at a time which would be least inconvenient on the pay front - say the late summer or autumn.

I am sending a copy of this letter to David Wright (Cabinet Office).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury

24 February 1982

Policy Unit

PRIME MINISTER

INDEX-LINKED PENSIONS

We have seen Geoffrey's minute to you of 23 February with the draft Cabinet Paper, together with the PSP and VP papers. There are really four questions:

1. Is this a nettle we HAVE to grasp?

1.1 The economic case looks powerful, with annual savings of around £½bn. As Geoffrey says, "The problem will not go away". He argues that public concern could increase if we succeed in holding pay down, while indexed pensions rise with prices. It is consistent with the Government's image - the long-term responsible approach - that we should grapple with the problem as surely as other parties would shirk it.

1.2 The political implications are substantial. There are 5.4 million members of index-linked schemes in the public sector, and a presumably substantial number of potential dependants of existing scheme members. Geoffrey says that the measures he proposes would be welcome to our supporters. Of course they would. But those who would welcome them most enthusiastically are unlikely to desert us at the Election if we disappointed them on this issue. Loyal Tory supporters cannot "vote harder" than they will in any case. So the possibility of losing votes - by alienating public sector pension scheme members - seems greater than that of winning converts. So we shall have to make great efforts to persuade public sector employees that our measures are, above everything, fair.

1.3 Geoffrey suggests that, in presentation, we should point to the alternative of ending index-linking altogether, and then discard it. This would be consistent with the "firm but fair" posture we have suggested in earlier minutes. A contract (ie indexed pensions) must be honoured; but the price must be fair.

1.4 We conclude that the nettle does have to be grasped at some stage. So the question is when?

2. <u>Should we leave it till the next Parliament</u>?

2.1 At first sight, this looks attractive. But if we mean to grasp the nettle some time, it would probably be better to do it soon. If we introduce the measures in March 1983 (the earliest practicable date, Geoffrey suggests, and it would be very difficult to leave it later, with an Election likely in the autumn of 1983) we could challenge Labour and the Alliance to repeal it if they came to power. Alliance in particular probably know that index-linked pensions were a major blunder and would not wish to repeal. If they promised to do so, they would be likely to alienate far larger numbers of those who do not enjoy indexed pensions, than would be won over from those who enjoy indexation. This challenge to the other parties would be crucial, since the measures would be introduced so soon before an Election.

2.2 We doubt if it would make sense for us to delay till the next Parliament. First, there would be a good deal of scepticism amongst our supporters and the public generally about whether we would really take any action, having delayed so long. Second, many members of indexed schemes in the public sector would probably vote against us, in self defence; while it would be much easier for Labour and the Alliance to hedge about whether they would introduce such measures (much easier than it would be for them to pledge to repeal such measures once they had been introduced).

2.3 So we conclude that we have to act soon or not at all.

3. <u>Do the colleagues grasp the pay implications</u>?

3.1 As the PSP paper says, there will inevitably be pressure for compensating pay increases. The argument will be that earlier pay awards explicitly took account of the value of indexed pensions.

3.2 It <u>may</u> be possible to show, for some public sector groups, that if those notional deductions had been added back in, their average pay levels would be absurdly high compared with their private sector comparators; and that therefore realistic deductions could never have been made, despite all the protestations after the event. But this would depend on the actual numbers and specific cases.

3.3 There is really no way of resolving the argument. The trade unions will say that they are being victimised and picked on unfairly. We shall be arguing that we are introducing fairness, at a time when the rest of the economy is having to face up to living within the country's means. It is unlikely, at least in the next 5 years, that we will ever find the time "convenient" for grasping this nettle, as we shall always be facing public sector pay pressures. So we really have to take it head-on and resolve to win the argument. It will help, presentationally, that MPs will have to take the Government's own medicine. Much will also depend on how "resistable" the various groups in the table at the end of Annex A of VP(82)5 are judged to be when the crunch comes.

4. <u>If the colleagues decide to delay</u>?

4.1 The colleagues may, despite all Geoffrey's arguments and their own decision in Cabinet, decide to delay this difficult issue on purely political and electoral grounds. There is a real danger of alienating very large numbers in the public sector and also getting a blow-back into pay, even before the implementation of new pension arrangements. If the colleagues decide to delay, the best way would be to make a Parliamentary announcement before the Easter Recess, indicating that they have been carefully considering the Scott Report; that it raised difficult and complex issues throughout the public sector (which is nothing less than the truth); but they have decided that it would be wrong to restrict the benefits of indexation; and that they are considering ways of ensuring that contributions fairly match those benefits; and that they would be issuing a consultative document in the summer. That document would then expose the very real difficulties, and by the time those consultations were finished, it would be too late to introduce anything into the next Parliamentary session. In view of the long delay since the Scott Report and the possibility of an Election only 18 months away, such an approach is likely to be suggested.

JOHN HOSKYNS

3pps

cc JV

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister

For tomorrow's meeting with the Chancellor. Do you agree the paper be circulated for Cabinet on 4 March?

MCS 24/2

PRIME MINISTER

INDEX-LINKED PENSIONS

It is now a year since the Scott Report on index-linked pensions was published, and it is becoming increasingly difficult to justify the delay in announcing the Government's views on it. Cabinet, on 10 December last, commissioned further work on the application to particular groups of our preferred scheme. I have now received this in the form of reports from the Official Committees on the Value of Pensions (VP) and on Public Service Pay (PSP(O) - copies are with your Policy Unit. I believe it is important to press on with an early announcement. Specifically, I would see advantage in including an announcement in my Budget Statement on 9 March. The absence of any announcement on this subject was one of the points specifically criticised about by Budget Statement last year.

2. Clearly there are difficult questions, which you and the Cabinet will wish to consider, about the timing both of an announcement and of the date of implementation. My own view is that this subject is likely to become more rather than less contentious with the passage of time and that, for the reasons given in the draft Cabinet paper enclosed, the best course is to press ahead as quickly as possible. I should therefore like to circulate this Cabinet paper on Thursday of this week for consideration on 4 March, so that the option of an announcement in my Budget Statement can be considered. I should be grateful if we could have a word about this when we meet tomorrow.

CONFIDENTIAL
MANAGEMENT IN CONFIDENCE

3. I am sending a copy of this minute and enclosures to Sir Robert Armstrong.

Peter Jenkins

(G.H.)

23 February 1982

(Approved by the Chancellor of the Exchequer and signed in his absence).

CONFIDENTIAL

DRAFT PAPER FOR CABINET

INDEX-LINKED PENSIONS

Introduction

It is now 12 months since the publication of the Scott Report and we are coming under increasing and understandable pressure to announce our conclusions. At Cabinet on 9th December (CC(81)40th Meeting, Item 4), we agreed in principle not to legislate to remove or reduce the inflation-proofing of public service pensions. Instead, we asked for further work on a new system of employee contributions. Essentially, public servants would pay, in addition to their present contributions, a new special charge towards the current cost of index-linking. We accepted that the scheme could not extend directly to the nationalised industries because of the legislative difficulty of bringing their contribution rates within Government control.

The Official Report

2. Officials have now completed this further work and their report is at Annex A. It is detailed, but that is inevitable given its scope and the complex legal and financial structures involved.

, I am satisfied that the basic concept of our preferred option is sound; and that the technical difficulties can be overcome. There is, indeed, considerable attraction (except for the people affected) in a course in which public servants would be seen to pay for the additional cost of full index-linking, as compared with private sector practice. And it must be right in principle.

3. The report distinguishes between the services where full pensions are earned over 40 years ("normal accrual") and those where pensions are earned more quickly and are payable from an earlier age ("fast accrual"). Fast accrual is much more valuable and the benefit of index-linking is correspondingly greater. I endorse the general view of officials that these better benefits should be paid for at a somewhat higher rate. But we must also recognise that the advantages of earlier retirement stem partly from the fitness requirements of the jobs concerned - in the police, fire and prison services, for example, and the armed forces.

Points for decision

4. On the main issues posed in paras 4-6 of the official report and para 4 of the Chairman's note, my views are as follows:-

a. Police, Fire and Prison Services - lower tier contributions

I would accept the Official Committee's recommendation that the lower-tier contributions for these services should in principle be increased. I doubt whether in practice it is realistic to aim at a single, uniform, contribution and it will probably be unavoidable that we negotiate rates tailored to the circumstances of each service. We should, however, aim to ensure that the treatment of the various services is consistent and avoid unnecessarily fine distinctions between them. (Similar considerations apply to the NHS Mental Health Officers.)

b. Calculation of the special charge (the upper tier)
Though it will complicate the scheme, I agree that the special charge should be calculated separately for the normal and fast accrual services. If there were a single charge for all, those in the normal schemes would claim that they were being required to subsidise the more costly inflation-proofing of the others. However, for the fast accrual schemes, the combined impact of increases in both tiers would be very severe. We may need to modify the higher special charge on the grounds that earlier retirement is imposed in these services.

c. The Armed Forces. It is desirable in principle that the scheme should have the widest possible coverage and that the Armed Forces should not appear to be getting specially favoured treatment. This argues for including them. On the other hand, the present pension deduction for the Armed Forces - increased last year to 11 per cent (equivalent to 13 or 14 per cent in a contributory scheme) - is unlikely to be criticised as inadequate. And although the method of calculation is different, the result is in line with what is proposed for the other fast accrual services. A change would require major adjustments to the Armed Forces pay and pension arrangements. On the balance of these arguments I would suggest that the Armed Forces should be excluded from the new scheme - at least for the time being.

5. For the normal accrual services - civil service, NHS, - teachers and local government - I agree that the lower-tier contribution should be 5 per cent (manuals) and 6 per cent (non-manuals) with a uniform special charge estimated at 2¼ per cent.

6. I would endorse the other recommendations in para 4 of the Report. In particular, I see it as an integral part of the proposals that the Civil Service scheme should become fully contributory. I would propose to enter into consultation with the Civil Service unions on the precise amendments needed to the pension scheme avoiding, so far as possible, "windfall" benefits for those about to retire. Arrangements equivalent to the special charge must clearly apply in the universities and other public service bodies mainly financed from public funds. It would also be right to invite the Top Salaries Review Body to review, in the light of the proposed changes, the arrangements under which they take account of pensions in assessing judicial pay.

7. I shall consider further the effect of the increases in contributions on the Inland Revenue limit that employee contributions should not exceed 15 per cent of pay in schemes qualifying for tax relief. My present view is that this limit should continue to apply to those who have not yet entered into contracts to pay additional voluntary contributions but be waived for those with contracts existing at the date of announcement, to the extent - and only to the extent - that the new arrangements would take them over the limit.

8. The special charge as estimated in the official report must be regarded as provisional, pending a proper review before implementation. However, the most likely overall effect of these proposals can be summarised as follows:-

	Total Contributions per cent	
	Existing	Proposed
Teachers, Local Government, NHS, Other bodies	5 manual 6 non-manual	$7\frac{1}{4}$ manual $8\frac{1}{4}$ non-manual
Civil Service	Total effective contribution approximately 8	$7\frac{1}{4}$ manual $8\frac{1}{4}$ non-manual
MPs	6	$8\frac{1}{4}$
Police, fire and prison services	$6\frac{3}{4}$ - 8	10-13 depending on negotiations
Judiciary	3 or 4	$5\frac{1}{4}$ or $6\frac{1}{4}$, plus TSRB pay adjustment
Armed Forces	Continued pay adjustment equivalent to 13 or 14 per cent in a contributory scheme.	

The gross public expenditure savings of these changes - that is, the additional income from employee contributions, assuming no offset in higher pay - would be about £535 million a year.

Implications for pay

9. The key question for decision is whether - sometime in 1983 or 1984 - we are going to insist that public servants should pay more for index-linked pensions. To impose a higher contribution would not be easy at any time. It will be particularly difficult now when most public servants are being asked to accept increases in pay which are below the increase in the cost of living. We must, therefore, expect our proposals to be vigorously resisted by the unions, even if the basic shape of the scheme is a fair one.

10. The Official Committee on Public Service Pay have pointed out (Annex B) that the introduction of the special charge will lead to claims of varying strengths for compensatory adjustments to pay. However, the whole scheme is designed to answer the charge that public servants pay too little for index-linking. Its purpose would be lost if we conceded automatic pay increases to meet the new charge - as would the savings in public expenditure. In my view, we should say there can be no assumption that pay will be increased to offset the special charge. We should then resist claims for offsets so far as possible.

11. These difficulties are, of course, inherent in any proposal to increase the contributions for index-linking over the next two years. The problem will not go away; and my judgement is that public concern about index-linking will increase if we are successful in holding down pay while pensions increase in line with prices. If we are to meet this concern, the only alternative to a genuine increase in contributions would be to cease full index-linking. We have rejected that course for other reasons. It might, however, help to secure the acceptance of the special charge if we pointed to this alternative during the process of consultation.

Announcement and implementation

12. The Official Committee on Public Service Pay have recommended against an announcement before the completion of the remaining public service pay negotiations - the Civil Service, the NHS and schoolteachers - and it is clearly

important not to prejudice their outcome. On the other hand, the matter has dragged on for over a year and we are now being pressed for a response to Scott. My Budget Statement last year was criticised for not dealing with it. I believe we should now act as quickly as possible and I should like to give some general indication in this year's Statement of what we have in mind. A decision will be welcome to many of our supporters, while an announcement that we do not for the moment intend to remove index-linked may slightly improve the climate on pay.

13. Before implementing this scheme we are committed to consult those affected and we need legislation taking power to impose the special charge. The earliest date for implementation would be the first pay settlement for each service after 31 March 1983, which would require a bill to be introduced very early next session, and on the Statute Book well ahead of that date. The alternative would be implementation from 31 August 1983, which would allow more time for legislation, but which would be criticised by those who already argue we have been dragging our feet, and would bring the process nearer to the likely date of the election. I can appreciate the timetable problems, but I believe nonetheless there is a strong case for going for the earlier date.

Recommendations

14. I ask my colleagues to agree, therefore:-

i. that I should announce in my Budget Statement our intention to consult with interested parties on the introduction of a two-tier system of contributions on the general lines of our preferred option, with a view to legislation next session and implementation in each service at the first pay settlement after March 1983;

ii. that the normal accrual schemes should be treated as proposed in paragraph 5 above and pay a special charge of around $2\frac{1}{4}$ per cent;

iii. that for the police, fire and prison services, contributions for pension benefits should be reviewed as proposed in para 4a above; that the special charge should be set at a higher rate; but that the overall impact of these changes may need to be modified (para 4b).

iv. that the scheme should exclude the Armed Forces, but that it should embrace all the other public services, including the judiciary and, indirectly, the universities and other public service bodies mainly financed from Government funds;

v. that the civil service scheme should become fully contributory and that the other recommendations in paragraph 4 of the official report should be accepted;

vi. that there should be no assumption that adjustments will be made to pay to offset the special charge; and

vii. that while the scheme cannot apply directly to the nationalised industries we should invite each industry to review its own level of employee contributions in the light of the changes proposed for the public services.

vtu 9-R

Ref: A06266

CONFIDENTIAL

PRIME MINISTER

Index-Linked Pensions: Follow-up to the Scott Report

I am submitting separately a Cabinet Office brief for the discussion of this item at Cabinet on 10th December.

2. I should like in this separate note to make the following comments with my MPO hat on:

(1) The public perception is of inflation-proofing as a perk of civil servants. This darkens counsel, because inflation-proofing is not confined to civil servants: it is a privilege enjoyed throughout the public services - all of whom are covered by the statute - and very widely in the public trading sector also. The fact that the public perception links inflation-proofing to civil servants tends to lead people to talk about remedies in terms of civil servants only; and this tendency is accentuated by the facts that civil servants are the Government's own employees and that their pension scheme is non-contributory. The Chancellor of the Exchequer's paper rightly draws attention to the extent of inflation-proofing and the difficulties of dealing with the whole range; but there are passages in it which seem to come near to saying, in effect: "even if we cannot deal with other people, let us at least deal with our own people in the Civil Service."

(2) I believe that many people in the Civil Service are sensitive to the feelings expressed by the private sector about inflation-proofing, and would accept (if not positively welcome) measures which either compensated for the advantage in terms of a higher contribution or set some limit to the extent of the benefit - provided that those measures were applied to all the public services and public sector schemes of which inflation-proofing is at present a feature. But it would grievously set back attempts to restore relations between management and unions in the Civil Service, and would generate deep resentment against the Government among the staff, if the Civil Service thought that they were

being discriminated against by comparison with other public service and public sector groups who enjoy index-linked pension benefits. These relations are going to be under strain anyway on pay, on the assumption that the 1982 claim (now submitted at 13 per cent) will have to go to arbitration: particularly if the Government then feels obliged to set aside the award.

(3) Under the old pay research arrangements, the rates derived from job comparisons were abated by $8\frac{1}{2}$ per cent in respect of the employee's pension contribution. This figure compared with the 6 per cent actually deducted in schemes in other public services (notably the National Health Service and local government). The extra $2\frac{1}{2}$ per cent was regarded as recognising the additional benefit (as compared with private sector employees) of index-linking. If the Civil Service was asked to contribute a further $2\frac{1}{2}$ per cent for index-linking, they would consider that they were being asked to pay for index-linking twice over, as compared with other public services.

(4) There is something to be said for making the basic "contribution" in the Civil Service, as well as the additional $2\frac{1}{2}$ per cent for inflation-proofing, actually instead of notionally deductible - though it should be borne in mind that, if salaries were expressed in gross terms and a pension contribution was actually deducted (instead of salaries being paid net of a notional contribution) pension benefits would presumably have to be calculated in terms of the gross pay: this could mean an increase of up to 6 per cent in the Exchequer cost of paying pensions. But there would be strong pressure that at the point of change there should be a corresponding once for all pay increase - so that, so far as contributions were concerned, the effect both on the Exchequer and on the civil servant was neutral at the point of change. An attempt to negotiate a once for all increase less than the amount of the new deduction would damage the prospects of the change being regarded as acceptable.

(5) If Ministers wanted to pursue the possibility of making the basic employee's contribution actually deductible, but not to take a decision or commit themselves to legislation at this stage, they could decide to put the idea to the Megaw Committee, as something to be considered and taken into account in thinking about the new pay arrangements. It is arguable that, if such a Committee is actually sitting, the most natural course is to put the proposal to the Committee to consider.

(6) The Chancellor of the Exchequer's paper is very much in terms of pension schemes which relate to a 40-year career. It rightly states that it would be necessary to consider the implications of what was agreed for schemes which relate to shorter careers - like those for the police, and for the prison officers - who are of course civil servants. I do not think that it should be readily assumed that it would be easy to translate what was proposed for 40-year career schemes to these shorter service schemes, and I believe that it would be prudent for Ministers to ask to see these implications worked out in detail before they committed themselves to final decisions.

(7) What is said to the Press about the Cabinet's discussion of this subject could itself have significant consequences in the public services concerned. That is something you will need to think carefully about and discuss with the Cabinet in the light of whatever decisions the Cabinet reaches on the questions of substance.

RtA

Robert Armstrong

9th December 1981

CONFIDENTIAL

Ref: A06265

PRIME MINISTER

Index Linked Pensions: Follow up to the Scott Report
(C(81)58)

BACKGROUND

At their meeting on 15 July the Ministerial Committee on Economic Strategy asked the Chancellor of the Exchequer and the then Lord President of the Council to arrange for officials to report to them by the end of September, and to make recommendations as soon as possible thereafter, for changes in the arrangements for public sector index linked pensions (E(81)24th Meeting). Officials were to work on the assumption that changes would apply to all public sector groups and that the options to be further examined should include the possibilities of changes in benefits as well as in contributions. The Committee wished any legislative changes to be made in the present Parliamentary Session on the grounds that it would be impracticable to introduce legislation to give effect to changes shortly before the next election.

Flag B

2. Officials reported on 7 October. Their report is attached as Annex A to the Chancellor of the Exchequer's memorandum C(81)58 of 7 December. Officials have analysed the options and, while they do not make recommendations, they regard action on contributions as practicable but see considerable difficulties in action on benefits, particularly if applied to past service. The Chancellor of the Exchequer would like to act on both fronts: be recommends firmly in favour of changes in the arrangements for contributions; on benefits he suggests that there might be full inflation proofing up to, say, 7 per cent with discretion to go further, and that these arrangements should apply to benefits for past as well as for future

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service. The Chancellor of the Duchy of Lancaster, in her minute of 8 December, recommends action on contributions only and argues against treating civil servants more harshly than other public service groups.

3. The legislation necessary to bring about changes in contributions and benefits would apply to those public service groups listed in Annex B at the back of C(81)58, ie the civil service, armed forces, teachers, local government, police and fire service and also to the judiciary, to Members of Parliament and Ministers. It is proposed that the civil service scheme should be made fully contributory. No action is proposed for nationalised industries but consideration is to be given to amending the tax law so as to bring benefits under nationalised industry and private sector schemes in line with the proposed limits for the public services.

Flag C

Pledges

4. The Cabinet will wish to consider what weight to give to the statements made during the 1979 General Election campaign. These were summarised in the Annex to E(81)78 which was before the Ministerial Commitee on Economic Strategy in July; for convenience a copy is attached to this brief. The statements seem to point to the possibility of changes in contributions but not in benefits.

... Flag A

MAIN ISSUES

5. The main issues for considerations are as follows:

a. whether action should be taken on contributions, or benefits, or on both;

b. if action is taken on contributions, whether this should take the form of a specific extra contribution for pensions increase and if so, how this should be determined for the civil service and the other public service groups;

c. if action is taken on benefits, whether this should take the form of making increases above a certain level discretionary and, if so;

i. what the level should be;

ii. what special treatment, if any, should be given to those who have purchased "added years" or who have "transferred in" service;

d. whether it is sufficient to leave nationalised industry schemes to be dealt with by possible amendment of the tax law;

e. whether it is feasible to go ahead with legislation in the current session.

Contributions

6. The report by officials considers two possible options for action on contributions. Option A is a straight increase in public service contributions to a unified level of 9 or 10 per cent. The Chancellor of the Exchequer agrees that this should be rejected on the grounds that there is no objective way of establishing that this is the right level of contribution. Instead he recommends Option B under which, in addition to the basic pension contribution, a special charge would be levied based on a calculation of the extent to which indexed public service pensions exceeded indexation in a number of private sector schemes which would be chosen for comparison. The special charge has been estimated at about 2½ per cent. Most public service groups (eg the local government workers, teachers and NHS staff) pay 6 per cent. Under the new proposals they would pay 8½ per cent.

7. There is however a difficulty in the case of the Civil Service where there is already a notional pension contribution of 8½ per cent taken

into account in the old pay arrangements. The Chancellor of the Exchequer argues nevertheless that the new additional charge of $2\frac{1}{2}$ per cent should be levied throughout the public services; and that Civil Service pay should not be adjusted upwards to compensate for this, or at any rate not by the full $2\frac{1}{2}$ per cent. In her minute of 8 December the Chancellor of the Duchy of Lancaster argues that civil servants should not be singled out to bear an unfair proportion of the extra contribution. It is in any event proposed in the officials' report and in the Chancellor of the Exchequer's paper that the civil service pension scheme should become fully contributory. This should help to put an end to much of the public criticism of civil service pensions. The Chancellor of the Duchy of Lancaster therefore proposes that in making this change the Government should face up to the fact that male civil servants already in effect pay something like the $8\frac{1}{2}$ per cent required and should not impose a further special charge.

below

8. Further work will have to be done on some groups. Manual workers currently pay 1 per cent less than non-manuals and it is for consideration whether their increased contribution should be $7\frac{1}{2}$ per cent rather than $8\frac{1}{2}$ per cent. The various uniformed services - armed forces, police, fire and prison officers - have better basic pension benefits reflecting their lower retiring age. The armed forces currently pay 11 per cent through a reduction in gross pay; the police and firemen contribute 7 and $6\frac{3}{4}$ per cent respectively and prison officers the same as civil servants. It is for discussion whether, apart from the armed forces, the special payment for these groups should be $3\frac{1}{2}$ rather than $2\frac{1}{2}$ per cent to reflect the better benefits.

9. The Chancellor of the Exchequer estimates that the annual savings from his proposals on contributions might be of the order of £300 million to £600 million a year. In practice net savings would depend on the extent, if any, to which benefits were reduced and so contributions were less. For all groups there will be arguments over the extent to which pay should be adjusted

to reflect the new contribution arrangements which are likely to be introduced from April 1983. Consultation over these arrangements could well colour attitudes in the 1982 pay round and will play a significant part in the 1983 round, particularly for any groups which are being asked both to accept a relatively low pay settlement and to pay higher contributions than previously.

Benefits

10. The Chancellor of the Exchequer points out that at the root of the problem is the guarantee of index linking in public sector schemes and the virtual absence of such guarantees in the private sector schemes; he judges that the problems of private sector funding of benefits will increase. He accordingly invites the Cabinet to consider the possibility of providing for full inflation proofing of public service schemes up to, say, 7 per cent with discretion to go further. Each 1 per cent abated would save about £30 million gross a year. But to get these savings it would be necessary to apply a scheme to benefits for past as well as for future service.

11. There are a number of difficulties about this proposal which the Chancellor of the Exchequer does not fully bring out in his paper. The Chancellor of the Duchy of Lancaster refers to some of them in her minute to you of 8 December. The Cabinet will wish to consider the following points:

i. The Attorney General has advised that, while civil servants have no contractual right to pension increases, there is a risk of a successful case against the Government under the European Convention on Human Rights; and that special consideration should be given to the moral claim of those who have purchased added years at a price which includes an element for index-linking of benefits and those who have transferred previous pension entitlements into the scheme on a basis which reflects index-linking (see the letter at Annex E to the report by officials).

ii. Whatever the strict legal obligation the figures in Annex B to C(81)58 suggest that around 7 million people could be complaining of loss of "rights" and of disappointed expectations if benefits were limited in public service schemes, and some 3 million more if nationalised industry schemes were affected.

iii. It would be argued that when in opposition the Government appeared to undertake to preserve benefits, though not necessarily the present contribution arrangements - see the Annex to this brief.

12. The Cabinet will need to weigh these points against the Chancellor's argument - which those people not benefiting from public sector schemes would no doubt support - that index-linking for public servants is unfair and must be tackled now before it gets worse. In looking at this the Cabinet will need to judge the extent to which higher contributions would offer an effective answer to these criticisms.

Application to the Nationalised Industries and other public corporations

13. The Chancellor of the Exchequer accepts that the legislation, on either contributions or benefits, should not apply to the nationalised industries, but hopes that they can be persuaded to come into line with the public services. Any attempt to legislate on contributions by nationalised industry employees would mean that the Government was involving itself in the settlement of the terms and conditions of service of nationalised industry workers and would offer no safeguard against the possibility that the nationalised industries would concede offsetting pay increases or other pension benefits. If there were to be a change in the arrangements for public service contributions it would, therefore, be left to the nationalised industries to take account of this, as they saw fit, in deciding on their own

arrangements.

14. Changes in public service benefits would apply automatically to a number of nationalised industry schemes which are currently linked with the public service pension increase system; there is, however, nothing to stop these schemes from creating a new link with the Retail Price Index. To deal with benefits it is suggested that the better course would be to operate through the tax system and restrict tax relief by withdrawing Inland Revenue approval from schemes which permitted pension increases to exceed what was provided by public service schemes. This change would also affect the private sector and a transitional period of several years would be required in which schemes could amend their rules. It is explained in more detail in paragraphs 85-94 of the report by officials.

15. In short, members of nationalised industry pension schemes would be likely to be treated less rigorously than those of public service schemes; though the extent to which this were so would depend on the attitutdes of the individual boards and on what they could negotiate with their employees.

Consultation and legislation

16. The Chancellor of the Exchequer recommends the introduction of legislation in 1982 to take effect in 1983-84, or sooner if practicable. He advises that the main recommendations could not be included in the Finance Bill and that separate legislation will be needed; this would be short but probably contentious. The Cabinet will wish him to give fuller guidance on how he sees the timetable.

17. If Cabinet took decisions this week, a consultation document might be issued in January. It would be desirable to provide an opportunity for comments from the trade unions and from other public sector employers

involved, from representatives of public service pensioners and, particularly if there were to be changes in the tax regime, private sector pension interests. Given the complexity and importance of the issues involved, and the need for the groups concerned to consult among themselves, it is doubtful if this consultation period could be much less than three months. If Ministers then took another month to decide, in the light of the consultations, the final form of the legislation, the Bill could not be ready for introduction much before the end of May. The business managers will wish to comment on this, and they are likely to point out that Royal Assent could not be achieved in the present Session without formidable timetabling difficulties, particularly in the House of Lords.

18. If it were decided that legislation was no longer practicable in the present Session, an alternative would be to introduce the Bill at the beginning of the next Parliamentary Session with a view to enacting it in time for the changes to take effect in 1983-84. This would be contrary to the view of the Ministerial Committee on Economic Strategy that legislation should preferably be in the present Session. On the other hand, on either timetable, contributions would not be changed before April 1983 and benefits not before the November 1983 uprating. It would be possible to abate benefits in November 1982 only if sufficient progress were made with the legislation for the necessary arrangements to be completed in time and if the convention were broken whereby November upratings are announced at the time of the preceding budget.

19. Any changes in tax law, to encourage nationalised industry and private sector schemes to limit their benefits, would be introduced in the 1983 Finance Bill at the earliest.

HANDLING

20. When you invite the Chancellor of the Exchequer to introduce his paper you could ask him also to clarify for Cabinet how he sees the timing of consultations and of legislation. You might then ask the Chancellor of the Duchy of Lancaster to speak to her minute; and to comment on the implications for the Civil Service and for business in the House of Lords. The Lord President will wish to comment on the implications for the legislative programme: obviously the difficulties will be much less if the proposal is to introduce legislation at the beginning of the next Session.

21. Most members of Cabinet will want to give their views, but you will wish to hear in particular from those Ministers responsible for the main service groups and to have their advice on the case for changes in benefits and contributions and what such changes might mean for pay negotiations and industrial relations. In addition to the Chancellor of the Duchy of Lancaster these Ministers are the Secretaries of State for the Environment, Scotland, and Wales, for local government employees; the Secretary of State for Social Services for the NHS; the Secretary of State for Education and Science for teachers; the Secretary of State for Defence for the armed forces; the Home Secretary for the other uniformed services; the Lord President for MPs and Ministers; and the Lord Chancellor for the judiciary. Ministers sponsoring nationalised industries will also wish to comment. The Attorney General will be able to advise on legal points, and in particular on the problems of making changes in benefits applicable for past as well as future service.

22. Although Cabinet will want an indication at the outset of their discussion of the likely timetable for consultations and legislation, you might reserve decisions on that until the main policy questions have

been discussed. The main questions you will wish to cover seem to be:

a. Should action be taken, on the lines of Option B, on contributions by public service employees?

b. If so:

i. should the same special charge of $2\frac{1}{2}$ per cent be levied on all groups, or should allowance be made for the higher contribution already notionally paid by the civil service?

ii. should the Civil Service pension scheme be made fully contributory, subject to consultations with the unions?

iii. is it agreed that particular problems about manuals and the uniformed services should be left for further examination by officials, and for discussion and negotiation in the consultative period?

iv. what should be said in the consultation period on the implications of higher contributions for pay?
(The best answer may well be that this is for negotiation with each public service group taking into account the details of their present arrangements; the aim might be to avoid giving firm commitments prematurely but also to avoid giving any impression that the new pension arrangements will be used as a device for docking pay.)

c. Should action be taken on benefits as well as contributions?

d. If so,

i. should the inflation proofing be up to 7 per cent with any further increase being discretionary? and should this be subject to Parliamentary approval by order?

ii. should the new arrangements apply to past as well as future service ?

iii. should there be special arrangements for those who have purchased "added years" or have "transferred in" service?

e. Is it agreed that there should be no action taken on nationalised industry schemes, but that they should be persuaded to come into line and, if public service benefits are to be changed, should there be consultations with a view to changing the tax law so as to bite on benefits in nationalised industry and private sector schemes?

f. How long should be allowed for the consultativeperiod and when should the legislation be introduced?

g. What should be said publicly about the Government's intentions (the best course might be for either you or the Chancellor of the Exchequer to make some statement when the consultative document is published).

CONCLUSIONS

23. You will wish to sum up with reference to the questions listed above, which pick up all the points in the Chancellor of the Exchequer's paragraph 18. It will be very important to get right both the tone and the details of any consultation document and I suggest that you should ask the Chancellor of the Exchequer to clear the draft in correspondence with all members of the Cabinet.

RTA

9 December 1981

ROBERT ARMSTRONG

ANNEX A

CONSERVATIVE STATEMENTS ON INDEX-LINKED PENSIONS AT THE TIME OF THE ELECTION

Our Manifesto made no mention of index-linked public service pensions. However, a guidance note on the subject was issued by Conservative Central Office to all candidates. This suggested the following line to take:

> "We are not proposing to change the index-linking provisions for public sector pensions.
>
> There is, however, a real problem about the way contributions are assessed in the public as compared with the private sector..... We would ensure that the independent Pay Research Unit Board is fully satisfied that the deduction which is made from public sector wage settlements for index-linked pensions is realistic".

In the course of the campaign, a good many letters were received from members of the public about index-linked pensions. The following is typical of the line taken in reply:

> "The Conservative Party is not proposing to change the index-linking arrangements for existing public service pensions...... We should want to ensure that deductions from public sector pay cover the cost of index-linked pensions at a proper and realistic level."

The Chancellor of the Exchequer was asked by a caller on Robin Day's Election Call on 22 April 1979 whether the Conservatives intended to take index-linking away from public service pensioners. The Chancellor replied:

> "No, there's no intention to do that......But of course it is important also to make sure that the cost of those benefits which existing public service pensioners are going to enjoy is properly shared."

A full transcript of this exchange was subsequently published in the journal of the Civil Services Pensioners' Alliance.

In August 1978, a detailed letter on armed forces pensions was sent to the Officers' Pension Society on behalf of the Prime Minister. On index-linking, the letter said:

> "I can assure you that the Conservative Government will continue with the present arrangements."

This letter was subsequently reproduced in the Society's journal.

TOP COPY TO BE RETURNED

Top papers with the
Prime Minister

Date 21/1/82

CDL to PM.

8/12/81

Given to Air Marshall Lock
(via Back Door) He won 273-5216.

DA

Self-interest probably prevents me from viewing this issue absolutely clearly. But this minute does seem to make political sense to me.

[illegible] 8/12.

A Duggan

6.9.

Chancellor of the Duchy of Lancaster

PRIME MINISTER

INDEX-LINKED PENSIONS: FOLLOW-UP TO THE SCOTT REPORT

There are two issues to which I would like to draw the attention of colleagues before we discuss the Chancellor of the Exchequer's paper C(81)58 on Thursday. First I believe that we should act on contributions only; and second I am concerned by the implication in the paper that we should load more by way of contributions onto the Civil Service than other groups.

We should do something about contributions. To do so would be in keeping with our Election commitment; it would, I think, have a fair chance of being accepted as reasonable by public service employees; and the financial savings which the Chancellor of the Exchequer estimates at £300m - £600m a year would be very welcome.

To attack benefits at the same time would be quite another matter. Annex B to the paper shows that we would be asking almost 4 million public servants (nurses, teachers, servicemen as well as civil servants) to pay higher contributions for worse benefits, and that some 10 million people (existing and potential pensioners as well as the contributors) would be affected. Such a proposal would, I believe, be presentationally and politically damaging. Nor do I think we can disregard the objections to retrospective action which the Attorney General has raised in Annex E to the official report.

Furthermore during the recent dispute, I understand that many middle managers worked extremely hard to implement our contingency plans, often doing work, as volunteers, which was well outside their normal duties. To act on both contributions and benefits would have an important bearing on attitudes throughout the Service and the impact would be likely to be particularly serious at those middle management levels on which we rely so heavily.

Whatever conclusions we reach on Thursday about contributions and benefits, we must make the necessary changes to all the public service groups in a consistent way. What I believe will not do is to single out civil servants, who, as you make clear in paragraph 9 already pay more than most public servants, bear an unfair proportion of the extra contributions. I believe that the right answer might be to go for a total pension contribution of around 8½% (for men and for women) and in doing so face up to the fact that male civil servants already pay something like that figure.

I am copying this to Cabinet colleagues, Cecil Parkinson, the Chief Whip, Attorney General and to Sir Robert Armstrong.

[illegible]

[illegible]G
3 [illegible] 1981

9 December 1981

Policy Unit

PRIME MINISTER

CABINET: PUBLIC SECTOR PENSIONS: POLITICAL IMPLICATIONS

1. John Verekers' minute summarises our thinking and recommends Course B. The original 1971 Act may have been, quite literally, "an Act of insanity". However, the right posture for this Government, it seems to me, is "Indexed pensions for the public sector have proved a very heavy burden for the economy to bear. Nevertheless, a contract is a contract and it cannot be rewritten later when it proves expensive. That would be unfair and inconsistent with the Government's responsibility to its own employees. However, fair dealing means, on the other side, that inflation-proofing should be paid for, and for large numbers of public sector employees, this is not at present the case". In other words, a Government which is at present unpopular for being firm, should win as many points as it can for making very clear that it is nevertheless fair. I think it would be helpful if this general position was spelt out by you in Cabinet.

2. In political terms, the numbers are very large indeed. Annex B to Geoffrey's memorandum C(81)58, shows 5.4 million existing scheme members and 2.2 million existing pensioners (including dependants). In addition to that total of 7.6 million, there is presumably another substantial number of potential dependants of existing scheme members. So the numbers of Government employees and future voters who could - if this issue is mishandled - feel a very real sense of grievance, is very large. The Government is already criticised for appearing to denigrate its own employees, talking as if those who work in the public sector are somehow less upright than those in the private, almost wilfully damaging the morale of the Civil Service etc. Whether these criticisms are justified or not, this is how the Government is perceived. The decisions on this issue and the way those decisions are communicated to the public give us a chance to improve the perception of Government by those who work in the public sector.

3. There is an entirely different but related issue which should not properly come up in the Cabinet discussion. But, in case it does,

it is the argument that there should be complete freedom for anyone, in the private or public sector, to buy as much indexing as they like, provided they pay the market price for it. For example, unrestricted indexed gilts might be purchased by pension schemes. If the demand for these gilts for indexed pensions is high, the price will rise and the yield will fall, and thus a market price will emerge reflecting the demand for inflation-proofed pensions. In a sensible world, this would be the right way forward, but it is a more radical and long-term solution.

JOHN HOSKYNS

CONFIDENTIAL

Prime Minister
MCS 9/12

PRIME MINISTER

POLICY UNIT

CABINET: PUBLIC SECTOR PENSIONS

The Chancellor has slightly recast the paper you saw earlier, in the light of your feeling that it would be wrong to take action on both contributions and benefits: but he still clearly prefers that course, with a 7 per cent upper limit on indexation. Janet Young's note sets out the case against action on benefits. We think she is right.

Looked at on its own merits (i.e. disregarding what is expected or desired by public servants, or by the public at large) we are clear that the best course of action is Course B - an increase in contributions so that there is a special element directly related to the cost of indexation. This produces the most benefits in public expenditure terms (up to £600m a year, depending how much is offset in higher pay); requires the least controversial legislation; and would be widely seen as fair, even by public servants, because it is based on the principle that people would be paying what the scheme actually costs.

The Chancellor suggests (paragraph 13 of his paper) that Civil Servants should also pay the proposed 2½ per cent special charge for index-linking, even though they are alone among public service groups in already paying fully (paragraph 29 of the report). Janet Young says it would be wrong to single out civil servants in this way. Again, we think she is right. Apart from the immediate effect it would have on pay bargaining, it would be

/widely

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widely regarded as unfair. The broader political implications of how we deal with public service pensions are set out in John Hoskyns' note.

Adding to increased contributions Course C - the imposition of an upper limit on indexation - produces little or no additional public expenditure benefit, since if you do Course B public servants pay exactly for the benefits they receive; requires more controversial legislation; and risks challenge in the European Court of Human Rights, because those who have contributed in the expectation of inflation-proofed pensions would be denied what they have paid for.

So we conclude that Course B is the right course, and that action on benefits as well isn't worth the problems it would cause. If colleagues see the balance of political factors differently, and feel it necessary to take action on benefits, we strongly recommend, in place of Course C, going to Course D - a discretionary power to increase pensions by less than the rate of inflation. That would be slightly less provocative to public servants, and would retain maximum flexibility for the Government. But it would still arouse widespread opposition.

J.V.

J. M. M. VEREKER

9 December, 1981

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ANNEX A B

SUMMARY OF REPORT BY THE OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS

In accordance with the decisions of Ministers on 15 July (E(81)24th meeting), this report examines in detail the courses of action described in paragraph 71 of the Official Committee's Progress Report. We have, as instructed, given priority to identifying action that could be taken quickly. The courses examined are as follows.

(a) Course A: an increase in employee pension contributions from their typical level of 5-7% in the public services to something significantly higher.

(b) Course B: a partial switch to "pay-as-you-go" contributions, under which members of index-linked schemes would pay a separate special charge directly related to the emerging cost of pensions increase.

(c) Course C: the imposition, in one form or another, of an upper limit on post-award increases in pensions.

(d) Course D: a discretionary power to increase pensions by less than the rate of inflation.

All these courses would involve primary legislation (paragraphs 1-4).

(ii) Misunderstanding of the present Civil Service arrangements is probably a significant factor in much public criticism of index-linking. It would be desirable to make the Civil Service pension scheme formally contributory. This could not be done before 1 April 1984; but that need not be a bar to earlier action on other aspects of the report (paragraphs 5 and 6).

(iii) Courses A and B would both involve changes in contribution arrangements. As presented in the report, they could produce a substantial yield from higher contributions. This could well, however, be eroded by pay increases. It is possible that Course A would yield higher maximum savings than Course B; but this possible difference should not be overstated (paragraphs 7 and 8).

(iv) Both courses envisage harmonisation of pension contributions between different public services. The Civil Service at present pays a higher effective pension contribution than most other services; it is therefore likely to appear to be more favourably treated. However, other groups of public servants will be able to claim that their pay, like that of the Civil Service, has been depressed to take account of the value of their pension benefits. This reinforces the argument that savings are likely to be at least partially eroded by pay increases (paragraph 8).

(v) Course A would generally entail an increase in employee contributions throughout the public services to 9 or 10% - up to 4% higher than now. It would be a natural response to the Scott Report; it would reduce the present illogical distinction between basic benefits and pensions increase; and it would produce a yield of £600 to £800 million a year (ignoring any offset through pay increases). But it would entail difficult and complicated negotiations; and, because there would be no way of demonstrating that the contribution levels under it were objectively justified, it might not be a stable solution. It would raise complicated technical problems over the financing of the local government and teachers schemes. The difficulties are too great for action to be possible in 1981-82 - and even in the longer term there would be serious problems (paragraphs 9-20).

(vi) Course B would leave most public service pension schemes undisturbed in respect of basic benefits and contributions. It would superimpose on them a separate contribution, or charge, specifically for pensions increase. This would be calculated as a percentage of the emerging cost of pensions increase; it would cover that proportion of the cost which the Government Actuary advised was in excess of typical private sector practice. The calculations would be averaged across all public services. The legislation could be ready in time for enactment in the 1981-82 Session. This course would produce a yield of nearly £500 million a year (ignoring any offset through pay increases); and since it would leave existing arrangements largely undisturbed, it would be easier than Course A to negotiate. It would be easier to present publicly and to staff interests. It would shift much of the financial risk of index-linking from the taxpayer to the staff. But there would be no better theoretical justification for the overall level of contributions than under Course A; and it would perpetuate the existing artificial distinction between basic benefits and pensions increase (paragraphs 21-33).

(vii) A variant of Course B which would avoid the artificial distinction between basic benefits and pension increase could be devised. It would involve extensive use of notional funding. It would raise many negotiating problems; and we doubt whether it offers the basis of a solution, even in the longer term. It is certainly not a possibility for action in 1981-82 (paragraphs 34-36).

(viii) Under either Course A or Course B it will be necessary to consider the position of the uniformed services (prison officers, armed forces, police and firemen). Members of these services receive better basic pension benefits than the generality of the public services, and derive more benefit from pensions increase. There is therefore a case for requiring them to pay higher contributions than members of other services, as some do already. The position of the Armed Forces, however, will need special consideration; and the whole range of issues should be considered further when Ministers have reached decisions of principle (paragraphs 37-42).

(ix) Overseas pensioners raise special problems, but can be excluded on de minimis grounds (paragraph 43).

(x) Courses C and D would involve changes in benefits. Course C would set an upper limit to inflation-proofing: it is likely to be more welcome to outside critics of index-linking. Course D would continue the existing presumption of inflation-proofing, but confer on Ministers discretion to give less: it is likely to be more flexible, and more readily accepted by staff and pensioner interests. There is no technical reason why the legislation required to apply either course to the public services could not be ready in time for enactment in the 1981-82 Session (paragraphs 44-46).

(xi) If either Course C or Course D is to produce significant immediate savings, and satisfy the critics of index-linking, it would have to be applied to past as well as to future service. This would be attacked as retrospectively affecting people's rights, and invalidating irrevocable decisions which individuals had taken in the past. For the Civil Service at least (the position of other public services is being urgently examined), the Attorney General has advised that the legislation would not affect contractual rights. However there is a risk of a successful case against the Government under the European Convention on Human Rights. The Government's defence could be strengthened by allowing those affected to reopen certain past decisions. But this is not a complete solution to the difficulties; and its details would certainly both take time to work out and be costly to implement. The choice therefore seems to lie between taking the risk inherent in immediate legislation covering past as well as future service; confining immediate legislation to future service; and deciding against immediate legislation and instructing officials to work out possible ways of reducing the difficulties (paragraphs 47-56).

(xii) Course C could take various forms. The most promising variant seems to be full inflation-proofing up to a stated figure (say, 10%) with half or two-thirds protection thereafter. The exact figures could be studied further if Ministers wished to pursue this general approach (paragraphs 57-61).

(xiii) Course D could also take various forms. The most promising variant seems to be guaranteed inflation-proofing up to a stated figure (say, 10%) with discretion to abate thereafter. Again, modifications and refinements could be studied further if Ministers wished to pursue this general approach (paragraphs 62-70).

(xiv) We do not recommend any "mixed" course, involving action on both benefits and contributions. There is a case, if Ministers favoured Course C or D, for action to align contribution levels in the public services, and at a higher rate than is now typical. But the negotiating difficulties would be severe. There may, however, be advantage in keeping open the possibility of action on benefits in order to encourage acceptance of action on contributions, or vice versa (paragraphs 71-76).

(xv) We do not think it would be possible to impose Course A or Course B on the nationalised industries (the most important part of the public sector outside the public services). It would be a large incursion by Government into the settlement of terms and conditions of service of nationalised industry workers. And the industries could always negate the essential purpose of the two courses - to make staff pay more for existing benefits - by improving other pension benefits or conceding pay increases (paragraphs 77-80).

(xvi) There is a better prospect of applying Course C or Course D to the nationalised industries: these courses would, in fact, apply automatically to many schemes, since these provide inflation-proofing through a link with the public service pension increase system. However, there are some important exceptions; and there would be nothing to prevent schemes from creating a direct link with the retail price index (RPI), which some already have (paragraphs 81 and 82).

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(xvii) Direct legislation to require existing links with the RPI to be broken would expose the Government to the risk of a successful action under the European Convention on Human Rights. Nor would it be satisfactory to make withdrawal of index-linking a condition of Government financial assistance to nationalised industries (paragraphs 83 and 84).

(xviii) An alternative would be to operate through the tax system, so as to withdraw Inland Revenue approval from schemes which permitted pensions increase to exceed what was provided by public service schemes. This would affect the private sector, which would be likely to protest. But there are good arguments in principle in favour of a limitation on these lines if Ministers favoured Course C or D for the public services. Legislation would not be possible before 1983 (though it could then be contained in a Finance Bill); and a transitional period of several years would be required in which schemes could amend their rules (paragraphs 85-94).

(xix) It is therefore not possible to ensure the application of Course A or B directly to the nationalised industries. If Ministers wished to apply Course C or D, the choice lies between use of the tax system; and relying on the existing links with the public service pensions increase code and the assurance of best endeavours offered by the Nationalised Industries' Chairmen's Group. The recently instituted arrangements for monitoring nationalised industry pension schemes would provide a mechanism for maintaining pressure on the industries to make any necessary changes.

(xx) We do not offer Ministers a recommended course of action. Our conclusion is that, in pension terms, there is a good case for harmonising contributions between different public services, and at a higher level than the generality of public services now pay. We regard Course B as the more practical way of achieving this result. Like Course A it offers the prospect of substantial initial savings; as with Course A these could be eroded by pay increases; but the prospects of minimising this are better under Course B. The arguments relevant to Courses C and D involve a more political choice. Any savings under Course C - and any variant of Course D which seemed likely to curtail benefits severely - could immediately be more than offset by higher pay or lower pension contributions. Both courses would raise the problem of retrospection if applied to past service. No approach to the problem of the wider public sector is free from difficulty: we think that Ministers' decisions on the public services should be taken on their own merits and not be determined by the position regarding the nationalised industries (paragraphs 97-104).

(xxi) It will be essential to begin consultations with the interests affected as soon as possible. These would be best conducted on the basis of a published document setting out the Government's views (paragraph 109).

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OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS: SECOND REPORT

1. At its meeting on 15 July, E Committee invited the Chancellor of the Exchequer and the then Lord President of the Council to arrange for us to submit a further report by the end of September, examining in more detail the courses of action described in paragraph 71 of our progress report. We were instructed to give priority to identifying action that could be taken quickly.

2. This report accordingly:

i. examines in detail the courses of action described in paragraph 71 of our progress report, as they might apply in the public services, with particular reference to the legislative and other action which each of them would require and the time scale on which it seems realistic to expect such action;

ii. discusses the position of index-linked pension schemes in the public sector outside the public services, and the ways in which any decisions regarding public service schemes might be applied more widely;

iii. suggests how Ministers' decisions could best be presented to interested parties and the general public.

3. It would overburden this report to repeat at length the material in our progress report. For convenience, however, we attach at Annex A summary details of the main public sector pension schemes (previously circulated as Annex B to our progress report), and a glossary of the main technical terms used in our report.

THE COURSES OF ACTION

4. The courses to be examined in this report are as follows.

Course A: an increase in employee pension contributions from their typical level of 5 - 7 per cent in the public services to something significantly higher.

Course B: a partial switch to "pay-as-you-go" (PAYG) contributions, under which members of index-linked schemes would pay a separate special charge directly related to the emerging cost of pensions increase.

Course C: the imposition, in one form or another, of an upper limit on post-award increases in pensions.

Course D: a discretionary power to increase pensions by less than the rate of inflation.

All these courses would involve primary legislation.

Annex B summarises the effects of each course on the main public service schemes. Our initial discussion is confined to the public services. Paragraphs 77 to 96 below consider the wider public sector.

A contributory Civil Service scheme

5. Experience in the Civil Service suggests - and Scott pointed out - that levying contributions by adjusting the level of gross salary is not well understood; and it presupposes, among other things, an agreed method of determining gross pay, from which a deduction is then made. Misunderstanding of the present Civil Service arrangements - a belief that civil servants "pay nothing for their pensions" - is probably at the root of much of the criticism of index-linking. Whatever approach Ministers may decide to adopt to the general question of index-linking, we think the process would be clearer - and public opinion reassured -if a contribution were simply levied from gross pay and the scheme made explicitly contributory.

6. The implications of making the Civil Service scheme contributory are discussed in Annex C. In brief, there could be problems of presentation in the raising of gross pay levels it would entail - though a good deal would depend on the vigour and coherence with which the case was put. A lot would also depend on the actual figures used for the adjustment. On present thinking there would be a small (about 1 per cent) reduction in net pay, reflecting the fact that pensions would in future be based on a higher rate of pay. But because administrative complications would in any case preclude making the change before 1 April 1984 it would be possible simply to announce acceptance of the principle of the change now, leaving precise figures for settlement nearer the time, following the necessary discussions with staff interests. We have no reason to think this would give rise to difficulty in the context of the Megaw Inquiry.

I - CONTRIBUTION OPTIONS

7. Although Courses A and B are conceptually different, and would raise very different negotiating and technical problems, they both set out to achieve an increase in the contribution from employees for the present level of benefits. They present a number of common features which we draw to the attention of Ministers.

a. It is possible to attach figures to the yield from higher contributions. Whether that results in a net saving will depend on the extent to which higher pension contributions are offset by higher pay. In the extreme case of the Armed Forces, the size of whose total remuneration package is largely determined by a formal process of comparability, changes in contribution arrangements are likely to have negligible effects on total expenditure. The position for other services is less certain.

b. Although there are important differences in the underlying rationales of Courses A and B the contribution levels that could be justified under them need not be very different. This report suggests a level of 9 or 10 per cent under Course A; but a lower rate would also be possible. Course B implies a level of 8½ per cent; but a slightly higher rate might be justified (see paragraph 27 below). Not too much should be made of apparent differences in the financial effects of the two courses.

Implications for pay negotiations

8. Courses A and B both concentrate on pension aspects and leave any adjustment in total remuneration which may be thought appropriate to be handled as a separate pay matter. The long-term effects on pay of an increase in pension contributions are hard to predict. Even in the short term, the effects will depend on the nature of future pay arrangements (the eventual Megaw recommendations will clearly have important implications for the Civil Service), on Government policy for pay in the public services, and on relative negotiating strengths. However, we must draw the attention of Ministers to the following points.

a. Because civil servants are currently making a higher effective pension contribution than most other groups of public servants, the general harmonisation of pension contribution required by either course will appear to bear less heavily on them than on others. (Course B, indeed, would imply, on current figures, no increase in Civil Service contributions beyond those implied in the 1980 pay research settlement). This is unavoidable under any course involving changes in contributions affecting the whole of the public services: to attempt to apply either course differently to different public service schemes, for example because of the past history of pay negotiations, would be quite impractical.

b. However, other groups of public servants - notably the Armed Forces, teachers and certain NHS groups - will also be able to claim that their existing levels of pay take appropriate account of the value of index-linking because these have been determined by a formal comparability exercise in the recent past, under which specific adjustments were made in respect of pension benefits (see Annex A).

It is clear that these facts will make both for presentational difficulties and for difficult pay negotiations.

COURSE A: STRAIGHT INCREASE IN CONTRIBUTIONS

9. Under this option, the pensions increase legislation would remain unchanged, but scheme members would be required to pay higher contributions based on an estimate of accruing costs. These contributions would not be divided between contributions for basic

benefits and contributions for pensions increase.

10. A general increase in contributions would be a natural response to the Scott Report. Events since our progress report, in particular the fact that index-linked gilts are still yielding over 2½ per cent in the (restricted) market in which they are available, mean that even within the context of the old Civil Service pay research arrangements it would have been difficult to justify on actuarial grounds a contribution of more than about 9 per cent.

11. As we also pointed out in our progress report, it would be possible to adduce other arguments in support of a contribution rate of 10 per cent; but these would be of a fairly pragmatic kind. They are mainly the value of the implicit guarantee of full protection against inflation; and the fact that pensions comparability exercises have not taken full account of some features of private sector practice.

12. It would then be reasonable to bring contributions for non-manual staff in other public services (other than the "uniformed services"*) into line with the Civil Service from their typical current level of 6 per cent. The argument would be that since benefits in the various schemes were broadly equivalent, so should the contributions be.

13. The negotiating difficulties would be formidable. Even within the context of the old Civil Service pay arrangements the arguments in favour of an increase by more than about ½ per cent would not be decisive. Other groups of public servants would argue strongly that there is no generally accepted relationship between pension benefits and employee contributions; that pay and pensions must be considered together; and that their pay had historically been negotiated in the light of their actual pension contribution. Hence any increase in pension contributions should be offset by an increase in pay.

14. A general increase in employee contributions to 10 per cent could yield approaching £800 million a year; an increase to 9 per cent would yield nearly £600 million. However, for the reasons outlined above, the unions would be under pressure from their members to recover the resulting worsening in conditions, particularly where it can be claimed that current pay levels reflect a specific adjustment on account of pensions; and in services outside direct Government control it is possible that the employers would themselves sympathise with the unions' case. It is improbable therefore that this saving could be fully maintained.

Technical aspects

15. For public service schemes, with some exceptions, the Government could impose an increase in contributions without primary legislation, though it would be necessary to consult

*The "uniformed services" (prison officers, armed forces, police and firemen) need special consideration. They are discussed in paragraphs 37 to 42 below.

representatives of both staff and employers beforehand. There would, however, be significant technical problems over the financing of some schemes, discussed in paragraph 17. Primary legislation would be needed to make the amendments referred to in paragraph 16 below.

16. The main exceptions involving primary legislation are as follows.

a. Local Government and other local services

Schedule 3 to the Pensions (Increase) Act 1971 provides that the cost of pensions increase to former local government employees shall be met by the employers. The same provision applies to the former employees of a wide range of other local services, including firemen, courts' staffs, civilian employees of police authorities, traffic wardens, probation service staff and certain teachers possibly receiving local authority pensions. It would be necessary to amend the Schedule to provide for employees to meet part of the cost of pensions increase

b. NHS and teachers

A similar point arises on these schemes. Schedule 3 to the Superannuation Act 1972 provides that contributions must be related to benefits under the schemes (which exclude pensions increase); this affects local government as well. A higher contribution would almost certainly have to be presented in terms of pensions increase, so that amending regulations to increase contributions could be ultra vires without primary legislation to amend the Schedule.

c. Parliamentary Pensions

The present contribution rates (6 per cent for MPs, 5 per cent for Ministers) are laid down by primary legislation. As the Government probably would not wish to put a specific new contribution rate in legislation presented to Parliament before it had concluded its consultations with staff interests in the public services (since that would imply that it had entered the consultations with a closed mind), the best course would probably be to take power to set the contribution rates either by statutory instrument or, more likely, by resolution of the House of Commons. (This might also be an opportunity to put the Parliamentary pension scheme into secondary legislation as a whole).

Financing of schemes

17. If employee contributions were raised it would be necessary to decide what to do with the resulting increase in contribution income. There would be problems in two schemes.

a. Local government pensions are financed by a mixture of actual funds (from which basic benefits are paid) and PAYG charges by employers on the rate fund to finance pensions increase. It would be illogical to pay into the funds an increase in employee contributions designed explicitly to take account of the cost of pensions increase (unless the funds were also to take on the cost of pensions increase). But if it were paid over to the employers, it would tend to be regarded as a PAYG contribution in all but name. There is no necessary relation between it and the PAYG cost of pensions increase: in 1980-81, for example, the cost of index-linking local authority pensions was less than 4 per cent of total pensionable pay, so that an increase of 4 per cent in employee contributions, as discussed above, would mean that employees were more than meeting the emerging cost of pensions increase.

An alternative course would be to abolish the existing funds and move to a system of notional funding or to pure PAYG. This has been under consideration for some time, and may perhaps be a possibility for the future, but is not a starter for action in 1981-82.

b. The teachers' scheme is notionally funded. Contributions from employees and employers are deemed to be paid into a fund, and the level of employers' contribution is assessed by reference to the notional state of the fund. But the cost of pensions increase is not charged to the fund: instead it is borne by the Exchequer. (This means that the Exchequer subsidises the employers -mainly local education authorities.) It would be possible for the Exchequer simply to appropriate the increase in employee contributions; but this would raise similar problems to those discussed in a. above; and there would be complaints from employers to the effect that the notional fund was being unfairly deprived of income and that they would have to pay higher contributions in consequence. More logically, it would be possible to charge pensions increase to the fund, to which the extra contributions would be credited; but again, this would require complicated negotiations between Government and employers, whose contributions would stand to be increased.

18. Essentially, there are two approaches to these problems. One would be to divide the new level of contribution between basic benefits and pensions increase. This would run contrary to the logic of Course A: it is more in keeping with Course B. The other approach is to recast the financial arrangements of the local government and teachers' schemes. While this has attractions on general grounds, it would broaden the discussion considerably, and would not be feasible for legislation in 1981-82.

Course A: Summary Assessment

19. The advantages of Course A are:

(a) It is a natural response to the Scott Report.

(b) It would reduce the extent of the present illogical distinction between basic benefits and pensions increase.

(c) The potential saving in public expenditure.

20. The disadvantages are:

(a) Since the increases in contributions would represent an important change in the construction of pension schemes and have implications for the way in which they are financed, there would need to be negotiation both about the contributions themselves (controversial especially with employees) and their allocation (controversial especially with employers). Even if this did not affect the outcome, changes could not be negotiated in time for legislation in 1981-82.

(b) There is no objective way of justifying an employees' contribution rate as high as 10 per cent; a figure of 9 per cent would be more easily justified, but in that case the potential savings would be correspondingly less.

(c) If implemented, there would be a danger of savings leaking back into higher basic pay.

COURSE B: PARTIAL SWITCH TO PAYG CONTRIBUTIONS

21. Under this course, there would be two tiers of employee contributions: one, based on accruing cost, towards basic pensions benefits; and a second, based on emerging cost, towards the cost of pensions increase.

22. The fact that basic pensions and pension increases are the subject of separate legislation and are sometimes paid by different authorities can be regarded as anomalous. Nevertheless, this separation is at present the pattern; the proposal under Course B accepts the pattern, and can therefore be implemented with less disturbance to existing schemes and less need for negotiation than Course A.

23. The present division of financial responsibility in the local government and teachers schemes effectively assumes that employees contribute nothing to the cost of pensions increase. One can, therefore, devise an approach which takes the present level of employee contribution (6 per cent in most schemes) for granted as a contribution towards basic pensions (which are similar for all services except prison officers, Armed Forces, police and firemen), and grafts on top of that a special charge towards the cost of pensions increase.

24. Again, building on the present arrangements, and seeking maximum clarity, the new charge could be related to (ie be a share of) the actual emerging cost of pensions increase, which has the advantage of being unambiguously knowable.

25. It would not, however, be appropriate to use emerging cost as the criterion in individual schemes - averaging would be necessary. This is mainly because, with the different degrees to which pension schemes are "mature" (and provide for a normal proportion of pensioners with full pensions), the cost of pensions increase as a proportion of pensionable pay varies from, for instance, 6 per cent in the Civil Service to under 3 per cent in the NHS. (The figure for the NHS will tend to increase as the scheme becomes more mature.) Averaging would have the additional advantage of reducing the fluctuations over time inherent in a pay-as-you-go approach as a result of variations in the ratio of active to retired staff. No doubt staff in services in which the emerging cost of pensions increase was below the average would complain; but the answer would be that the pensions increase system applied alike to all public servants (subject to the point discussed in paragraphs 37 to 42 below), and it was reasonable that all should pay the same contribution.

26. What proportion of the emerging cost of pensions increase should be covered by supplementary contributions? Overall, public service pensions increases cost rather less than 5 per cent of the public service pay bill. Private sector employers used as analogues in the 1980 pay research evidence gave post-award pensions increases providing about 50 per cent protection against inflation. If the other 50 per cent of protection from which the public services benefit were to be charged entirely to employees, this would imply that the rate of supplementary contribution should be 2½ per cent of pensionable pay. This figure would vary slowly over time, as public service pension schemes mature, with changes in the level of inflation, and with the practice of private sector pension schemes; and it would tend to be reduced, other things being equal, as guaranteed minimum pension entitlements under the State scheme built up, since the State scheme provides pension increase on this entitlement.

27. Further study may need to be given to the analogy with the private sector. On the one hand, the analogues used for the pay research evidence tend to be drawn from employers who are likely to give more generous pensions increase than the private sector average. On the other, private sector pensions are typically based on 60 ths of final salary rather than 80 ths plus lump sum, as in the public services; and this increases the relative cost.

Implementation

28. Legislation would be needed to provide the Minister for the Civil Service with power to prescribe a special charge related to the aggregate emerging cost of pensions increases, to be paid by members of public service pension schemes; the proportion of cost to be covered by the special charge would be variable from time to time in the light of advice from the Government Actuary based on surveys of private sector practice. The legislation would provide that the special charge should be appropriated by the authorities responsible for financing the pensions (thus obviating the problems discussed in paragraph 17). The

legislative changes outlined in paragraph 16(a) and (c) above would also need to be made.

29. In the case of the Civil Service there is in effect a combined contribution already for both basic benefits and pensions increase. This would be increased under Course A. Course B would require the contribution towards basic benefits to be brought back into line with the contributions of local government workers, teachers and NHS staff, ie 6 per cent; the 1980 Pay Research data indicated that an appropriate contribution for basic benefits would have been 5.8 per cent. A 2½ per cent special charge on top would make the total Civil Service contribution 8½ per cent, broadly the same as would be charged on the existing basis if the Civil Service scheme were contributory. If the special charge were levied before the Civil Service scheme became formally contributory (paragraph 6) it would be necessary to make a separate reduction in pay for basic benefits. This would be untidy, but could be defended as an interim measure.

30. Manual workers in local government and the NHS at present pay a 5 per cent contribution towards basic benefits. A differential of 1 per cent or so between manual and non-manual workers has been regarded as appropriate because the greater career progression of non-manual workers makes their benefits, as related to salary, more expensive. Manual workers' basic contributions might therefore remain at 5 per cent, with the 2½ per cent charge on top. While it would seem natural to apply the same rate of 5 per cent to the industrial Civil Service, this would, on the basis of the comparability data used in 1980, amount to giving them a pay increase of 2.9 per cent; some additional adjustment to pay would probably be necessary to maintain the former equivalence of total remuneration with that of the outside analogues.

31. The gross yield from this course might be of the order of nearly £500 million a year. As with Course A (see paragraph 14 above), there would be some immediate offset through pay adjustments; and even the remaining savings could in time be eroded by pay increases, though there is perhaps a better prospect that savings from a separate charge, related to a clearly identified benefit, and subject to variation in the light of future assessments of private sector practice, would last longer than those from an undifferentiated increase in pension contributions to a level well out of line with private sector practice.

Course B: Summary Assessment

32. The advantages of Course B are as follows:

(a) Pensions increase has traditionally been provided for by special legislation, and sometimes financed by authorities separate from those who pay basic pensions; Course B would be a further adjustment within this basic pattern and therefore relatively straightforward to present and implement.

(b) Benefits and contributions under individual public service schemes would not be affected, and there would therefore be no need for negotiations about them. The special charge for pensions increase would be regarded as part of the pensions increase system, on which it has never been the practice to negotiate; and any consultations could be handled as a general matter.

(c) It would shift a large part of the financial risk of index-linking (high expenditure due to inflation, and not matched by private sector practice) from the taxpayer or ratepayer to the staff.

(d) The savings it would produce, though initially smaller than under Course A, would be more likely to last.

33. The disadvantages are:

(a) There is no actuarial basis for the resulting level of contributions (this criticism is bound to apply to some degree to any scheme in the absence of a formal comparability arrangement).

(b) Some public services may object to paying a charge for pensions increase related to the average.

(c) It would be difficult presentationally to exempt from the new charge any service which retained a non-contributory pension scheme (as the Armed Forces well may); but a pensions contribution which was partly explicit (the charge for pensions increase) and partly a reduction in gross pay could be confusing.

(d) It preserves the existing artificial distinction between basic benefits and pensions increase.

A Possible Variant: notional funding

34. The main objection to Course B is that it would combine two very different approaches to the assessment of pension contributions (paragraph 33d above). This would tend to perpetuate the existing illogicalities in the financing of, particularly, the local government and teachers schemes (though it would also make it easier to take earlier action regarding those schemes). The variant described in paragraph 43 of our progress report (under which notional funds would be set up and employee contributions would be adjusted to take account of the past non-fulfillment of actuarial assumptions) would avoid this awkwardness; and we have considered it further.

35. A fuller note of the proposal and the arguments relating to it is at Annex D. In practical terms, the complexities would be considerable. This is because an extension of notional funding would be involved, as a basis for determining employee rather than employer contributions; this would be a novel principle in pension practice, public or private. The required changes in pension schemes would be substantial and contentious;

much negotiation would be involved, and probably detailed legislation. Quick implementation would not be possible. There would be additional costs in running the system.

36. Apart from these administrative considerations, the Committee thought it doubtful whether such an approach, even if implemented, would fully achieve its object. It is questionable whether a notional fund for each scheme (and especially two notional funds if this proved necessary - see Annex D) would provide a sufficiently authoritative basis for requiring contributions from employees or for persuading the public that adequate contributions had been paid. It is an interesting and potentially useful concept and is the only way by which the adequacy of past contributions can be checked and adjustments made; but, in the light of their consideration, the Committee regard Course B as a more practical, if cruder, means of tying back to employees a substantial share of any unanticipated increase in the (money) cost of pensions. In any event, we are clear that the variant is not a possibility for action in the 1981-82 Session.

THE UNIFORMED SERVICES

37. It is necessary under any contribution option to consider the position of the uniformed services (prison officers, Armed Forces, police and fire).

38. Members of all these services enjoy better basic benefits (lower retiring age and faster accrual of pension) but these are partly in compensation for early termination of career. They also derive more benefit from pensions increase, since this is payable from age 55, and, in the case of police and fire, on a pension based on 60ths of final salary. In recognition of this fact they mostly pay higher contributions than the public services in general. The Armed Forces pay 11 per cent through a reduction in gross pay; the police and fire service contribute directly 7 per cent and 6¾ per cent respectively. But prison officers in effect pay the same as other non-industrial civil servants, on whom their pay is based.

39. The Armed Forces are in a special position, with a career pattern of variable length unlike any other public service. On average only 16 per cent serve long enough to receive an immediate pension; and of these the majority are obliged to leave before they can earn a full pension. Moreover, some 15,000 servicemen a year leave with less than 5 years' service. The Armed Forces pay for their benefits by adjustment of their pay, taking all those factors into account. Last April, on the basis of a study by the Government Actuary, the Government agreed to a recommendation by the Armed Forces Pay Review Body that there should be an increase to 11 per cent in the indirect contribution paid by the Armed Forces for their pension benefits including index linking. Although this recommendation explicitly took no account of the Scott Report, it might still be difficult to justify a further increase as proposed in Course A; and any such increase would, no doubt, be taken immediately into

account in the annual earnings comparison exercise on which Armed Forces pay is still based. While in principle Course B could be applied to the Armed Forces, it would be a substantial change in the approach adopted by the Review Body, to replace one element in a comprehensive comparability exercise by one differently and separately calculated. It is not impossible that the total contribution from the Armed Forces would be reduced (a fall of 1 per cent would be worth about £22½ million at current pay rates).

40. There might, therefore, be no public expenditure saving, and perhaps extra cost, as well as suspicion generated within the Armed Forces themselves, from imposing either of the contribution options on the formal system of comparability by which Armed Forces pay is at present determined. On the other hand it would be presentationally difficult to appear to exempt one public service scheme from the treatment being applied to others. While the Armed Forces have so far not been criticised in this area, it is possible that much of the criticism and misunderstanding currently directed against the Civil Service (paragraph 5 above) could be transferred to them. The issue will need to be considered further if Ministers favour a contribution option.

41. For the other uniformed services an explicit contribution rate would certainly have to be set. An essential step in the logic of Course A is that similar contributions should be paid for similar benefits. Hence, as now, better benefits should entail higher contributions. Prison officers and members of the police and fire services should therefore pay a contribution in excess of the standard 9 or 10 per cent under this course.

42. Under Course B, police and fire contributions could be left untouched; but prison officers should pay more than the basic 6 per cent envisaged for the rest of the Civil Service. Subject to the points in paragraphs 39 and 40 above, there would be a good case for levying the charge in respect of pensions increase at a higher rate for all uniformed services than the public service average since members of those services derive significantly greater benefits from it. If the higher rate were, say, 3½ per cent (instead of 2½ percent) - and this is less than could be justified on grounds of comparative cost - the police would be paying a total contribution of 10½ per cent, which would not be far out of line with the effective contribution in the Armed Forces. There are, however, other considerations; prison officers, in particular, who have only suspended their recent industrial action, could be expected to oppose any suggestion that they should be treated differently from other civil servants. These issues would need further detailed investigation if Ministers favoured a contribution option.

OVERSEAS PENSIONS

43. Most of the overseas officers entitled to pensions increases from UK funds under the pension increase legislation have retired. For the minimal numbers still in service and

employed by overseas governments, on terms which require no contribution for the UK pensions increase expectation, Courses A and B could not be enforced without concurrent overseas legislation, which could not easily be obtained. But under either course, the very small consequential expenditure on UK pensions increase would justify excluding these potential pensioners from any contribution obligations.

II BENEFIT OPTIONS

44. Courses C and D would involve limitations (or the possibility of limitations) on benefits. Subject to the very important point discussed in paragraphs 47 to 56 below, neither would present technical difficulty. For the public services, all that would be required is fairly straightforward amendments to the pensions increase legislation (mainly section 59 of the Social Security Pensions Act 1975).

45. Although it would be necessary to consult quite a wide variety of interests, there would be no need for negotiations as such. This does not mean that all would be straightforward: there would be many protests and representations to be dealt with, and continuing pressure from staff interests for compensation, whether in the form of lower pension contributions or higher pay. What it does mean is that either benefit option could undoubtedly be the subject of legislation in 1981-82, if a place could be found in the legislative programme.

46. The two options could take a number of different forms, discussed below; but the essential difference between them is that Course C sets an upper limit to inflation-proofing beyond which Ministers may not go without new primary legislation, whereas Course D continues the existing presumption of inflation-proofing but confers on Ministers discretion to give less. This difference has the following general implications for any choice between the two courses.

a. Course C will be more welcome to the critics of index-linking, Course D to current and prospective beneficiaries.

b. Course C, because of its inflexibility, gives Ministers more protection against conflicting pressures in the operation of the system; by the same token, if it produces results which Ministers think inappropriate, they cannot readily be corrected.

c. It cannot be predicted in advance which Course would produce greater savings (this would depend on the design of the system, the pattern of inflation and the exercise of Ministerial discretion); but, in situations where the automatic Course C was strongly restrictive, there would be difficult-to-resist demands for lower contributions or higher pay or discretionary topping-up of benefits.

d. Course D is likely to raise fewer difficulties of retrospection (paragraphs 47 to 56 below).

The force of these general arguments will naturally vary with the precise nature of the preferred version of each course.

Problems of Retrospection and Reserved Rights

47. Courses C and D would not produce significant savings for many years, or satisfy public critics of inflation-proofing, unless they were applied to pensions already in payment and to the whole of pensions awarded in future (ie to pensions in respect of service before the date of the change in the pensions increase system, and not only to pensions in respect of service after that date).

48. Legislation to this effect could be attacked as retrospective; and we have accordingly obtained the views of the Attorney General. These are set out in the letter of 24 September from his office, reproduced at Annex E.

49. This concludes that, at least in the case of civil servants, there is no legal right to pensions increase. Pensions increases are governed by statutory provisions which may be changed without giving rise to any claim in contract.

50. It could, however, be argued that civil servants and pensioners have a moral right to continued inflation-proofing of benefits. This argument would be clearest in the case of staff who have transferred service to the Civil Service scheme from previous pensionable employment, or who have bought added years. Such staff have paid a price for a defined benefit; and it could well be argued that to reduce the value of the benefit was retrospectively to change the terms of a bargain. An aggrieved civil servant or pensioner might take action under the European Convention of Human Rights. The Government would have a defence; and the outcome cannot be predicted with certainty; but there is a risk that the Court would find against the Government.

51. The Attorney General has advised that the Government's defence would be strengthened if it were prepared to offer those who had transferred in service or bought added years either compensation or an option to reopen the agreement into which they had entered where additional index-linked benefits have been acquired at an agreed price of exchange. Examples are additional contributions for higher widows' benefits and the partial allocation of pensions to provide or increase the pension of a dependant. We do not think that the offer of compensation would be an entirely satisfactory solution.

(a) The categories of staff just mentioned are not always clearly distinguishable from other categories. Moreover, the practical effect would be different for transfers from schemes participating on the transfer club (where the arrangements are essentially year-for-year reckoning) on the one hand and private sector schemes on the other. The argument is much weaker in the former case, where the position of staff would be little different if they had served wholly in the Civil Service.

(b) Since a precise deduction has for many years been made from Civil Service pay rates to take account of the inflation-proofing of pension benefits, it will be argued that reckonable service earned in the ordinary way is just as much part of a specific bargain as reckonable service gained by purchase.

52. It is more likely that a solution could be devised by allowing pensioners and scheme members to reopen past decisions, such as a decision to buy in added years. But this could itself create problems; and most of the difficulties outlined in paragraph 51 above would remain. It would be impossible to solve them in time for legislation in 1981-82; and, even if they could eventually be solved, the solutions would be certain to entail a formidable administrative cost.

53. What is said in paragraphs 49-52 above applies only to the Civil Service. It is likely to hold good for the other public services as well; but it is possible that members of some services (and nationalised industry schemes) have a contractual right to inflation-proofing. If so, the chances of the Government losing a case under the European Convention of Human Rights would be much higher. Departments are discussing the position urgently with their legal advisers.

54. If Ministers concluded that full inflation-proofing could not be removed from pension entitlements earned in the past, all existing pensioners would continue to receive it, and those retiring within a few years of the change would continue to have most of their pension fully inflation-proofed. The financial savings in the first few years would therefore be negligible; and it might be 20 years or so before significant inroads were made into pension costs. There could also be considerable administrative complicatons. In these circumstances, it is open to doubt whether it would be worth pursuing Course C or Course D.

55. There is no compromise or half-way house in which to avoid the difficulties. For instance, leaving existing pensioners with full inflation-proofing, but not guaranteeing it on the pensions of those yet to retire would be of doubtful equity, and would lead to many anomalies. The only possible way of reducing the difficulties would be on the lines indicated in paragraph 52 above; and, as that paragraph makes clear, even if a solution could be devised, it would take time and be expensive to put into effect.

56. If Ministers favour Course C or D in principle, the choice seems to lie between:

(a) immediate legislation in respect of all service, with a risk of losing a case under the European Convention of Human Rights;

(b) immediate legislation in respect of future service only, although this will mean that no significant inroads into the cost of pensions increase can be made for perhaps 20 years;

(c) deciding against immediate legislation, and instructing officials to consider possible ways of reducing the difficulties outlined in paragraph 51 above.

COURSE C: A CUT-OFF POINT

57. The imposition of a cut-off point could take one of various different forms. The main types are as follows.

(i) A fixed percentage figure, say 10 per cent

58. Full inflation proofing would be given in any year in which the rate of inflation was less than the cut-off point; protection would be given up to but not beyond the chosen figure if inflation exceeded that figure in any year. For each percentage point by which inflation exceeded 10 per cent in November 1982, the full-year saving for the public services would be £28 million; the saving in 1982-83 would be around £10 million*. This variant would have the advantage of being apparently based on those private sector schemes which provide for automatic stated increases, typically 3 or 5 per cent, provided they do not exceed the rate of inflation; but the similarity would be more superficial than genuine since most private sector schemes have discretion, normally exercised to a considerable extent, to provide higher increases. The change would limit the cost of pensions increase. The drawbacks seem to be:

a. it would be a clear worsening of existing terms of service, and so be certain to lead to pressure for compensation - eg through reductions in pension contributions - and raise the problem of retrospection in an acute form;

b. it would be difficult to choose and defend a figure; any figure could be rendered inappropriate by circumstances which could not be predicted in advance.

c. if inflation exceeded the cut-off figure for any length of time, there would be strong pressure for further ad hoc pensions increase.

(ii) Pensions increase of a fixed proportion (say two thirds or four fifths) of the annual rate of inflation

59. This would automatically create, even when inflation was low, a permanent and growing erosion of the real value of pension benefits. This would be hard to defend on any ground of principle, and would not be in line with private sector practice. If inflation ran at high rates for very long, the reduction in the real value of benefits would quickly become serious; again this would lead to pressure for ad hoc additional increases. If inflation were

*These figures are discussed more fully in Annex B. The discussion there is also relevant to paragraphs 59, 60, 67, 68, 69 and 70.

10 per cent in November 1982, the saving would be £20-30 million in 1982-83, £60-90 million in a full year.

(iii) Full inflation-proofing up to a stated figure (say 10 per cent) with half or two thirds protection thereafter

60. This, effectively a combination of (i) and (ii), would link their advantages, but not eliminate their disadvantages. It would provide full protection when inflation was low, but keep increases down when inflation was high and public disquiet about inflation-proofing could be expected to be greatest. There would be a good chance of avoiding ad hoc supplementation unless inflation continued at a high level for quite a long period. But the system would be rigid and there would be no means of predicting in advance how it would compare with private sector practice. The saving would be up to £5 million in 1982-83, £15 million in a full year, for each percentage point by which inflation exceeded 10 per cent in November 1982.

61. If Course C were felt to be attractive, we would regard the approach at (iii) above as being defensible in more situations than either (i) or (ii). If Ministers wished to pursue it further, more work could be done on the relevant figures (the level up to which full protection would be given and the degree of protection thereafter).

COURSE D: POWER TO INCREASE PENSIONS BY LESS THAN INFLATION

62. Under this course, the presumption would be that full inflation-proofing would be given unless, in any particular year, Ministers chose to give less.

Parliamentary procedure

63. On this basis, it would be consistent with normal practice for any Order in line with the statutory presumption (ie full inflation-proofing) to be subject to negative resolution, whereas any involving use of the exceptional power would be subject to affirmative resolution.

Use of the power

64. If Ministers decided to take a relatively open-ended power of this sort, they would be expected to give an indication of how they intended to use it. They might say, for example, that it might sometimes be necessary to abate pensions increases to match public service pay increases when these were held below the rate of inflation. However, there could be complications if the pay of different public services were being treated in significantly different ways.

65. Alternatively, it might be indicated that pensions increases would be abated in circumstances where output or earnings in the economy as a whole were declining in real terms. This would be a more stringent condition, so that the power would be exercised less frequently than under the approach outlined in the previous paragraph. It would be readily defensible at the time in terms of equity between different groups in the economy; but there would also be arguments that the power should be used symmetrically to allow for catching up when, after a period of constraint, real incomes were rising.

66. Against this background, a number of different approaches would be feasible.

(i) Unlimited discretion to abate increases

67. This would leave pensioners and staff interests uncertain of their position and would make it harder to maintain contribution levels. It would stir up the controversy about the whole principle of index-linking in an acute form. It might not be easy to square with the sort of approach outlined in paragraphs 64 and 65 above. The scope for savings is large -the 1981 increase will cost £232 million in a full year - but it is most unlikely that substantial de-indexation could be maintained very long without pressure for ad hoc increases or reduced employee contributions.

(ii) Power to abate by up to, say, 5 percentage points

68. This would limit the amount of real income which pensioners could lose in a single year, and in practice a decline in the real value of pensions by 5 per cent in any one year might be as much as Ministers would wish to contemplate. But it could still be represented as unfair and give rise to hostility on the part of staff and pensioners, since it could be used to procure regular reductions in real income even when inflation was low and when private pensions were being more fully protected. Full use of such a power at the 1982 uprating would yield £140 million in a full year, and approaching £50 million in 1982-83.

(iii) Power to abate by up to a stated proportion (say, one third or one half) of the rate of inflation

69. This version, by contrast, could lead to unpredictably large reductions in the real value of pensions if there were a resurgence of inflation. If inflation were 10 per cent, its use in 1982 could yield £30-50 million in 1982-83 and £90-140 million in a full year.

(iv) Guaranteed inflation-proofing up to, say, 10 per cent, but discretion to abate increases above that level

70. In our view, this combined approach is more likely than (i) - (iii) above to provide Ministers with the discretion to act in particular circumstances without generating needless alarm on the part of employees and pensioners because of the unpredictable way in which

the provisions could work. Pensioners might indeed still improve their relative position if there were a combination of low inflation and falling real earnings; conversely, high inflation and rising real incomes would leave pensioners relatively worse off. If Ministers wished to pursue an option on the broad lines of this approach, further work could be done on the level of the limit, and further refinements could be considered. It would, for example, be possible to include limitations on the exercise of discretion, perhaps on the lines of variant (ii) discussed in paragraph 68 above. For each percentage point by which inflation exceeded 10 per cent in November 1982, a maximum saving of £28 million in a full year, £10 million in 1982-83, would be possible.

A "MIXED" COURSE

71. In the light of the emphasis on early legislation and implementation, we think "mixed" courses should be avoided as far as possible.

72. If the main response to this report is to take action on contributions, this would presumably be related specifically to the benefit of index-linking, and a change in benefits at the same time would make those higher contributions more difficult to achieve.

73. The same arguments do not, however, apply precisely in reverse. The application of either Course C or Course D would still leave a wide disparity in contribution rates (Civil Service effective rate of 8½ per cent; many other services 6 per cent) for comparable benefits; and the benefits would still include a substantial degree of index-linking.

74. Under Course C or D, therefore, there would still be a case for aligning contributions in the public services, and there might be grounds for arguing that this should be at the level of Civil Service contributions rather than the lower level of other services.

75. There would, however, be substantial negotiating difficulties, since the proposition would be higher contributions for worse benefits. Similar considerations would apply on the contributions side, therefore, to those discussed in relation to Course A.

76. There is one other respect in which possible action on benefits and contributions may need to be handled simultaneously. Our Progress Report suggested that negotiating advantage might be obtained by the presentation of alternatives. For instance, the actual or implied threat of Course D could help towards obtaining rapid acquiescence to Course B.

POSITION OF THE WIDER PUBLIC SECTOR

77. The discussion so far in this report has concerned itself solely with the position of the public services (ie schemes in the first section of Annex A). E Committee took the view that in principle the assumption should be that any change would be applied to all public sector schemes. It is therefore necessary to consider the wider public sector, and in particular the nationalised industries.

78. All the nationalised industry schemes are funded. The operations of the funds, which are controlled by trustees, are independent of both Government and industry (in 1971 the Government revoked the orders requiring Ministerial consent to changes in the terms of the pension schemes). Pension arrangements have hitherto been a matter for negotiation between the industry and its employees; action by the Government to influence these arrangements would be an unprecedented direct intervention by Government in the bargaining process.

79. Some nationalised industries are to move to the private sector shortly, and it might be difficult to explain why their funds, which are index-linked and similar to funds of industries which will remain in the public sector, should be free from any controls proposed for funds which remain in the public sector. This difficulty is greater in the cases where parts of a nationalised industry have moved into the private sector and new funds, with rules modelled on those of the parent industry's scheme have been set up and were acceptable to the investing institutions.

I - COURSES A AND B

80. The only way of applying Course A or Course B directly to the nationalised industries would be to legislate so as to require the imposition of the relevant level of employee contributions. Such legislation might be hybrid; but we have not investigated this aspect, since other objections seem decisive. These are as follows:.

a. It would be a large incursion by the Government into the settlement of the terms and conditions of service of nationalised industry workers. It is the Government's general policy, which it has recently reaffirmed, not to intervene in the pension arrangements of nationalised industries.

b. The underlying purpose of Courses A and B is to make employees pay more for the same benefits. It would not be possible to ensure that this purpose was fulfilled unless Ministers were prepared to take power also to control benefits in nationalised industry pension schemes: without such a power, the increase in employee contributions could be used to finance increases in basic benefits beyond what is provided by public service schemes. This would take Ministers straight back into the detailed control of nationalised industries pension terms which was abandoned in the early 1970's. Alternatively (and perhaps more likely), higher contributions might be immediately offset by pay increases.

It could be added that Course B, with its mixture of accruing cost and PAYG contributions, would be hard to reconcile with the genuinely funded nature of nationalised industry pension schemes.

II - COURSES C AND D

81. An objection on the lines of that in paragraph 80(a) above could also be made against an attempt to apply Course C or D to nationalised industries. However, it would have less force, since it would be possible to reply on the following lines.

(a) The cost of inflation-proofing is particularly difficult to forecast, and hence to fund with confidence.

(b) Hence, if the nationalised industries offer inflation-proofed benefits, they are implicitly relying on the fact that the Exchequer ultimately guarantees their continued existence.

(c) The resulting contingent liability is as a matter of principle unacceptable to the Government, which will therefore require the industries not to go further than public service practice, which it endorses.

82. Course C or Course D would, in fact, apply automatically to the majority of nationalised industry pension schemes, since they provide inflation-proofing through a link with the public service pensions increase system. The Nationalised Industries' Chairmen's Group (NICG) has drawn attention to this fact in its observations to the Government (attached at Annex F). However, it might be thought unsatisfactory to take no further action. First, a number of important nationalised industry schemes (including those of gas, electricity and coal) would be unaffected. Secondly, there would be nothing to prevent industries from amending their schemes so as to provide inflation-proofing by a direct link with the retail price index (RPI), as some already do.

83. Legislation directly to require nationalised industry schemes to break an existing link with the RPI would almost certainly involve the abrogation of contractual rights and therefore expose the Government to the risk of a successful action under the European Convention of Human Rights. This risk could be avoided by limiting the effects of the legislation to future entrants, or to schemes which do not already have a direct link with the RPI; but the resulting solution would be bound to be criticised as unfair and anomalous.

Certainly it would fall short of meeting the wish of Ministers for broad uniformity across the public sector.

84. Another approach would be to make the withdrawal of index-linking a condition of Government financial assistance to meet operating losses or enable a capital reconstruction. This would suffer from serious disadvantages.

a. It would affect only some industries; the monopoly industries could always pass the burden of index-linking to the consumer.

b. Those industries which were caught would be affected at different times and in different circumstances: the upshot would be a long drawn out series of battles, no doubt including strikes and the threats of strikes.

We do not think this approach would be satisfactory.

Use of the tax system

85. A quite different approach would be to act through the tax system. It could be made a condition of Inland Revenue approval for pension schemes that increases in benefits after award should not exceed those payable under the pensions increase legislation in force from time to time. The new condition would apply to existing as well as to newly created or modified schemes.

86. This might avoid the potential difficulties under the European Convention of Human Rights mentioned earlier in this report, since the legislation would not itself abrogate, or require the abrogation of, existing contractual rights. But, since the loss of Inland Revenue approval has severe financial consequences for a pension scheme, there would be a strong incentive to both employers and employees to renegotiate pension terms so as to come into line.

87. This approach would inevitably affect the private as well as the public sector, since the same tax rules apply to both. However, this could be justified on the grounds that there is no reason why the taxpayer should assist private sector schemes, through tax concessions, to provide levels of pensions increase which, ex hypothesi Parliament had decided to be so objectionable in the public services as to require legislation to defeat current expectations of index-linking.

88. The Inland Revenue are clear that a limitation of this sort could not be imposed by the exercise of their discretion under the existing law: fresh primary legislation would be required. In broad terms, this would require pension schemes so to arrange their rules as to prevent the payment of pensions increase which, on a cumulative basis, was more generous

than that paid in public service schemes. Unlike other legislative changes discussed in this report, it could be included in a Finance Bill.

89. This would be a departure from previous practice in that it would require schemes already in existence and enjoying Revenue approval to include new restrictions in their rules: many pension schemes permit increases in line with increases in the RPI (even if in practice they are unable to be so generous), and their rules would have to be amended to prevent this if it were more generous than public service practice. In the circumstances, it might be thought excessive to expose such schemes to the full consequences of loss of Revenue approval (principally, assessment of employees to tax on both their own and their employer's contributions, and assessment to tax of the pension fund on both its income and its capital gains); and some less severe penalty might be devised, such as partial or complete withdrawal of relief on the income and capital gains of the fund.

90. If Ministers favoured this approach, the details would need to be considered further and discussed with the pension industry. Legislation could not be ready for enactment earlier than the 1983 Finance Bill; and it would be necessary to allow a transitional period of several years thereafter in which schemes would adapt themselves to the new requirements.

91. This approach has attractions as a way of applying Course C or Course D to the wider public sector without appearing to single public sector schemes out for unfavourable treatment; and there is an argument of equity in favour of limiting tax relief to private sector schemes in line with what can be afforded in the public services. It would not be consistent for private sector pension interests, which have so strongly criticised index-linking in the public services, to object to the imposition of limitations on post-award increases in both public and private sectors.

92. Nevertheless, the approach would be likely to be heavily criticised by the pensions industry. The main lines of attack would probably be as follows:

(a) the approach was unnecessary, because few private sector schemes in practice provided full inflation-proofing;

(b) it was unreasonable, since those private sector schemes which could afford to provide full inflation-proofing should be allowed to do so;

(c) it was simply an indirect way of forcing employers to go back on contractual obligations freely entered into or to pay a price in the loss of tax benefits for something which they cannot now go back on, and which at the time they entered into the agreement was perfectly lawful;

(d) particularly under Course D, decisions taken by Ministers about the pensions increase which could be afforded in the public services could affect much of the private sector, which might be in quite different circumstances.

93. There would be a reasonable defence to these arguments. The fewer the schemes affected, the less objection there should be to the changes; schemes that can afford full index-linking can do so, in large measure, only because of tax concessions; and if the criticism at paragraph 92(c) were thought to be damaging, it could be met by exempting schemes which had an explicit link with the RPI (though this would mean exempting a number of nationalised industry schemes at which the exercise was in large measure directed).

94. The Committee believes that the arguments of principle favour use of the tax route if Ministers select Course C or D. But Ministers will wish to balance against these arguments the likelihood of strong objections from the pensions industry.

WIDER PUBLIC SECTOR: CONCLUSION

95. In our view, the following conclusion may be drawn.

(a) If Ministers were to act on contributions for public service schemes, this might be reflected in nationalised industry practice; but it would be pointless to attempt to enforce such a result in the absence of detailed control over nationalised industry pension benefits and the extent to which higher contributions might be offset by higher pay.

(b) If Ministers were to act on benefits, their lead would be more likely to be followed; the terms of many nationalised industry schemes are directly linked to the pensions increase legislation. But there are important exceptions; and schemes could always link their pension increase explicitly to the RPI.

96. An attempt to solve the problem outlined in paragraph 95b by direct legislation would expose the Government to the risk of a successful action under the European Convention of Human Rights. The alternatives are:

(a) relying on the automatic effects outlined in paragraph 82 above and encouraging the NICG to use their best endeavours to withdraw index-linking where it exists: the recently instituted arrangements for monitoring nationalised industry pension schemes would provide a mechanism for maintaining pressure on the industries to make the necessary changes (or for resisting the reintroduction of index-linking in schemes automatically affected by Courses C or D); and

(b) use of the tax system on the lines described in paragraphs 85 to 94 above: there are good arguments in favour of this; but it would be strongly resisted by the pensions industry.

GENERAL ASSESSMENT

97. The options considered in this report have been discussed in terms of all their implications as far as we have been able to identify them. On such a contentious issue, and one in which our own interests are involved, we refrain from presenting a recommended course. There are, however, some conclusions we would tentatively draw.

98. On contributions, we think there is a good case for action to harmonise contribution levels. Those schemes in which the contributions take the form of a reduction in gross salary (civil service and armed forces) are the only ones in which the cost of inflation-proofing has been systematically taken into account in fixing the contribution level. In other cases the (lower) contribution levels were determined on other grounds; and it can be argued that they do not take full account of index-linking. At least, therefore, increasing contributions in these cases would be justified in terms of pensions policy, since similar benefits should be accompanied by similar contributions.

99. Secondly, if one takes the present level of Civil Service contributions as the datum point, there would be justification for raising this, within the context of the system that has existed hitherto, simply on actuarial grounds - the Government Actuary has already used, for the Pay Review Bodies, a lower assumption for the real rate of interest than that which was used for the 1980 Civil Service pay settlement. There are, however, three arguments against this:

a. The actuarial argument would support only a very small increase (about ½ per cent) for the Civil Service; a bigger increase would have to be argued on more general grounds.

b. The actuarial assessment was part of a comprehensive comparison of total remuneration that is no longer made.

c. An assessment which was valid for the Civil Service would not necessarily be so for other services.

100. Ideally, arrangements for pensions increase should not be financially segregated from the arrangements for "basic" pensions. The total contributions required to maintain basic pensions are likely to vary inversely in relation to those necessary to finance pensions increase: it therefore makes sense to run the two together if possible. If one were embarking on a substantial reconstruction of public service pension schemes to achieve this, one might well be led in the direction of Course A.

101. But it would involve substantial changes, which would take time to negotiate and implement. Furthermore, the outcome would be uncertain, particularly since the suspension

of comparability has knocked away even the possibly contentious datum point of the Civil Service. We therefore think that the supplementary charge envisage in Course B would be a more practicable means of obtaining higher contributions in respect of the generality of public services. Under Course B the degree of inflation-proofing in the private sector is the datum, and anything above that in the public sector is to be paid for by public servants directly on a pay-as-you-go basis; the level of basic contribution for most services would remain as now. Thus there would be no new objective justification for basic contributions; but there would be an objective means of determining the supplementary charge. Technical and negotiating issues are more straightforward than under Course A; and, in this context, the fact that pensions increase is (in the main) separately financed from basic pensions becomes a convenience.

102. As argued in paragraphs 5 and 6 above, it is anyway desirable to make the Civil Service pension scheme formally contributory. Course B would leave the Civil Service at least initially paying an effective rate of contribution (after adjusting for making the scheme contributory) very little different from at present. Actual contributions would, however, be higher than now (and net pay lower) as the converse of the bigger pensions based on gross pay under a formally contributory scheme.

103. Under either Course A or Course B the maximum potential savings would be large, running into hundreds of millions of pounds a year. There would, however, be dangers of erosion through higher pay. These would be somewhat easier to resist under Course B than Course A though, ultimately, market considerations put a floor under the value of the total reward package (pay plus pensions) and so constrain the extent to which contributions can be raised without affecting pay.

104. On benefits, the arguments go both ways and involve a more political choice. It can be represented as unfair, on the one hand, that public service pensioners should have the real value of their pensions protected, while private sector schemes do not give such undertakings. On the other hand, it can be argued that the State should not use inflation to reduce the real value of obligations forming part of implicit bargains with its employees. (Some general considerations were discussed in paragraphs 8-18 of our Progress Report).

105. The first of the arguments in the above paragraph again introduces comparison with the private sector. However, neither Course C nor Course D (which reduce benefits) are directly aimed at imitating private sector practice. Course C involves an automatic formula (with the advantages and disadvantages of that); Course D involves Ministerial discretion - in that case, interest would centre on how the discretion should be exercised and how far it should be curtailed in the legislation itself. Any argument for a similar degree of inflation-proofing in the public services as in the private sector needs to take account of the fact

that, at least in the case of the civil service and armed forces, the effective contributions, much higher than those in the private sector, have specifically provided for inflation-proofing at a price accepted by the Government at the time. A curtailment of benefits in line with the degree of inflation-proofing historically offered by the private sector would therefore entail a reduction in civil service contributions, and thus in respect of those services an initial cost to the Government probably greater than the savings of pensions. Course D is designed to minimise this repercussion as far as practicable by maintaining the presumption of index-linking.

106. Under Courses C and D there would also be the problem of retrospection. The advice of the Attorney-General is that, at least in the case of the Civil Service, legislation affecting pensions increase would not interfere with previously existing contractual rights. But some legal risk is involved, particularly if there were to be a challenge in the European Court of Human Rights. The issue of retrospection would not arise on Courses A or B.

107. Finally, there is the position of the wider public sector, chiefly the nationalised industries. There is no way of imposing Courses A or B on the industries. Courses C or D would apply automatically to many of the industries, but not to all; and, unless further action were taken, schemes could always change their rules so as to avoid their effects. If Ministers wished to avoid these consequences, the most promising approach would be to act through the tax system on the lines described in paragraphs 85 to 94 above. That would have to cover the private sector as well as nationalised industries; and there are good arguments of principle for this. However, it would not be free from difficulties; and it would be strongly criticised by the pensions industry.

108. There is no doubt that failure to apply whatever Ministers may decide for the public services to the wider public sector will be heavily criticised by public service staff interests. Nevertheless, in view of the complications, which would need to be considered further if Course C or D were to be followed, we think that Ministers' decisions on the public services should be taken on their own merits and not be determined by the position relating to nationalised industries.

109. The arguments on both sides of the contributions/benefits issue can thus be summarised as follows:

(i) In favour of action on contributions:

(a) This is the most natural response to the Scott Report; the arguments for some increases in public service contributions are difficult to refute.

(b) It is easier to reconcile with the Government's political commitments.

(c) It avoids the problem of retrospection. It cannot be argued to be inconsistent with moral obligations.

(d) In the form of Course B, it is based to a larger degree on objective evidence and does not involve the exercise of discretion. If it is accepted at the outset, it should prove a stable solution.

(e) It should yield larger savings, certainly in the first instance, and probably in the longer term. Course B, for example, in effect charges employees with half the cost of pensions increase; but it is very unlikely that any of the variants of Course C or Course D could be operated so as over time to halve the rate of pensions increase.

(ii) In favour of action on benefits:

(f) It would make public service pension benefits more comparable with those on the private sector.

(g) The general approach could be applied to at least a substantial part of the public sector outside the public services (though, for the reasons indicated in paragraphs 107 and 108 we do not regard this as decisive since the only way of ensuring reasonably general application would be to operate through the tax system in a way which might prove contentious).

(h) In the form of Course D it would give Ministers greater flexibility.

CONSULTATIONS

110. Whatever course is preferred, Ministers are committed to consulting a wide variety of interests (in particular, by the Prime Minister's announcement of the terms of reference of the Scott Committee): trade unions, and other employers in the public sector as a minimum; and possibly, in addition, representatives of public service pensioners and, particularly if Ministers were to decide on an approach involving changes in the tax regime, private sector pension interests. It seems desirable to arrange for the early issue of a document setting out the Government's views as a basis for consultation.

MAIN PUBLIC SECTOR PENSION SCHEMES (UK)

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing?	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
Public services									
Civil Service	732	391	787	1½% (men)	-	about 6½% (1980-81)	1971 Act	unfunded	All benefits
Armed forces	317	281	544	-	-	~~AFPRB~~ 11% (1981-82) ~~(unquanti~~i- ~~fied)~~	Follow 1971 Act	unfunded	All benefits
Local government	1077	359	686	5% (manual) 6% (other)	8½% (average)	2.8% in 1979 manuals settlement	1971 Act	funded for basic benefits	60% of PI and employer contributions
Teachers	693	187	670	6%	8.4%	about 1½% in 1979	1971 Act	notionally funded for basic benefits	All PI, 60% of employer contributions
NHS	822	208	480	5% (manual) 6% (Other)	7½%	various arrangements, between 1½% and 4% as for most staff in 1979	1971 Act	notionally funded for basic benefits	PI and employer contributions
Police	139	78	192	7% (men) 5% (women)	-	None	1971 Act	unfunded	Grant element of benefits
Fire	40	25.5	44	6¾%	-	None	1971 Act	unfunded	60% of benefits
Overseas	6	47	80	-	-	-	1971 Act	mainly unfunded	All PI
Judiciary	1	0.5	4	3-4%	-	TSRB make (unquantified) allowance	1971 Act	unfunded	All benefits

A1

ANNEX A

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
Parliamentary	0.65	0.3	0.8	6%	16%	None	1971 Act	**Fully funded**	**Employer** contribution
Total public service (approx)	3830	1580	3500						
Nationalised industries etc									
British Airports Authority	7.5	1.2	2.9	6-7%	11[illegible]-12[illegible]	None	Yes-follow RPI	Fully funded	Nil
British Airways	47	15	46	$7\frac{1}{4}$%/$8\frac{1}{2}$% (men) $5\frac{3}{4}$%/7% (women)	12.65% - 25.5%	**None**	Follow 1971 Act	Fully funded	Nil
British Railways Board	217	64	40 (1979)	$9\frac{1}{2}$%	14%	None	Follow 1971 Act	Fully funded	Some, for historical reasons
British Steel	128	101	127	8% (staff) $5\frac{1}{4}$% (manual)	16%	None	Follow 1971 Act	Fully funded	Nil
Civil Aviation Authority	7.4	1.6	8.7	$7\frac{1}{2}$%	25%	Linked to Civil pay	Follow 1971 Act	Fully funded	Nil
Cable and Wireless	9.1	1.2	4.3	6.5% (men) 5% (women)	17-22.5%	None	Yes, discretionary	Fully funded	Nil
Forestry Commission	8	4.7	7.1	$1\frac{1}{2}$% (men)	-	As for Civil Service	1971 Act	unfunded	All

A2

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
National Bus Co	36	5	6	2½% (manual 7½% (staff)	7½% 22½%	None	Broadly follow 1971 Act	Fully funded	Nil
National Freight Company	34	10	14	7¾%	11¾%	None	Follow 1971 Act	Fully funded	Some, under Transport Act 1980
Post Office	400	180	571	6%	9%	None	Follow 1971 Act	Fully funded	£45 million a year under 1969 Act
UKAEA etc	35	7.5	18	4¼%-7½%	10-12½%	Non-industrials linked to Civil Service	Follow 1971 Act	Fully notionally funded	Employer contributions (except in BNFL and TRC)
Electricity supply	143	66	133	6%	12%	None	Follow 1971 Act in practice	Fully funded	Nil
NCB: miners	240		130	5¼%	5¼%	None	RPI since 1975, subject to Actuary's advice	Fully funded	About £50 million in 1980-81
NCB: staff	59	50	85	4½-5½%	10-12%	None	About 92% since 1971	Fully funded	Nil
British Gas	93	39	65	6%	15.2% (manual) 29.1% (staff)	None	Follow 1971 Act	Fully funded	Nil
London Transport	50	14	21	5% (manual) 6% (staff)	13¼% (manual) 18.9% (staff)	None	Follow 1971 Act	Fully funded	Nil
Water Industry	56	11	27.5	5% (manual) 6% (staff)	11%	None	1971 Act	Funded for basic pensions	Nil

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation Proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
New Towns	3	0.2	1.6	6%	11.5%	None	Follow 1971 Act	Fully funded for basic provision and indexation up to 7% p.a.	Some for corporations operating revenue deficits
Crown Agents	1.7	1	3	1½% (men)	35% (pre-1980 entrants) 18¼% (others)	As for Civil Service	Follow 1971 Act for pre-1980 entrants only; 5% limit for others	Fully funded	Nil
British Council	2	0.9	3.6	1½% (men)	23¾%	As for Civil Service	Follow 1971 Act	Fully funded	Grant-in-aid
University Superannuation Scheme	58	38	52.5	6¼%	14%	None	Follow 1971 Act	Fully Funded	Grant-in-aid
BBC	21.5	7	21¼	7½%	20½%	None	Follow 1971 Act in practice	Fully funded	Nil
IBA	1.4	0.1	0.6	6%	12%	None	80% of RPI practice	Funded for 3% pa post-retirement increases	Nil
Total nationalised industries etc (approx)	1600	580	1200						
Total public sector (approx)	5400	2200	4700						

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Glossary

"Accruing cost" The level percentage of annual pay estimated to be required during the working lifetime of future entrants to provide their benefits, plus any additional costs expressed as a level percentage of pay eg to liquidate deficiencies.

"Actual fund" A fund of cash, stock exchange investments, property etc, into which employer's and employee's contributions are paid. The resources of the fund, including contribution income and interest and dividend on investments, are used to defray the cost of benefits.

"Actuarial value of assets" The value placed on the assets by the actuary; commonly this is the capitalised value of estimated future income and proceeds of redemption.

"Actuarial value of future contributions" The capitalised value of the estimated income from future contributions.

"Actuarial value of liabilities" The capitalised value of estimated future outgoings.

"Capitalised value" The total of the amounts of a series of future payments or receipts discounted at interest (discounted cash flow).

"Deficiency" The excess of the actuarial value of liabilities (q.v.) over the actuarial value of assets (q.v.) and actuarial value of future contributions (q.v.)

"Emerging cost" The total pension benefits actually paid out, year-by-year.

"Employee's contribution" A deduction from gross pay, typically expressed as a percentage of pensionable salary. It bears no close or necessary relation to the value of the benefits provided by the scheme.

"Employer's contributions" The balance of the accruing cost (q.v.) not met by employees' contributions. They may be divided into 'future entrant' contributions (sometimes called 'normal contributions') and other payments (eg to liquidate deficiencies or to provide improvements in benefits); but often this distinction is not made.

"Notional fund" An accounting arrangement which imitates the operation of an actual fund, but under which contributions are not actually invested but are deemed to be invested in a portfolio of assets. Credits are registered in the books of the fund, corresponding to actual contributions and the income which it is calculated would have been earned on the portfolio. Benefits and other outgoings are debited in the books.

"Surplus" The excess of the actuarial value of assets (q.v.) and the actuarial value of future contributions (q.v.) over the actuarial value of liabilities (q.v.).

"Valuation" The comparison of the actuarial value of liabilities (q.v.) with the actuarial value of assets (q.v.) and the actuarial value of future contributions (q.v.). The process requires assumptions as to:

(a) the experience of members - mortality, retirement, salary progression due to promotion and seniority etc;

(b) future rates of interest and general increases in pay and prices.

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ANNEX B

EFFECT OF EACH COURSE ON THE MAIN PUBLIC SERVICE SCHEMES

Course A (a general increase in contributions)

1. Table 1 sets out how Course A would affect each of the main public service pension schemes, on the assumption of a general increase in contributions to around 10% of pay. The gross savings, in terms of employee contribution income to the schemes would be approaching £800 million. As explained in the report, however, this may considerably overstate the likely savings to the Exchequer, both because 10% may not be attainable and because the saving may be eroded by offsetting pay increases. If a contribution rate of 9% had to be settled for, the gross savings would come down to nearly £600 million, even before the effects of any offsetting pay increase.

Course B (partial pay-as-you-go contributions)

2. Under this course, existing contributions would remain unchanged, except that the Civil Service would be charged 6% by deduction from gross pay rather than, as now, by reducing pay rates themselves. A further charge would be levied of 2½% for the non-uniformed services and possibly 3½% for the uniformed services (except possibly the amed forces). If such a charge were levied on the armed forces, the existing pay reduction made by the AFPRB would probably be less.

3. The effects on each service are summarised in Table 2. The gross savings amount to nearly £500 million and public servants as a whole would be meeting around half the current cost of index-linking.

4. These estimates depend in part on assumptions about the immediate effect on pay of any change in contribution arrangements. It is, for example, assumed in Table 2 that because the total contribution from the Civil Service would be little different from that in the 1980 pay research settlement, the net gain from Course B would be small - ie, that there would have to be virtually full/ immediate offset through higher pay. But there would be an argument for taking the line that:

(a) the change to a contributory scheme charging 6% for basic benefits should be precisely offset through higher pay (but allowing for the higher value of pension benefits); but

(b) any further offset on account of the special charge for pensions increase was a matter for negotiation.

The gross savings from Course B in respect of the Civil Service would then be about £140 million.

5. On the other hand, as pointed out in the body of the report, there are other groups of staff in the public services (eg in the NHS) who could claim that their pay had been determined by recent comparability exercises which had allowed for the value of index-linking, and that they should therefore receive an increase in pay to offset the higher level of pension contributions.

6. And, of course, even if there were no immediate offset, the savings would still be eroded by laterpay increases.

7. These arguments apply in a broadly similar way to both Course A and Course B. It follows that too much weight should not be placed on apparent differences in the yield of the two courses.

Courses C and D (limitation of index-linking)

8. Pensions increases apply in the same way to all public services. Therefore the consequences of changing these benefits do not vary from service to service, as do the effects of Courses A and B, which tackle contributions.

9. It is impossible to say how much each of the variants of the two courses might save without specifying its precise form and making assumptions about the future course of inflation and the use that Ministers might make of any discretion under each variant. However, as an indication of the possibilities, the savings from increasing pensions at the 1982 uprating by 1% less than the rate of inflation would be distributed approximately as follows:

	£ million
Civil Service	6½
Local government	4½
Teachers	5½
NHS	3½
Armed Forces	5
Police and fire	2
Overseas	1
	28

10. The savings from holding pension increases below the rate of inflation from year to year would be cumulative. However, there would presumably be a practical limit on the total reduction that could be imposed on the real value of pensions. And a substantial reduction in the real value of pensions would generate pressure for reductions in contributions, higher pay, or other improvements in conditions of service.

TABLE 1 : EFFECTS OF A GENERAL INCREASE IN CONTRIBUTIONS TO 10%

	Increase in contribution rate	Financing implications	Legislative implications	Maximum initial saving £m 1980-81 prices
Civil Service	1½%	Nil	Nil	110
Local government	4%	Very difficult. Probably associate with de-funding	Amend Pensions (Increase) Act 1971 and regulations (contained in SI)	240
Teachers	4%	PI brought into notional funds. Controversial with local authorities	Amend Superannuation Act 1972 Amend regulations by SI	200
NHS	4%	PI brought into notional funds	Amend Superannuation Act 1972 Amend regulations by SI	200
Armed Forces	Nil	Nil	Nil	Nil
Police and fire	Probably 3-5%	Nil	Amend regulations by SI	30-50
Parliamentary	4% MPs 5% Ministers	Nil	Amend Parliamentary and other Pensions Act 1972	0.4
Judiciary	Not settled	Nil	Amend Judicial Pensions Act 1981	Small

TABLE 2: EFFECTS OF A SWITCH TO PARTIAL PAY-AS-YOU-GO CONTRIBUTIONS

	Increase in contribution rate	Maximum initial savings £m 1980-81 prices
Civil Service	7%*	40
Local government	2½%	150
Teachers	2½%	125
NHS	2½%	125
Armed Forces	2½-3½% or nil	Nil
Police and fire	2½-3½%	40
Parliamentary	2½%	0.25
Judiciary	Not settled	Small

* Except for prison officers, for whom a higher contribution may be appropriate.

NB

As noted in paragraphs 4 and 5 the figures in the final column depend on assumptions about the immediate effect on pay rates of changes in contribution arrangements. It would be equally plausible, on the one hand, to increase the estimate for the Civil Service to £140 million or, on the other, significantly to reduce the figures for the NHS (and perhaps some other services)

ANNEX C

A CONTRIBUTORY CIVIL SERVICE PENSION SCHEME?

Introduction

This paper discusses some of the main implications of making the Principal Civil Service Pension Scheme fully contributory. At present male civil servants pay direct contributions of $1\frac{1}{2}\%$ of salary towards the Widows Pension Scheme (WPS); basic pension benefits and pension increases are paid for by means of adjustments to gross pay. Under a fully contributory scheme the separate pay adjustments and WPS contributions would be replaced by a contribution from gross pay covering all benefits.

Effects on Pay and Pensions

2. It would be broadly consistent with the Government Actuary's calculations in the 1980 pay research exercise to increase salaries by 6.5% and to levy contributions of 8.5% for men and 7% for women (the difference reflecting the fact that most women do not pay contributions for dependants' benefits). As is usual in a contributory scheme, pensions would be based on the higher gross pensionable pay and would therefore be bigger than at present. Non-pensionable emoluments based on pensionable pay, such as overtime, would also increase. Higher pensions would, however, be paid for by a cut of about 1% in net pay: there would be no increase in public expenditure or central government borrowing.

3. One major advantage of such a change is that it would remove the need for complex pension adjustments under a pay comparability system, while ensuring that a proper contribution was actually being paid. It remains for consideration whether pensions should be totally separated from pay determination by the setting up of a free-standing system for determining and adjusting pension contributions. The Megaw Inquiry will no doubt be considering this as part of its wider examination of the system of determining civil service pay.

Contribution Levels

4. The precise level of contribution would need to be determined in the light of Ministers' decisions on the options discussed in this Report. If it is decided that men and women should pay the same contribution, there would undoubtedly be pressure for pensions to be paid as of right to the widowers of all women civil servants, or for contributions to be lower for women than for men. Either change could have important repercussions in other schemes, in particular, the teachers' NHS and local government schemes when the same contributions are paid by all, but dependants' benefits, except in very restricted circumstances are paid only to men's dependants.

Inland Revenue Limits

5. The Inland Revenue limit for the receipt of tax relief on pension contributions is 15% of salary. A move to a fully contributory scheme, particularly if it were at a high contribution level, would therefore require special arrangements for some civil servants who pay additional contributions out of gross salary towards added years or enhancement of widows' pensions in respect of pre-1972 service. The Inland Revenue are being consulted about this.

Union Reactions

6. It is likely that more senior staff would welcome a fully contributory scheme while more junior staff would be concerned at the cut in net pay. This difference of view would be reflected in the views of individual unions, though the majority would probably favour the change. They would, however, all be likely to resist any increase in contributions much above 8½%. Under section 1(3) of the Superannuation Act 1972, the unions would have to be consulted about such a change. It might, however, be helpful presentationally if the proposal for the change came initially from the Unions themselves.

Timing

7. A number of technical matters, raising important questions of superannuation policy, would need to be considered and discussed with the unions. None of these are insoluble, but it would take time to study them and negotiate the necessary amendments to the scheme. It would also be necessary to adjust administrative payroll and computer systems. It is unlikely, therefore, that the change could be introduced before April 1984. If decisions were dependent on the results of the Megaw Inquiry into civil service pay the change could take longer.

Financial Effects

8. An increase in pay of 6.5% and the levy of contributions at 8.5% (men) and 7%(women) should be financially neutral in the long run, lower net pay being offset by higher pensions. For several years, however, there would be a net saving because higher pensions would take time to work through. Against these savings, refunds of contributions could increase, as could overtime rates. The longer term effect of this could, however, be to a great extent offset by making London Weighting non-pensionable. The financial implications would then be as follows:

£ millon 1981-82 prices

	year 1	year 2	year 3	year 4	year 5	long run
Net pensionable pay	- 42	- 40	- 38	- 38	- 38	- 38
Pensions	+ 1	+ 4	+ 8	+ 12	+ 15	+ 30
Lump sums	+ 6	+ 12	+ 12	+ 12	+ 12	+ 12
Overtime	+ 15	+ 15	+ 15	+ 15	+ 15	+ 15
Refunds	+ 1	+ 4	+ 6	+ 7	+ 8	+ 8
Saving (-) or increase (+)	- 19	- 5	+ 3	+ 8	+ 12	+ 27
Offset by non-pensionable London Weighting	- 3	- 6	- 8	- 9	- 11	- 20
Net saving(-) or increase (+)	- 22	- 11	- 5	- 1	+ 1	+ 7

Presentation

9. The Scott report drew attention to the complexity of the arrangements under which civil servants now pay for their pensions, and the misunderstanding to which this gives rise. The introduction of a fully contributory scheme would have important presentational advantages. The public confusion surrounding the present arrangements would be dispelled, and civil servants would be clearly seen to be paying a pension contribution about twice the private sector average. In the short term, however, the change would need to be carefully presented, for though it would not involve an increase in public expenditure, the higher gross pay could be misrepresented as a pay increase and pensions would be seen to be bigger. It might appear, therefore, that civil servants were paying with one hand and receiving back rather more with the other. The likely effect on national earnings statistics would also need careful consideration.

10. It might therefore be advisable not to make such a change at the same time as an annual pay settlement, to avoid the impression that pay was being further increased. However, for administrative simplicity a pay settlement date might be preferable, in particular the first which followed the introduction of a new pay system arising out of the Megaw Inquiry. At such a time it would also be easier for serving civil servants to accept the cut in net pay that would result from changing to a fully contributory scheme. Decisions on such matters would not, however, be required for some

time after a decision in principle had been taken to make the change. That decision would imply willingness to face the short term presentational problem for the sake of the long term gain and the secure knowledge that proper payment was being made for pension benefits.

ANNEX D

SCHEME FOR EMPLOYEE CONTRIBUTIONS MADE VARIABLE TO REFLECT NON-FULFILMENT OF ACTUARIAL ASSUMPTIONS

The actuarial approach which underlies Course A is forward-looking: it uses assumptions for the future in order to determine a contribution, appropriate to a "new entrant", which is then applied to all currently in service. Any systematic under - or over - provision (if it is believed to be a continuing one) can be corrected in the case of future new entrants, and partially corrected in the case of those with some time still to serve. But, in general, by-gones are by-gones and any miscalculation eventually affects the employer. Course B, on the other hand, ties the cost of pensions (at least in so far as inflation is concerned) back to the reality of emerging costs and adds a consequential charge to contributions - but that leaves each generation paying on behalf of its predecessor a contribution which might be inappropriate for its own pensions.

2. There would be attraction, if it could be worked, in an actuarially-based scheme in which the fulfilment or otherwise of assumptions is regularly and automatically checked and inadequate or excessive employee contributions are corrected on a basis which adjusts for the past as well as provides for the future. There would still be some rough justice between past and present employees; but such a system would come as close as practicable to ensuring that individuals pay a proper share (however that may be determined) of the value of their pension rights.

3. The simplest route to this broad result is notional funding, with deficits being recovered (or surpluses remitted) over a short period of years through changes in contribution rates.

4. The NHS and teachers schemes are notionally funded, but on a different basis. They are deemed to be invested solely in fixed interest securities, and the funds do not bear the cost of pensions increase. The funds determine contributions from employers but not from employees. The local government scheme is actually funded but, again, the fund does not bear the cost of pension increases.

5. It would be possible to change the way in which these three schemes operate, so as to approximate to what is described in paragraph 2, and to constitute other public sector

schemes on this basis. But in administrative terms it would be a bigger undertaking than other courses discussed in the report. And various aspects of the reform would be contentious, difficult to negotiate and probably complex in terms of legislation. Some particular difficulties are discussed below:-

(a) In order to assess the existing and accruing liabilities of a pension scheme, data are required about the scheme's members and pensioners, particularly statistical breakdowns by age, marital status and sex. In addition, for scheme members only, details would be needed of length of service and, at least initially, contributions paid. It would also be necessary to know about entitlements under the state scheme. Some of this information is not currently available; some of it is available only in inappropriate form.

(b) Decisions would be needed on the notional investment portfolios. This has caused controversy in the teachers' scheme, which would be intensified when pensions increase became a liability of the notional fund and employee contributions made dependent on fund performance. To invest notionally in fixed interest Government stock, as with the existing notional funds, would be untenable. Staff might expect investment exclusively in index-linked stock; but this would imply notional investment exceeding the total quantity of index-linked stock available to other investors. It would be practicable, and more realistic, to base performance on that of actual pension funds; but unions might not be satisfied with this.

(c) When the scheme was working, there would still be problems in deciding the allocation of surpluses/deficiencies as between employers and employees. It would be difficult to treat differentially divergencies which arose from changed assumptions on inflation or real interest rates as against those related to, say, withdrawal rates; any attempt to do so might require the operation of two notional funds for each scheme, one reflecting actual experience and the other "normalised" in relation to any factors not to be reflected in changed contributions. Probably it would be necessary to agree in advance with staff interests on a standard division of pension costs and to apply this to the treatment of surpluses and deficiencies in the notional fund. Agreement would not be easy to reach or maintain.

(d) It would be necessary to decide how rapidly corrections should be made. The actuarial assumptions to be used would be applied to a long range of future years. Quite small changes in, for instance, the postulated real rate of return could throw up deficits or surpluses which, if corrected over a short run of years, would result in sharply varying contributions; if the correction were spread over longer periods, a bigger discrepancy would arise between the expected value of benefits and the contributions made towards them, and to that extent the scheme would fail to meet its object.

(e) It would be difficult to start any new notional fund on any basis other than wiping the slate clean in respect of any possible surplus/deficit derived from the past; we are advised that it would be impossible to create a fund retrospectively. The presentational problem would be greatest in the case of existing notional funds: additional notional assets would have to be credited to them in order to balance the new liabilities for pensions increase which the funds would be taking on.

(f) A scheme of this kind is more appropriate to a system of pay comparability than standing on its own. All systems need a starting point, which for the civil service has been provided by the pay research analogues. For other services (and perhaps for the civil service in future) contributions to free-standing pension schemes are more arbitrarily determined, whereas an actuarial approach towards varying contributions presupposes more objective justification for the basic level.

(g) In the case of the teachers and local authorities, the incorporation into funds and notional funds of liabilities for pensions increase and contributions towards these would shift the financial balance between the employers and the Exchequer. The general reconstruction of public service pension schemes would need to take account of this.

6. A refinement intended to reduce the rough justice in Course B, and create an employee pension contribution which is variable on an actuarial basis in relation to past experience as well as to future expectations, would thus not be a simple one. It would be a novel principle in pension practice (private or public) and require substantial changes in the constitution of all public service pension schemes.

ANNEX E

01-405 7641 Ext. 3020

Communications on this subject should be addressed to
THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

24 September 1981

P V Dixon Esq
HM TREASURY
Parliament Street
SWI

Dear Dixon,

REPORT ON THE VALUE OF PENSIONS: BENEFIT OPTIONS

I have been asked by the Attorney General to give his views on the matters referred to him which are within the purview of VP.

2. It is an essential feature of the proposals under consideration that there would be a worsening in the pension arrangements for public sector workers; this is to be either in the form of a cut-off point beyond which index-linking of benefits will no longer apply (Course C) or in a new discretionary power to abate increases (Course D).

3. As a matter of general principle, whilst Parliament is competent to do it, no Government should take away from its employees without adequate compensation any legal rights which have vested in them and bear a monetary value. There are two perspectives from which any proposal which might infringe this principle must be viewed. The first is that of UK domestic law, namely whether there are any existing legal rights which could now be enforced in the UK Courts. Secondly, there are the obligations of a High Contracting Party to the European Convention on Human Rights, which may be the subject of proceedings first in the European Commission of Human Rights and subsequently in the Court.

4. The Attorney General has been able to study the pension arrangements for civil servants under the legislation and the Principal Civil Service Pension Scheme. He advises that whether or not there is any contractual entitlement to a pension (upon which it is not necessary for him to express a view) civil servants have no contractual right to pension increases. Pension increases are governed by statutory provisions which may be changed without giving rise to any claim in contract. He also considers that civil servants who have transferred in pension entitlement from previous employment or who have purchased added years are legally in no different a position.

/5. Accordingly,

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ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

5. Accordingly, in relation to the Civil Service, there is no legal right recognised in the UK Courts which should restrain the Government from proposing legislation to remove or reduce the index-linking of benefits. However, in the Attorney General's view Ministers should give serious consideration before formulating their policy to whether one particular class of civil servant or pensioner has a valid moral claim to be safeguarded against its effects. This is the class of those who have purchased added years at a price which includes an element in respect of the index-linking of benefits, if those benefits are to be materially worsened. In his view:-

(1) such persons should be compensated by the return of a proportion of the amount they have already paid, in making a specific election to buy added years, for a benefit which will have fallen in value owing to the policy - this despite the fact there will be an element of arbitrariness in any scheme for determining the amount payable as compensation;

(2) those still paying on a periodical basis at the time the legislation comes into force should have the right to cease participating and be credited with years of service by reference to the amount of their contributions to date; and

(3) for those who elect to continue, there should be a reassessment of the level of their payment for the added years which would reflect the alteration in the value of their pension.

(1) above applies equally to those who have transferred previous pension entitlements into the PCSPS, and for whom the number of years to be credited has been assessed by reference to the index-linked nature of civil service benefits.

6. Article 1 of the 1st Protocol to the European Convention on Human Rights provides that "no one shall be deprived of his possessions except in the public interest and subject to the conditions provided by law and by the general principles of international law". This is, in effect, a guarantee against deprivation of property without payment of full compensation. The term "possessions" has been interpreted as

/covering

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LONDON, W.C.2.

covering any property right or interest including pension rights, at least if they are of a contractual nature.

7. The Attorney General considers that there is a real risk of proceedings under this Article being instituted by an aggrieved civil servant or pensioner. If it were, our possible defences would include the arguments that the "right" to pensions increases, being non-contractual, did not fall within the Article at all; that the Government's decision that the action was required "in the public interest" was within its legitimate margin of appreciation; and that the obligation to pay compensation, deriving from the reference to "the general principles of international law". does not bind a State in respect of its own nationals. The Attorney General considers that the first of these arguments stands a reasonable chance of being successful and that the second is even more likely (though not certain) to succeed: but the third, which we are already advancing in other current cases, may well be rejected.

8. On balance, the Attorney General considers that our chances of eventually deflecting a challenge under the Convention are better than even but that the risk of an adverse finding is not negligible. Naturally, the degree of risk will be affected by the severity of the option chosen. The Attorney General also wishes to point out that, in the two "special cases" referred to in paragraph 5 above, the existence of safeguards on the lines he has proposed would tend to strengthen the Government's position before the Court.

9. Since he has not been provided with any information the Attorney General has not been able to consider the details of any other public sector pension arrangements (all these were within the terms of reference of the Scott Committee and of VP). Where other groups of public servants have no contractual right to pensions increase (either because this depends entirely on Statute or upon the terms of a scheme which is freely amendable), the same principles as above are likely to apply.

10. However, the Attorney General notes from Table 5 in Appendix 3 to the Scott Committee Report that in relation to various public sector pension schemes (including, for example, those of the Post Office, British Steel and London Transport, a total of 622,000 employees) benefits are inflation-proofed

/under

01-405 7641 Ext.

Communications on this subject should be addressed to
THE LEGAL SECRETARY
ATTORNEY GENERAL'S CHAMBERS

ATTORNEY GENERAL'S CHAMBERS,
LAW OFFICERS' DEPARTMENT,
ROYAL COURTS OF JUSTICE,
LONDON, W.C.2.

under the rules of the scheme and are not linked to the Statute. Legislation which sought to extend to these schemes would be highly complex and different in nature from a straightforward amendment to the pensions increase legislation such as would be needed for the civil service. Moreover, if there are contractual rights in any of these cases to pensions increases (and the rules may contain provision against worsening) the Attorney General considers that legislation designed to override these rights without adequate compensation would carry a greater risk of the Government's being held to be in breach of the provisions of the European Convention referred to above.

11. Finally, the Attorney General wishes to re-emphasise that the problem must be seen in the broad context of <u>all</u> public sector schemes, whereas his legal advice is necessarily restricted to the civil service scheme. Presumably any decision by Ministers to change the position adverseley would have to be "across the board" of the public sector in order to be acceptable politically. But Ministers must, in the Attorney General's view, be made aware that (a) the legislation would be extremely complex and take some time to prepare; and (b) in respect of other parts of the public sector could involve more substantial difficulties of legal principle, and in proceedings before the European Court. This in turn might suggest that a fully comprehensive scheme should not be embarked upon.

12. I am copying this letter to John Catlin (Treasury Solicitors), R B Saunders (CSD) and W Moyes (Cabinet Office).

Yours sincerely,

Laurence Oates

LAURENCE OATES

ANNEX F

RESTRICTED

NATIONALISED INDUSTRIES' CHAIRMEN'S GROUP

Observations on the Scott Report
on Index-Linked Pensions

1. The Nationalised Industries' Chairmen's Group wishes to present its observations on the Report of the Scott Inquiry into the value of index-linked pensions, (Cmnd 8147).

SUMMARY

2. The whole complex of pension-cum-pay arrangements existing in the public sector industries differs very substantially from the overall pattern existing elsewhere in the public sector (paras 3-9 below). As a result it would neither be desirable, nor indeed practicable, to include the public sector businesses directly within the scope of any legislative action which the Government may take regarding changes in index-linking arrangements in the public services (para 10 below). However, the Chairmen's Group accepts that individual Corporations could reasonably be requested to examine their present index-linking provisions if the Government and Parliament were to alter the arrangements currently operating in the rest of the public sector, (see para 13 below). Indeed, for the majority of the Corporations, there could be an automatic impact if the Pensions (Increase) Acts were to be amended in certain ways, (para 12 below).

DIFFERENCES IN PENSION AND PAY ARRANGEMENTS

3. NICG submitted a substantial memorandum of evidence to the Scott Inquiry providing information and comment on aspects of the pension arrangements in the public sector industries of common concern to all or most Corporations. In addition, further detailed information was provided by individual Corporations, either directly to the Scott Inquiry or through their sponsor Departments and the Civil Service Department. For convenience, a copy of the factual Appendix to the NICG evidence is attached to this submission.

4. Two main features stood out from this evidence:-

a. the Corporations' pension arrangements differ considerably from those in the public services, in a number of major respects; and

b. pension arrangements differ appreciably from Corporation to Corporation.

5. With regard to the general shape of pension arrangements, there are two fundamental differences between the position in the public sector industries and that in the public services:-

a. The Corporation's schemes are almost all operated on a contributory basis, whereas public service schemes are mostly operated on a non-contributory basis.

RESTRICTED

b. The Corporation's schemes are almost always operated on a "funded" basis and subject to actuarial valuations, (ie the expectation is that payments to their pensioners will be financed from the returns on their accumulated funds), whereas public services schemes are normally operated on a "pay as you go" basis, (ie the payments to their pensioners are financed by calls on the public purse).

In addition, there are a number of other technical differences in the operation of the schemes which have a substantial impact on individual pensioners: eg the public service schemes are more favourable both in terms of the nominal pensionable age and in relation to the account taken of entitlement to the State pension.

6. With regard to the arrangements for the index-linking of pension benefits, a further basic difference exists. Whereas the public services arrangements are governed by Statute, such statutory guarantees exist in only two cases in the public sector businesses. In all other cases, the provision made for some degree of index-linking stems, in effect, from understandings of some sort between the Corporations concerned and their employees/Unions, which have subsequently been incorporated in the rules of their pension schemes. How far this process would be reversible if a Corporation wished to reduce index-linking benefits will depend in part on whether the formal provisions governing the amendment of the rules of its pension scheme allow the Corporation concerned to act unilaterally, or whether they require the agreement of the Trustees and/or members. Be that as it may, however, there is also the practical consideration that, whatever the rules may say, the Unions concerned would certainly expect to be consulted in advance about any reduction in benefits, and could be expected to oppose them strongly.

7. That point leads on to a still-wider difference between the public services and the public sector businesses, viz the ways in which pensions issues are fitted into the whole complex of decisions about the "total remuneration package" of employees. The Civil Service has traditionally tended to determine pay levels on the basis of elaborate comparability exercises; and they have then worked out offsetting deductions for advantages enjoyed in areas such as non-contributory pensions, guaranteed index-linking, greater job security, etc by means of other highly formalised procedures. The public sector businesses, on the other hand, have traditionally determined the total remuneration package, and settled the balance between pay, pensions and other elements in that total package, in much the same way as applies throughout industry as a whole, ie by means of "trade offs" negotiated on an ad hoc basis.

8. Thus, if the Government were to decide on a new method of appraising the value of index-linked pensions for public service employees, there is no way in which an exactly comparable adjustment could be made to the individual Corporations' pay/pension arrangements. For reasons already exposed, the two situations are entirely different. At most, the Corporations could only attempt to follow suit indirectly, either by seeking to increase their employees' pension contributions, or by seeking to restrain their next pay increase, or some combination of both. Whether such action would succeed would depend essentially on the Corporations' negotiating strength vis-a-vis their Unions at the particular point in time; and that issue would be unlikely to be influenced by nice actuarial calculations of the value of index-linking.

POLICY IMPLICATIONS

9. The Chairmen's Group hopes that, when the Government comes to consider what stance it should take on the Scott Report, two matters will be borne particularly in mind with regard to the position of the Corporations:-

a. Firstly, it should be recognised that, whereas the Government is the direct employer in the case of the public services, this is not the case of the public sector businesses.

b. Secondly, full account should be taken of the point demonstrated in paragraphs 3-8 above, viz, that there are very considerable differences between the public services and the Corporations, both as regards their pension arrangements and as regards the ways in which those pension arrangements impact on pay settlements.

Accordingly, the Chairmen's Group believes that the Government should consider the position of the Corporations quite separately from that of the public services. Such a course would be wholly in line with the statement by the Scott Inquiry that its findings were to be regarded as ones applicable to "all areas of the public sector where pay is determined by comparability exercises", (Report, para 11) - a formulation which effectively left the Corporations aside.

10. The Chairmen's Group recognises, however, that the provisions now made for the index-linking of pensions in the public sector Corporations could not simply continue unquestioned if Parliament were to make significant changes in the arrangements currently operating elsewhere in the public sector. Indeed, the sentence from the Scott Report quoted above as justifying the exclusion of the Corporations from the direct scope of any Government decisions goes on to recommend that, "in areas of the public sector where comparability exercises are not used, the pay negotiators ought to draw on our findings to assess whether proper account is currently being taken of differences in pensions in their arrangements", (Report, para 11).

11. To a considerable degree, such a review would occur automatically in the event of a significant change in the public services' index linking arrangements. Out of 31 pension schemes in 19 Corporations, 24 provide for increases in line with those guaranteed to retired public servants under the existing provisions of the Pensions (Increases) Acts, and so would be directly affected by any amendment of those Acts which had the effect of limiting the size of the increases granted. Most of the other 7 schemes provide for increases calculated by direct reference to the Retail Price Index; and in these cases, revision would not be automatic. However, the Corporations concerned would naturally tend to review their situation if the benefits hitherto granted to other public sector employees were limited in a way which left their own pension benefits at an exceptionally favourable level in relative terms.

12. Despite this assurance of more-or-less automatic action, it may be that the Government will still wish to draw its decisions on index-linking arrangements in the public services to the attention of the Corporations. In this event, the responses of the Corporations would, of course, be a matter for individual decisions, and not for the NICG collectively. For its part, however, the Chairmen's Group takes the view that Corporations could reasonably be expected to agree to examine their present index-

linking provisions if the Government and Parliament were to alter the arrangements currently operating in the rest of the public sector. As already noted in paragraph 6, however, any such reviews of pension arrangements - and hence of the associated pay arrangements - would have to be made in conjunction with the Trustees of the pension funds concerned, and with employees and their Unions.

13. So far, this memorandum had focused on the possibility that the Government may favour changes in the present arrangements for index-linking in the public services which would reduce the present benefits to some extent. It must be borne in mind, however, that this is not the main thrust of the Scott Report. Its central conclusion favours a wider extension of the principle of index-linking, with the Report declaring it to be "a highly desirable social objective that the standard of living of those in retirement should be protected", (para 6). And as to the mode of progression towards that objective, the recommendations of the Report place less stress on "levelling down" the benefits currently provided in the public sector than on "levelling up" the benefits currently provided in the private sector where, though about two-thirds of all the larger employers are now awarding pension increases covering a significant proportion of the increases in living costs, the Scott Report states roundly that, the general pattern is "not good enough", (para 41).

PRIME MINISTER

MEETING WITH THE CHANCELLOR: 2 DECEMBER AT 1730 HOURS

We have suggested two issues which you would raise with the Chancellor tomorrow afternoon - Index Linked Pensions and Interest Rates.

Index Linked Pensions

The Chancellor is thinking of both increasing contributions and reducing benefits at the same time, in the face of opposition from a number of colleagues. You have his draft E paper and two notes from John Vereker.

Interest Rates

In the face of recent events in the money markets, there seem to be two courses of action which could be followed. One would place very great emphasis on sterling M3 of which bank lending is at present a massive component (£2¾ billion estimated for banking October). This school of thought would argue that, in order to keep sterling M3 within or near the target range, we should overfund, and spin out any reduction in short-term interest rates. The other school of thought argues that our rates are suddenly high in relation to international rates, and that the evidence of the narrower aggregates together with the exchange rate suggests that monetary policy is tight at present, notwithstanding the behaviour of sterling M3. We should therefore aim to speed up a reduction in bank base rates, and reduce the centre of the undisclosed interest rate band from 15 to 14 per cent (i.e. a base rate reduction of probably 1 per cent by the end of this week).

The latter school of thought includes Messrs. Bruce-Gardyne, Burns and Middleton. The Chancellor has not yet accepted their recommendation. You have Alan Walters' note arguing in favour of the Burns/Middleton school of thought.

/One or two points

One or two points which you may like to bear in mind on these issues:

(a) By edging down interest rates we will avoid the charge that we are deliberately acting to keep up the exchange rate and interest rates. (It is unlikely that the exchange rate would fall as a result of such a reduction.)

(b) The degree of departure from a sterling M3 target implicit in the Burns/Middleton view may well cause some embarrassment vis-a-vis the MTFS, and in due course it may, presumably, be necessary to put some other target or targets in place.

I know of no points which the Chancellor wishes to raise.

MCS

1 December 1981

Econ Pol

cc Mr. Wolfson
Mr. Scholar
Mr. Duguid
Mr. Vereker

MR. HOSKYNS

INDEX-LINKED PENSIONS: FOLLOW-UP TO THE SCOTT REPORT

CHANCELLOR'S MEMO TO THE PRIME MINISTER, 27 NOVEMBER 1981

1. The Chancellor broadly suggests that the public sector should be brought more closely in line with what happens in the private sector so that he suggests a combination of a reduction in benefits and an increase in contributions. This, it is thought, will take some of the sting out of the criticisms that the public sector is getting away with conditions which are better than the average in the private sector.

2. I suspect that the Chancellor's approach is too rigid. It will incur both obloquy and opposition from interested parties. They will argue they are being squeezed at both ends.

3. My objection to the Chancellor's proposal is, however, rather different. I believe strongly in the principle that people should be able to buy as much indexing as they like, provided they pay the market price for it. There should be a choice of the degree of indexing of pensions and this should be reflected in the contribution. After all, we are a Government who believe in choice and surely we should allow choice in the public sector, and indeed encourage it in the private sector. In the latter, of course, there is already some choice in so far as firms have very different arrangements and one can choose when one negotiates for a job.

4. If we have a good indicator of the cost of inflation-proofing then, at the simplest level, we could offer a pension arrangement that is completely inflation-proof, costing say 7% of salary, and another pension proposition which is, let us say, inflation-proof only up to 5%. This latter might cost only, say, 1 or 2% of salary. There are in principle a wide variety of options which can be offered. Then the employee can pay his money and take his choice.

/5. It may be

It may be argued against this that it is difficult to find an appropriate price of index-linking. I doubt that this is the case. We have restricted index gilts which have some sort of market, and its likely that some more index gilt issues will appear, either indexed or non-indexed. There are also likely to be indexed issues in the private sector from which one can calculate real rates of return.

6. As well as expanding choice, this sort of system would more nearly approximate to conditions in the private sector. There variety reigns. If we do not provide variety in the public sector, this will be less attractive than if we do. (Again, provided as always we charge the true cost of the arrangements.)

AW

1 December 1981 ALAN WALTERS

CONFIDENTIAL

cc: Mr. Hoskyns

MR. SCHOLAR

Public Sector Pensions

I do not wish to add unnecessarily to the papers the Prime Minister has to look at on pensions; I understand from you that she has seen my note of 24 November, but that she will only see this evening the Chancellor's note of 27 November to which is attached his draft E paper and the full report by officials. Perhaps I could offer just three short comments on the Chancellor's E paper:

1. The Chancellor appears to be led to the conclusion that action must be taken on benefits as well as contributions, from his assertion (paragraph 5) that "our aim should be to reduce the unevenness in the present situation by bringing the public sector more closely into line with what happens in the private sector". I think the Prime Minister may want to look closely at this premise. First, since all are agreed that the cost of pensions should be greater for public servants who have some inflation proofing, there is no reason to suppose that the benefits ought also to be the same. Second, if there is to be a reduction in the "unevenness", many people argue that the move should be towards maintenance of real value of pensions rather than away from it.

2. The Chancellor suggests that we should introduce legislation in 1982, to take effect in 1983-84. Clearly the room for such legislation in the timetable, and the desirability of it becoming effective in 1983-84, are points the Prime Minister will need to consider carefully.

3. The Chancellor proposes that a consultative document be issued setting out his proposals. Since they would have a significant downward effect on real wages in the groups affected, on top of the effects of this week's announcements, it must be expected that there would be some adverse feedback in pay bargaining.

J.

John Vereker
30 November 1981

CONFIDENTIAL

We can't increase contributions any reduce benefits at the same time and

cc JV AD AW

(2)

Prime Minister

You are going to discuss with the Chancellor at 5.30 on Wednesday. John Vereker's note at flag A makes 3 criticisms of the Chancellor's approach.

MLS 30/11

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

INDEX LINKED PENSIONS : FOLLOW-UP TO THE SCOTT REPORT

At the meeting of E Committee on 15 July (E(81)24th Meeting), I was asked together with the then Lord President of the Council to arrange for the Official Committee on the Value of Pensions to make their report by the end of September, and to make recommendations as soon as possible thereafter.

2. We have now prepared within the Treasury a paper making such recommendations, which I propose now to circulate to E Committee together with a copy of the Official Committee's report. I understand that E will on present plans be taking this issue on 10 December.

3. I thought you might wish to see a copy of my paper before it issues because of the political controversy it is likely to give rise to.

4. The main difficulty is whether we take action on the levels of benefits as well as on contributions. I feel we must act on both, not least because most of the public complaint is directed at the fact of full index linking, rather than at under contribution. However there is no doubt - and Barney Hayhoe I know feels this strongly - that action on the level of benefits will be politically very controversial.

5. I have of course consulted Janet Young on this subject, and she has seen both the latest draft and earlier drafts of

/the paper

CHANCELLOR OF THE EXCHEQUER

the paper. We have agreed that it would not now be appropriate for it to be circulated as a joint paper.

6. I would be grateful to know whether you are content for me to circulate the paper as it now stands.

G.H.

(G.H.)

27 November, 1981

E(81)119
24 November 1981 COPY NO.

CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

INDEX-LINKED PENSIONS: FOLLOW-UP TO THE SCOTT REPORT

Note by Chancellor of the Exchequer

Introduction

E Committee last considered this on 15 July (E(81)24th Meeting) and concluded that:

a. the assumption should be that any changes made would apply to all public sector groups with index-linked pensions;

b. any legislation would have to be taken through Parliament in the 1981-82 Session (with consideration being given to use of the 1982 Finance Bill); and

c. the options to be examined for the final round should be:

- Option A: a straight increase in contributions to a unified level of 9 per cent or 10 per cent;

- Option B: leaving the existing contribution structure broadly unchanged but levying in addition a specific charge for index-linking related to its current cost and private sector practice;

- Option C: an automatic cut-off on the degree of indexing in any year;

- Option D: a discretionary power, subject to Affirmative Resolution, to increase pensions by less than inflation in any year.

2. The report by the Official Committee on the Value of Pensions (attached as Annex B), examines these options in the light of our earlier comments. A public statement is expected of us soon and we now need to reach agreement on what to do.

General approach

3. In deciding what to do it is important to look at the problem in the wider context of pensions generally - in the private as well as the public sector. There is serious doubt whether the present level of benefits in the private sector can be funded without serious detriment to the financial position of many of the companies concerned. It is likely, too, that the cost of the earnings-related element in the National Insurance pension will impose very considerable financial problems in the years to come. Public concern is already being expressed about these matters. The forthcoming reports of the Government Actuary on the quinquennial review of the State scheme and on contracting out will focus further attention on the matter. It may be necessary to consider the structure of benefits as well as of contributions and we should take care to ensure that the action we took on public sector pensions should not appear to be inappropriate in the wider context.

4. In the matter of pensions, as in other things, inflation has produced injustice. The effect of inflation has been to lighten the

real burden on private sector employers of providing pensions, because for the most part they do not give full indexation; at the same time, it has reduced the value of those pensions. By contrast, the burden of maintaining pensions in the public sector has not changed in real terms - and has thus increased relatively; but this burden is carried by the community as a whole, mainly through taxation. Nor have public sector pensioners suffered from inflation in the way that most private sector pensioners - and many others - have.

5. In the private sector practice varies considerably. At one extreme, there are those who have pension rights in money terms and get little or no adjustment for inflation; at the other extreme, there are some who do get full inflation-proofing in practice, though without any formal right to it. The majority lies somewhere between these two extremes. Our aim should be to reduce the unevenness in the present situation by bringing the public sector more closely into line with what happens in the private sector. Since the cardinal difference between public and private sectors is the guarantee of index-linking, this leads me to the view that, whatever we do on contributions, some action on benefits should be a part of the package.

Benefits

6. The Official Committee identified two broad approaches towards limiting inflation-proofing. The first (Option C) involves an automatic cut-off (the precise formula could be defined in many ways). The aim would be that, once set, the formula might avoid the difficulty of an annual decision. On the other hand, however it were devised, its automatic operation would be bound to seem inappropriate in some years, and pressure would mount for further ad hoc increases. There is therefore a case for introducing an element of discretion. The alternative approach (Option D) would leave the existing legislation largely unchanged but with a discretionary power to break the index-link in any year. This mightseem less alarming to pensioners. It would cause difficulty only in years when the power was exercised, and it would be possible to deploy specific arguments about the circumstances then

prevailing. However I myself doubt whether it goes far enough and would prefer a clear ceiling modified by discretion to go beyond that.

7. It is a matter of debate where the ceiling should be set. Most private sector schemes guarantee as little as 3 per cent to 5 per cent. At the other extreme, 10 per cent (as envisaged in the official report) would be little more than window-dressing if we genuinely expect to reduce inflation. I would recommend 7 per cent with, as I have said, discretion to go above that. The new system should apply to benefits for past as well as future service. We may face charges that we are acting retrospectively to deprive people of accrued rights; but, as I understand the position (Annex E to the official report), it should be possible to rebut this.

<u>Contributions</u>

8. Against this background, it is necessary to decide what would be a reasonable contribution regime. It is relevant that most public servants pay less for their pensions than civil servants, although they pay by actual contributions, whereas civil servants pay through adjustment of their salaries. There is a correspondingly strong case for increasing the generality of contributions; and this will being substantial benefits in terms of public expenditure. What is needed is a system of contributions which is publicly defensible, demonstrably linked to the cost of pensions increase; and applicable on broadly similar lines to all the public services.

9. There is no objective way of establishing a right figure, particularly on a forward-looking actuarial basis (as discussed in the report's Option A). In my view, action on the lines of Option B best meets the criteria in paragraph 8. Under it existing levels of contribution for basic benefits would be left unchanged and a special charge based on the cost of public service pensions increase in excess of the private sector average would be levied. The Government's stance should be that there should be no offset to the new charge through higher pay.

10. On current estimates, though these need refining, the result would be that most public servants would pay a total pension contribution of 8½ per cent (6 per cent for basic benefits and a 2½ per cent special charge for pensions increase). The special charge, and hence the total, would vary with variations in the relative generosity of pensions increase in the public and private sectors. How far the uniformed services could be fitted into such arrangements needs further consideration.

Financial effects

11. The financial effects of acting on contributions and benefits are significantly different. Increasing contributions as in Option B should produce savings of between £300 million and £600 million a year depending on what is assumed about the effect of the change on pay negotiations. Action on benefits, on the other hand, would have to be severe to produce anything like comparable figures - curtailment would yield about £30 million p.a. for each percentage point of shortfall below full indexation. These figures cannot be added together because curtailing benefits would also have the effect of reducing the savings generated by Option B (which are calculated to equal the differences in inflation-proofing between public and private sectors).

The Civil Service

12. At present the deduction from civil servants' pay rates is regarded - at least within the service - as meeting the cost of their better inflation-proofing. To impose in addition a "special charge" of 2½ per cent or so for index-linking could lead to an immediate demand from the civil service unions that pay rates should be increased to offset it. In that event, the Civil Service would contribute no more than it does at present. Since much of the public criticism has focussed on the Civil Service this poses a problem. There is a strong case for making the 2½ per cent contribution specifically deductible to preserve uniformity throughout the public services. On the question of whether or to what extent we should be prepared to accept a consequential adjustment of pay rates, at one extreme we could argue that no adjustment should be made on the grounds that until Megaw

reports there is no agreed basis on which future pay rates should be set; at the other extreme is full adjustment. In my view, if we accepted any adjustment at all, we should negotiate for less than 2½ per cent on the grounds that the Civil Service is currently paying too little for its pensions.

Making the Civil Service Scheme formally contributory

13. Under the proposal discussed in the previous paragraph, the Civil Service would be paying actual contributions of only 1½ per cent for family benefits plus the 2½ per cent special charge, a total of 4 per cent while most of the public services would be paying 8½ per cent. This would cause widespread public misunderstanding, even if a significant further adjustment to pay rates were being made. More important, if a looser form of pay determination results from the Megaw Inquiry, a fully contributory scheme will be the most effective way of ensuring - and demonstrating - that civil servants are paying a proper pension contribution. There is therefore a case for making the Civil Service scheme specifically contributory. Since pensions would then be based on the grossed-up salaries they would be somewhat higher in future; by itself this would result in a "windfall" for those already in the scheme - this could be avoided by splitting pensions and making service before the change eligible only for pensions on the old basis, whereas future service would qualify for the new basis; meanwhile civil servants would be paying for the improvement through a continuing reduction in net pay, which in the early years would more than offset any additional cost.

Groups covered

14. The earlier decision was that changes should apply to all public sector groups. Effectively, however, we can enforce a decision directly only on the public services and even then there are difficulties. Short of taking new statutory powers, we cannot compel the nationalised industries to come into line; and even then there would be problems. But we would hope that we could persuade them to do so, as suggested in the official report; and the tax law might be amended to make them, and indeed the private sector, more willing to do so.

Legislation

15. The provisions required to give these recommendations effect cannot be included in the Finance Bill. Separate legislation will be needed. It would be short but probably contentious. This will create difficulties for the Parliamentary timetable.

Consultation

16. We are committed to consultation with both employers' and employees' organisations. This should be on the basis of clear proposals. Once a decision is made, the consultation document should be drafted urgently with a view to early publication and legislation next year.

Conclusions

17. [~~I have consulted the Chancellor of the Duchy of Lancaster - and we are generally agreed on this presentation of the issues~~]. My [~~own~~] conclusions are as follows:-

(a) We should act on both benefits and contributions. On benefits, we should give full inflation-proofing up to 7 per cent, and have discretion to go further. This approach would apply to benefits for past as well as future service.

(b) On contributions, I recommend Option B.

(c) The Civil Service should pay the "special charge" for pensions increase under Option B and we should resist claims for compensation through higher pay; and we should aim to make the scheme fully contributory and consult the unions (but without commitment at this stage).

(d) We should bring pressure on the nationalised industries to come into line with the treatment of pensions increase and to raise employee contributions; the tax law might be amended with a view to increasing this pressure on nationalised industries and more generally.

(e) We should issue as soon as possible a consultative document containing our proposals.

(f) We should introduce legislation in 1982 to take effect in 1983-84.

H.M. Treasury (G.H.)
24 November 1981

PUBLIC SECTOR PENSIONS

Public Service	Pensioners, 000			Cost of pension * benefits 1981/82 £m	Cost of 1981 increase £m	Average pension after 81 increase £ pw	Average increase £ pw
	Retired	dependants	total				
Civil Service	290	94	384	£ 960m	£52m	£32.60	£2.60
Armed Forces	226	55	281	£ 600m	£40m	£33.80	£2.70
Teachers	173	10	183	£ 780m	£44m	£58.60	£4.60
NHS	174	31	205	£ 540m	£30m	£36.40	£2.80
Local Government	289	67	356	£ 700m	£37m	£25.70	£2.00
Police/Fire	69	32	101	£ 300m	£19m	£44.20	£3.60
Overseas	44	13	57	£ 120m	£10m	£40.30	£3.40
Total Public Sevices	1265	302	1567	£4000m	£232m	£35.80	£2.80

*including lump sums; continuing pensions account for about ¾ of the figures.

TOTAL ACTUAL AND POTENTIAL PENSIONERS

	Pensions in payment million	Employees in schemes million	Preserved pensions million	Wives* million	Total**
Public Services	1.6	3.7	0.4	? 3.0	?? 7-8
Nationalised Industries	0.9	1.9	0.4	? 2.0	?? 3-4
Total Public Sector	2.5	5.6	0.8	? 5.0	??10-12

* based on numbers of male employees and pensioners (rounded down)

** allowance has to be made for double-counting - eg wives who belong to pension schemes themselves, or employees who have preserved pensions from other public sector schemes.

CONFIDENTIAL

OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS : PROGRESS REPORT

INDEX AND SUMMARY

Part A - Introductory — Page 1

The purpose of this progress report is to expose the issues raised by the Scott Inquiry and the index-linking of public sector pensions; to outline possible ways of dealing with them; and to secure Ministerial guidance regarding future work. In particular, guidance is sought on the objectives which Ministers wish to achieve and which of the possible courses of action we have identified they consider to be the most promising (paragraphs 1-3).

Part B - Scope — Page 1

Study should extend to the public sector as a whole, and not be confined to the Civil Service (paragraphs 4-6).

Part C - The Scott Inquiry and Related Issues — Page 2

Public disquiet has stemmed mainly from comparisons between public and private sectors created by indexation; and the cost of index-linking. So far as such points are well-founded, they do not necessarily entail that any action should be on the benefit rather than the contribution side; the Scott report was confined to the latter. Both types of action are considered in the report (paragraphs 7-10).

Part D - Pension Schemes and the Impact of Inflation — Page 4

The Scott report saw the preservation of the real value of pensions as a desirable social objective. It has never been the intention that pensions should be eroded with time: that is the fortuitous effect of inflation. For a variety of reasons inflation has affected public and private sector schemes differently. Assumptions for the future are needed as a basis for determining contributions to funded schemes and valuing the comparative benefits of pay-as-you-go schemes. Index-linked gilts, as well as helping to make indexed pensions practicable for schemes dependent on funding, will facilitate the valuation of indexed benefits; but they are not yet sufficiently established or widely available to provide solutions on their own (paragraphs 11-18).

Part E - Public Sector Pensions Schemes — Page 6

It is necessary to take account of variations within the public sector in the Government's responsibility for, and control over, pensions schemes; and in its financial involvement (paragraphs 19-21). Arrangements for negotiating pay are also relevant; again, they and the Government's role in them vary widely (paragraphs 22-24). Any new arrangements should be adaptable and easy to administer (paragraphs 25-26). There would be attractions in making the Civil Service and Armed Forces schemes formally contributory (paragraph 27). Changes in contributions and benefits could be related to each other for negotiating purposes, but ultimately the choice between these approaches is crucial both for individuals and for the Government (paragraph 28).

Part F - Possible Changes (Contributions) Page 9

It would be difficult to rely on more severe actuarial assumptions as the sole means of achieving substantially higher pension contributions (notional or actual); but the actuarial approach can be used to reinforce other approaches (paragraphs 29-35). It might be realistic (Course I - paragraphs 36-40) to aim at securing pension contributions in the public services of the order of 10 per cent (instead of the present 5-8 per cent). An alternative (Course II - paragraphs 44-46) would be to require a part of pensions increases (e.g in excess of average practice in the private sector) to be financed by employee contributions on a pay-as-you-go basis.

Part G - Possible Changes (Benefits) Page 15

Possible changes discussed are (Course III - paragraphs 48-50) purely discretionary increases; (Course IV - paragraphs 51-52) increases limited to average private sector practice, which would probably have to be estimated in arrears; (Course V - paragraph 53) increases paid from surpluses in real or notional funds; (Course VI - paragraphs 54-56) containing increases below a cut-off point fixed in advance; (Course VII - paragraphs 57-58) a power, presumably subject to Parliamentary procedure, to hold increases below the rate of inflation within some pre-determined limit; (Course VII - paragraphs 59-61) to give smaller increases to larger pensions; or (Course IX - paragraphs 62-64) to use an alternative index.

Part H - Financial Implications Page 21

The financial estimates are subject to heavy reservations and qualifications (paragraph 65). In the very long term, once benefits and contributions are in the right relationship, changes to one would be offset by changes in the other; but initially contribution changes are likely to be bigger in their effects. Whether the large immediate savings to be sought from higher contributions could be maintained would depend on pay determination systems and how they were operated (paragraph 66). The smaller initial savings from reduction in benefits could, in the case of the Civil Service, be more than offset for several years by associated reductions in employee contributions (paragraphs 67-69).

Part J - Future Work

The options need further study before final decisions are taken. It is desirable - and essential if early decisions are required - to narrow down their range. For negotiating purposes it is desirable to have available at least one benefit and one contribution option. We envisage further study of those underlined in the text of F and G above (paragraphs 70-72). This assumes that courses involving changes in benefits as well as those involving changes in contributions are acceptable; that changes should in principle affect at least all the public services alike, and not just the Civil Service; that any changes will have to be justified on reasonably objective grounds; and that there would not be reserved rights in respect of past service. These assumptions need to be confirmed or modified (paragraphs 73-74).

Annexes to the Report are also attached as follows:

A. Recommendations of the Scott Report

B. Details of Main Public Sector Pension Schemes

C. Private Sector Pension Schemes.

D. Pensions (Increase) Legislation before 1971

REPORT

A. INTRODUCTORY

1. We were set up with the following terms of reference.

"To examine the issues raised by the report of the Committee of Inquiry into the Value of Pensions under Sir Bernard Scott and report to the Chancellor of the Exchequer and the Lord President of the Council".

2. The Scott recommendations are summarised in Annex A. We have concentrated on those numbered 1-4. All relate to the valuation of pension benefits and to the way in which this is taken into account in determining pay (ie through contributions, whether actual or, as with the present Civil Service arrangements, through a reduction in gross salary), as was required by the Scott committee's terms of reference. We have not regarded ourselves as precluded by our terms of reference from examining courses of action involving possible changes in benefits as well as contributions, but we have done so only in the context of inflation-proofing and its cost; proposals which call in question the basic structure of public service pensions (e.g by changing the method of calculating basic benefits) we have treated as outside the terms of reference.

3. Our initial work has identified a wide variety of approaches to the issues. Therefore we ask Ministers for guidance concerning the objectives they wish to achieve and which types of approach they consider most promising. Possible courses of action then need to be worked out in greater detail for decision.

B. SCOPE

4. Although public discussion has focussed very largely on the Civil Service, the questions raised by index-linking do not apply solely, or even mainly, to the Civil Service. All public service pension schemes (indeed, nearly all public sector schemes) give index-linked benefits, but the Civil Service accounts for only 16 per cent of the total numbers. Annex B gives summary details of the main schemes involved.

5. Moreover, the Civil Service is virtually alone in having had a system of determining pay and pension contributions consistently taking formal and explicit account of the value of pensions, including index-linking.

6. Much of our work has been directed towards the case of the Civil Service, partly because Scott also concentrated on it, partly because the Government is directly responsible

as employer, and partly because, as with the setting up of the schemes in the first place, the Civil Service is perhaps the natural leader. There is, however, a strong case for applying the principles across most or all of the wider public sector, though it must also be borne in mind that Ministers do not directly control the terms of many such schemes.

C THE SCOTT INQUIRY AND RELATED ISSUES

7. The Scott Inquiry was set up in response to the following main points of public disquiet.

(a) It has been argued that the cost to public funds of index-linking pension benefits is excessive.

(b) It is sometimes argued that it is wrong in principle to index pay and related benefits, such as pensions, because indexation creates inflexibility and insulates those who benefit from it against economic circumstances.

(c) It may be thought unfair that members of public sector pension schemes should be assured that their benefits will be fully protected against inflation, whereas other people, e.g members of private occupational schemes or the self-employed, rarely enjoy protection on the same scale, and virtually never have an assurance of it.

8. In considering these arguments the following facts are relevant.

(a) In 1980-81 the total expenditure on Civil Service retirement benefits was about 17½ per cent of the pay bill, of which 11½ per cent was accounted for by basic benefits and 6 per cent by (cumulative) pensions increase. Corresponding figures in other services were local government 12½ per cent (8 per cent basic, 4½ per cent pensions increase); NHS 8½ per cent (5½ per cent basic, 3 per cent pensions increase); teachers 14 per cent (8 per cent basic, 6 per cent pensions increase). The variations between services are mainly a reflection of different ratios between pensioners and active staff.

(b) Private sector pension schemes are discussed in Annex C; most give some form of protection against inflation after retirement; and the State scheme provides protection in respect of the guaranteed minimum pension provided by contracted out pension schemes. Practice varies widely; but the Government Actuary's Department estimated in the most recent non-industrial pay research settlement that the private sector analogues gave on average 50-55 per cent protection. The Government would in any event have to provide some form of pensions increases for all the public services. The current annual additional cost of full inflation-proofing in the Civil Service, beyond average good private sector practice, is of the order of 3 per cent of the pay bill.

(c) This figure of 3 per cent relates to "emerging costs" (as discussed further in paragraph 35), and should not be taken as necessarily representative of the cost on a funded basis, though it happens to be about one percentage point below the Government Actuary's 1980 estimate (2.2%) of that part of the Civil Service "deduction" attributable to the greater degree of inflation-protection than found in the analogues.

(d) While full inflation proofing is very rare in the private sector, and even then not a matter of right, a number of large employers have provided protection of the order of 80 or 90 per cent, and done so in relation to basic pensions at the rate of one-sixtieth of final salary for each year of service, compared with one-eightieth in most public service schemes (the difference, representing a lump sum benefit in the case of the public services, does not qualify for pensions increase). The cost of inflation-proofing a pension based on sixtieths is, of course, one-third greater than the cost of inflation-proofing a pension based on eightieths.

(e) Some criticism is directed against increases in the largest pensions; but most public service pensions are small: in the Civil Service the average pension is £29 a week, and over half are less than £20.

9. Perhaps the most difficult argument to assess is that of <u>fairness</u> (paragraph 7(c) above). This may be taken in two senses.

(a) It may be argued that, although pension arrangements may legitimately differ between public and private sectors, the total of remuneration (pay, pensions and other benefits) must be held in reasonable balance. Hence if public servants enjoy superior pension benefits, that is acceptable if, but only if, they pay an appropriate price for them. The problem here is partly that the determination of an appropriate price for pension benefits depends on assumptions regarding the long-term course of prices, earnings and real rates of return, on which views can and do differ widely and the outcome may differ from the assumptions. It is also that many people regard public sector pension benefits as something on which <u>no</u> objective price can be put, because fully comparable ones are not available in the market.

(b) For these or other reasons, it may alternatively be argued that pension benefits in the public and private sectors should be brought as closely into line as possible.

10. The first of these two arguments would imply that attention should concentrate on setting an appropriate level of <u>contributions</u> from <u>employees</u>; the second that attention should concentrate on ensuring that the level of <u>benefits</u> paid to <u>pensioners</u> is appropriate. Both are defensible; and we have assumed that Ministers would not wish at this stage to

choose between them. We have considered a range of options, discussed in the body of this report, intended to meet in varying degree legitimate public concern regarding disparities between public and private sectors and the cost of public sector pension arrangements.

D. PENSION SCHEMES AND THE IMPACT OF INFLATION

11. A pension is part of the implicit contract of employment; and it is therefore important to both employer and employee to be able to assess its real value; with a very long term contract, some form of compensating for inflation, until it is brought down to low levels is the only way of satisfying that need.

12. Civil Service pensions have been paid very much on the present basis (equivalent - see paragraph 8(d) - to one-sixtieth of final salary) for 150 years; and they have been followed by the rest of the public sector. Until about the middle of the present century they were markedly superior to those in most of the private sector; but this was a matter of basic terms rather than of inflation-protection; their real value was maintained simply through the general absence of inflation. Recent years have seen a great increase of private sector pensions in both numbers and quality; so that, leaving inflation-protection aside, the benefits of public sector schemes are no longer notably superior.

13. The resources needed to pay pensions have to be provided in one way or another by the economically active part of the population, whether in the public or private sector, and whether on a "funded" or "pay as you go" basis. Irrespective of decisions on the public sector, the overall amount of these transfer payments will rise for some years as schemes mature. Pension funds provide a mechanism through which employers and employees can combine to create the necessary claims on the next generation; funding also provides a means of valuing, ie attaching a current price to, future pension benefits. But it is a convenience to be taken advantage of only if it is useful. The approach of the Scott Report was to value public service pensions on the basis of the contributions which would be necessary if they were funded.

14. The essential difference between public and private schemes, however, is not funding (which may or may not be applied in both public and private sectors), but the nature and certainty of the benefits. Public service pensions under present legislation are maintained in real terms - but provide for no improvement over this, for instance if earnings (as has been usual) rise faster than prices. Private pension funds, on the other hand, cannot guarantee inflation-proofing; but, like other private investments, they theoretically could secure a return which allows real improvement in benefits and, until the 1970s, often did. This disparity in the form of contract is not necessarily wrong. But the disparity in <u>recent</u> performance, as a result of the unanticipated acceleration of inflation, is a perceived inequity.

15. Inflation has drastically disturbed the institutional arrangements in both sectors. In the case of the private sector, it has eroded the value of past savings in pension funds and therefore created an unintended gap between the values of pensions in money and in real terms which has been bridged in some cases by deficiency payments or ad hoc topping up. In the public services, where pay-as-you-go rather than funded schemes are more frequent, employers have maintained the real value of pensions, but they have done so by means of "pensions increases", treated as being distinct from "basic pensions" and sometimes even financed by different authorities.

16. Nevertheless, although inflation redistributes systematically in favour of borrowers (eg mortgagors and the government) it does not necessarily make it impossible for pension funds (which depend on lending) to maintain the real value of benefits. The crucial question is the extent to which the inflation is anticipated and reflected in interest rates and other financial returns. The real rate of return, net of inflation, was negative during much of the 1970s. But, since the period of a pension contract may last 60 years or more (taking contribution and benefit periods together), it is necessary to take a very long term view of economic variables - short-term deviations, provided they do not turn into long-term ones, can be coped with. Clearly, nobody can predict what rates of return will be far into the future; but some assumptions are needed in order to do the arithmetic at all, reflecting a reasonable view of what can be expected in the very long run. This is necessary not just for inflation-proofing but also for securing and valuing even the basic benefits of a funded scheme.

17. The market flotation of index-linked bonds is useful in a pensions context because it provides both a more certain store of value than existing securities and also a guide to the expected real rate of interest. It enables pensions to be secured in real terms for those prepared to pay the price, so that indexation need not in future be confined to the public sector. We do not, however, think that the fact that such bonds are now available - and we recognise that the main reason for their issue was a monetary one - has yet much reduced the difficulty of the problems we have to tackle. The initial issue of £1 billion is small in relation to the assets and liabilities of the pensions industry; and it will not permit index-linked benefits to be offered at all widely. Moreover, the market in the bonds will initially be small and it is confined to certain institutions. Although it is too early to make a firm judgement, the allotment at par perhaps suggests that 2 per cent is a reasonable view of the minimum real return expect by pension funds (this is lower than that normally assumed by actuaries) - the fact that other investments are being bought by pension funds when the indexed gilt is yielding over 2 per cent implies that to those who buy them the possibility of doing better outweights the risk of doing worse. If ultimately these and similar bonds become widely available and markets become accustomed to them, they could provide a more reliable indication.

18. Thus neither the public sector nor the private sector can yet be said to be coping with the disturbance of inflation so far as pensions are concerned. In the public sector the retention as separate concepts of "basic pensions" and "pensions increases" has given rise to anomalous financing arrangements; in the private sector those responsible for pensions have been slow to recognise and adjust to the low real returns being obtained (and apparently expected) on investments. The Scott report saw the preservation of the real value of pensions as a desirable social objective - which would be impaired if action were taken on benefits but would remain intact if it were taken on contributions - but one whose full cost has yet to be recognised.

E. PUBLIC SECTOR PENSION SCHEMES - GENERAL CONSIDERATIONS

(i) Range of schemes and financial arrangements

19. As noted in paragraph 4 above and Annex B, nearly all public sector pension schemes offer index-linking. It is convenient to divide them into four main groups.

Group 1:

Schemes for employees of central government (Civil Service, Armed Forces, NHS).

Group 1a:

Office-holders whose pensions are provided by the State (MPs, Ministers, the Judiciary).

Group 2:

Schemes for employees of other public services (school teachers, local government employees, police, fire service).

Group 3:

Schemes for employees in the rest of the public sector (mainly nationalised industries and other public corporations).

20. The Exchequer naturally bears the full cost, net of any contribution from members, of all benefits, including pensions increase, provided by schemes in Groups 1 and 1a. But it is also involved in the finances of certain schemes in the other groups. In particular, it bears the full cost of pensions increase in the teachers' schemes; it contributes, through the RSG, to the cost of the local government, police and fire schemes; and it contributes, under specific statutory arrangements, to the cost of the miners and railworkers schemes.

Schemes in Group 2 are of course a charge on local taxes, and those in Group 3 a charge on consumers, to the extent that the Exchequer does not itself pay for them.

21. It is clearly desirable that the basis of any Exchequer contribution to the costs of public sector pensions schemes should be consistent. It would not, for instance, be easy to defend a situation in which the Government ceased full inflation-proofing for its own employees, while meeting its full cost in other schemes providing otherwise similar benefits.

(ii) Negotiating arrangements

22. For all schemes in Group 1 the Government settles the terms after discussion with staff or receipt of advice as may be required. In addition, it lays down the terms of the major schemes in Group 2. However, it is not the employer of members of schemes in Group 2; and its ability in practice to insist on a change in terms, at any rate if both employers and employees objected, is open to question. There would also be difficulties with schemes in Group 1a. There is a link with the point discussed in paragraph 20 above: even if the Governemt could not secure a change in benefits or contributions which it considered justified, it might nevertheless limit its own financial contribution.

23. The arrangements for negotiating pay are also important in this context. If Ministers decided that it was appropriate to raise employees' contributions, they could, at least *de jure*, achieve such a result in all major public service schemes. This would have some value on its own. But for employees in schemes in Group 2 it would be for local rather than central government to ensure that the increase in contributions was not sooner or later offset by increases in pay. Even for members of schemes in Group 1, unless their pay was determined by a formal process of comparability, once the initial reduction in net pay had taken place, it would be possible to say no more than that the value of pension benefits, including pensions increase, had been taken into account in pay negotiations - it would be up to the government to make the best bargain it could in the circumstances.

24. As for the members of schemes in Group 3, most of the nationalised industry schemes are funded and have a substantial financial and organisational independence. The Government has no control over either pension terms or pay negotiations. To ensure that pension terms were changed would require specific and contentious legislation; and nationalised industry managements would vary in their resistance to increases in contributions being offset by increases in pay.

(iii) Adaptability to changing circumstances

25. Major divergences between pension arrangements in public and private sectors produce criticism and misunderstanding and could inhibit labour mobility; other things being equal,

there is much to be said for bringing the two sectors closer into line. But private sector practice is not static. Moreover, economic circumstances change; and it is far from certain that any changes introduced into current arrangements will seem appropriate in 10 or even 5 years time. Any new arrangements therefore need to be adaptable as requirements change. But, since pensions represent delayed payment for services rendered (paragraph 11), adaptability needs to be distinguished from flexibility to pay less than the contracted benefits (though there may be argument about what these are).

(iv) Administrative simplicity

26. There are some 2½ million public sector pensioners, in widely varying circumstances. Any changes that may be made must be administrively feasible. Other objections apart, attempts to discriminate between different categories of pension or pensioner, if taken far, could rapidly lead to unworkability.

(v) The contributory principle

27. Most public service pension schemes involve actual contributions from employers, but this is not the case with the main Civil Service scheme or with the Armed Forces. Although the pay of civil servants is reduced on account of their pension benefits (and the same approach is followed in the Report of the Armed Forces Pay Review Body), they are widely believed to "pay nothing for their pensions". The presentational drawbacks of this may be thought to justify making the Civil Service and Armed Forces schemes formally contributory in respect of all benefits. The argument is strengthened if changes in contributions are made following the Scott recommendations, since experience shows that public opinion is unlikely to believe that adequate adjustments have been made solely through the process of pay determination. Although the Civil Service unions have not yet expressed a view collectively, it seems probable that they would welcome a formally contributory scheme. However, further study of the implications (including those for staffing) is required before decision.

(vi) Changes involving contributions or benefits

28. Paragraphs 29 to 64 below discuss possible courses of action which Ministers might wish to take against the considerations discussed in paragraphs 11 to 27 above. For convenience, they are divided into changes affecting contributions and changes affecting benefits. This does not mean that changes from the two categories could not be combined; and there are in fact two options, one from each category (paragraphs 44 and 51 below), which are closely related. Changes in both benefits and contributions would involve complex negotiation. Although ultimate choice may be necessary, there is, however, advantage in keeping both options open at present. If pursued to the negotiating stage, it would give

increased scope and, for instance, enable the government to suggest lower benefits if its objectives on contributions were not met; or to offer smaller increases in contributions in exchange for lower benefits. The concept of fairness can be applied to either approach, but in different ways (paragraphs 9-10). Ministers should be aware also of pre-election statements. The two approaches are very different in effect: for the government there are big differences in the profile of costs (paragraphs 65-69); for public servants the balance between generations is affected (paragraph 18). Furthermore, if it were decided that changes were to apply from a current date and that acquired entitlements were to be protected, the financial balance for the government would swing more strongly in favour of changing contributions rather than benefits (paragraph 74).

F. POSSIBLE CHANGES - CONTRIBUTIONS

29. The report of the Scott Committee dealt with the valuation of pension benefits and suggested, in the particular context of the Civil Service, a range of values. It is natural to suppose that the right way forward is to decide the correct figure within the range, deduce the consequences for pay or pension contributions, and proceed accordingly.

30. It is difficult, however, to get a conclusive result from this approach.

(a) Actuarial valuation assumptions, as has been said, relate to very long periods, and therefore tend to be stable. By the time observed changes in trend are established, it is already late to adjust. There is no objective way of establishing in advance which set of assumptions will actually be fulfilled.

(b) The Government Actuary in evidence to Scott said he would welcome greater outside scrutiny of his work in the context of the Pay Research machinery, including his assumptions for valuing the Civil Service scheme (we agree this is desirable); but in practice his assumptions are likely to remain fairly close to those commonly used by the actuarial profession. It would of course be possible for the Government to postulate different assumptions; but it would be hard to make arguments justifying the particular ones chosen. Furthermore, it would no longer be possible for the Government Actuary to act as adviser to both sides in Civil Service pay negotiations on the basis of assumptions imposed by only one side.

(c) Moreover, to impose pessimistic economic assumptions would have other implications: it could affect the terms for contracting out of the State pension scheme; and it would imply (perhaps correctly) that most private sector and nationalised industry pension schemes were grossly under-funded.

31. There is therefore a limit to the increase in contributions which could be secured with the actuarial approach. There are so many variables that it is impossible to arrive at a definitive conclusion. Nevertheless, table 4 in paragraph 104 of the Scott Report analysed the sensitivity of the calculations in relation to changes in each of the main assumptions and this showed the key importance, as already suggested, of the assumptions relating to the real rate of return on investments. The argument that contributions are too low in the public sector is essentially an argument that actuaries (and this includes the actuaries of private sector schemes as well as public ones) have been too optimistic in their assumptions in this respect.

32. The figures at the pessimistic end of the Scott range are based on a real return of zero. This is not the lower limit of what would be possible. Brealey and Hodges (Annex 7 of the Scott Report)* arrived at negative rates of return for both fully and partly index-linked schemes. While theoretically possible, however, this would be an extreme conclusion bearing in mind that one is looking at a long period ahead, since:

(a) There is no obvious historical precedent for negative rates of return except in the last decade; and there are artificialities (for instance large use of short-term fixed interest securities) in the portfolios constructed by Brealey and Hodges in order to simulate an indexed bond (which did not then exist).

(b) The indexed bond now floated does not point to a negative rate of return.

(c) If real rates of return were negative, funding as a concept would be called in question, since contributions for funded schemes would have to be higher, as a proportion of salaries, than the emerging cost (also as a proportion of salary) of the pensions actually being paid, assuming a stable level of workforce. Funding, as opposed to pay-as-you-go, would become a financial penalty; and valuation of pension benefits on a funding basis would be of doubtful relevance (the more extreme public comment, indicating very high figures for the "actuarial" value of public service pensions, seems to miss this point).

(d) The Scott Committee thought the assumption of a real rate of return of less than zero implausible.

33. For these reasons and others (eg the interdependence of some of the assumptions) we think that the range of valuations suggested by Scott can be taken as realistic, ie that the pessimistic end of the range is pessimistic enough for policy purposes. We now turn to what the implications would be.

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*See also footnote on page 12.

34. At the pessimistic end of the Scott range, the "normal contribution rates" (for employer and employee combined) were of the order of 36 per cent for the civil service and 24 per cent for the analogue benefits, a difference of some twelve percentage points. In terms of employee contributions this would have indicated an increase in the "deduction" from civil service pay from 3.8 per cent to 8½ per cent, pointing to an increase in the total effective employee contributions of civil servants from 7.9 per cent to 13½ per cent of pensionable pay. On this basis it might, at the outside, be right to ask civil servants to pay about 4½ per cent per annum of their salaries more than at present.

35. However, this could result in some rather unrealistic conclusions in terms of "emerging cost". The emerging cost of the civil service scheme (ie the cost of pensions currently in payment, including pensions increase, as a proportion of the total pay bill) is of the order of 17-18 per cent, and likely to reach a peak of about 25 per cent in the late-1980's before falling back later. A 13½ per cent employee contribution would leave the employer paying only about 4 percentage points of the current emerging cost. As against this, the typical private sector employer is paying about 12 per cent of the pay bill into the pension fund. Although the figures are not strictly comparable, this is bound to influence what is negotiable. Thus the conclusion on Scott is useful but limited - an increase in contributions which can be made without implausible implications in terms of the sharing of emerging cost is likely to be within the range suggested by Scott, and the Scott arguments will be helpful in justifying it.

Course I Straight increase in contributions

36. The Scott Report conclusion that in 1980 the total effective employee contribution for the Civil Service was 7.9 per cent compares with contributions in the range of 5-7 per cent by other public servants (apart from the Armed Forces for whom the corresponding figure for their earlier pensions is now 11 per cent). Given the harmonisation of benefits in recent years, there seems no good reason for this wide range of civil contribution rates, and levelling up to the Civil Service rate would seem justified. In the light of the Scott Report, it would be reasonable to go further and seek a general increase in contribution rates. There is no objective way of determining the "right" contribution, and negotiation would be involved. But there would be advantage if public servants were seen to be paying significantly higher contributions for their better benefits, as compared with the private sector; and, within reason, public servants themselves would accept this.

37. If Ministers considered that higher contributions were justified as their main response to the Scott Report, it seems unlikely that an increase of less than 2 per cent for the Civil Service (10 per cent in all) would be seen as an adequate reaction to public concern. A higher figure, on the other hand would be difficult to justify in negotiation. It would be

argued that the present rate had been assessed by the Government Actuary on assumptions widely applied by the actuarial profession - even taking a percentage point off the expected real rate of return, making it 2 per cent, would add only 1 per cent to the required contributions; also that, with an employee contribution of 10 per cent, serving civil servants would be meeting some 56 per cent of the currently emerging cost of the scheme and about 60 per cent of the normal contribution rate as assessed by Government Actuary in 1980 (this latter figure compares with a typical employee share of one-third or 4 per cent of gross pay in the private sector). Therefore, while 10 per cent is not the limit of what might properly be sought in negotiation, and even higher figures might be possible, it is as much as we think it realistic to take as a planning figure. Any figure agreed would be subject to periodic review.

38. A variety of arguments may be deployed to justify a higher rate of contribution than at present. They do not in themselves imply any scientific basis for a 10 per cent or higher contribution, but might be made with some force in the course of negotiation in support of such an objective.

(i) Public servants might be expected to pay a higher proportion of the total cost than their private sector counterparts because the advantages of indexation include not only its measured value but also the security of knowing there is protection. In the calculations of Bealey and Hodges* this was worth about half a percentage point on the real rate of return, ie half a percentage point also on contributions.

(ii) The Government Actuary has recently strengthened his actuarial basis for some purposes, eg the pensions of the Armed Forces, assuming a 2½ per cent rather than 3 per cent real rate of return; this also would imply an increase of about ½ per cent in Civil Service contributions. There could be certain sets of assumptions not wholly outrageous (such as 2 per cent real rate of return and double figure inflation) which would imply a 10 per cent contribution rate, though it would be difficult to substantiate a case on these grounds alone.

(iii) The pension advantage over the private sector generally is greater than the advantage over Pay Research analogues. In particular, Scott recommended that public sector analogues should be excluded, which would add a small amount to the Civil Service contribution. This argument will, however, need to be carefully formulated in relation to whatever comparisons are adopted in future for civil service pay.

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*B&H's basic theory, which is a distinct issue from that of low or negative interest rates, is that a lower rate of interest should be used to calculate the discounted value of Civil Service benefits than of analogue benefits, hence putting a relatively higher value on the former, because the real value of index-linked benefits is less uncertain than the real value of non-linked benefits.

(iv) Existing comparisons based on jobs do not take sufficient account of the pension losses suffered by job changers in the private sector insofar as these reflect higher labour turnover.

(v) Some minor and inexpensive improvements in schemes might be offered.

(vi) If contributions were not raised as proposed, the arguments for reducing benefits would be strengthened.

39. If civil servants were persuaded to agree pay contributions of around 10 per cent of gross pay, it would be hard to defend not levying employee contributions in other public sector schemes which were equivalent (taking into account any differences between the schemes) - indeed, levying similar contributions in other services would probably be necessary in order to secure agreement for the Civil Service. It would be much more difficult to achieve this with the other public services because of the bigger increases in contributions (without improvement in benefits) implied. The arguments in paragraph 38 could be deployed with differing force in each service, but the main thrust would have to be that the value of an index-linked pension had become apparent only in the last few years; that it would be inequitable for the groups concerned to pay less than Civil Servants; and that the greater increase simply reflected the extent to which benefits were undervalued in the other public service schemes.

40. In the light of this, the difficulties to be aware of with this approach are the following:

(a) Opposition to such increases in contributions, certainly outside the Civil Service, and possibly within it in the absence of pay comparability, might be strong; even the current contributions of the Civil Service are (just) within the Scott range. If not negotiable, increases would have to be imposed with perhaps adverse implications in terms of industrial relations.

(b) It is not easy to argue for a particular point in the Scott range and the scope for argument about whether a "proper price" was being charged for benefits would remain.

(c) The savings, particularly in services not controlled by central government might be eroded by subsequent pay increases. Certainly the difference between employee contributions in the public services (around 10 per cent) and the private sector (on average little more than 4 per cent) would be large and hard to sustain.

(d) If the Civil Service scheme were converted into a contributory one, the establishment of gross pay figures to replace net ones could be misrepresented as a pay increase (see paragraph 27).

(e) An increase in contributions explicitly related to pensions increase would make it even more difficult subsequently to depart from index-linking.

Course II A partial switch to "pay as you go" contributions

41. The approach under Course I was to estimate what the cost of pensions was likely to be and to ensure that employees made appropriate contributions in advance. But that would still leave the possibility of the outcome being different from that assumed and the actual cost being more or less than forecast. An alternative approach, therefore, is to relate contributions more directly to the costs as they emerge (which is how indexed pensions are financed in France). This implies that the employees' contribution should be a variable one. This approach gets over problems caused by inflation, provided that pensions and salaries move in step. But it is liable to produce bizarre results if for demographic, economic or policy reasons there are shifts in the numerical balance between those working and those retired, or changes in the levels of benefit for which the retired are eligible. This will be the case with many of the relatively new public service schemes, including that for the NHS, as retirees progressively have more years of reckonable service; the civil service scheme, by contrast, is mature; but both it and, for instance, the teachers' scheme might become temporarily unbalanced as numbers are reduced. The significance of such shifts would be reduced if the coverage of pensions schemes were extended from single occupational groups to broad sectors of the population, but could still be substantial.

42. The randomness of variability of pay-as-you-go can be reduced by retaining at least a substantial actuarial element, subject to pay-as-you-go correction when assumptions are falsified. There are several ways in which this could be done.

43. One would be to recalculate the adequacy of past (as well as current) contributions at intervals of several years and to impose a surcharge or allow a credit on contributions to recover or repay, over a short period of years, any estimated deficiency or surplus insofar as it reflected different assumptions on inflation or the real rate of return. This would amount to the use of a notional fund, with contributions rather than benefits being the variable element. It would require further study but might result in rather large swings in contribution rates because the changes would have to pick up past errors and make provision for the future. The changes in accounting procedures required might also be costly.

44. Another approach, which we have examined in more detail, would be for the Government (or employer, as appropriate) to finance pensions increase up to, say the same extent as average practice in the private sector, and to levy from employees a percentage of salary sufficient to finance the remaining emerging cost of inflation-proofing. This would fit well with Course IV discussed in paragraphs 51-52 below, and much of the argument there

is also applicable here; the two combined perhaps provide the most convincing way of reconciling changes in benefits with pre-Election statements.

45. The attractions of the course outlined in paragraph 44 would include:

(a) Since it would be based on private sector practice, it could be represented as making for greater fairness between public and private sectors; and it would respond automatically to changes in private sector practice;

(b) It would yield significant savings; and since the pay as you go contributions would be assessed separately, and revised at intervals, it is possible that they would be less likely to be offset by subsequent pay increases.

(c) Since the system would, in principle, be based on objective evidence about actual payments, it would reduce the scope for argument about valuation.

(d) It might give the Government more options for dealing with schemes in groups 2 and 3. In the case of the teachers' schemes, for example, the Government could meet the cost of pensions increase corresponding to private sector practice, leaving any additional cost of inflation-proofing to be the subject of negotiations between employers and employees. (This could, of course, result in different levels of protection against inflation in different public services).

46. On the other hand -

(e) It could lead to serious financial problems if the ratio between pensioners and active members changed significantly: the teachers' scheme is a case in point.

(f) It could be expensive to administer, since pension contributions would vary from one period to another.

(g) It would have to work in arrears, to allow for inevitable delays in collecting information about private sector practice (this is developed in more detail in paragraph 52 below).

(h) It could be regarded as raising problems of equity between different generations of scheme members. For example, if the rate of inflation fell, and real returns improved, full inflation-proofing might become normal in both public and private sectors. People who, in employment, had paid large pay-as-you-go contributions on account of pensions increase for their previous colleagues might find in retirement that they enjoyed no preferential benefits.

G. POSSIBLE CHANGES - BENEFITS

47. It is not realistic to suppose that no arrangements for increasing pensions after award need be made. Even in times of relatively low inflation, hardship (and consequential

political pressures) would quickly grow; there have been measures to increase public service pensions since just after the First World War; and post-award pensions increase is commonplace in the private sector. The question is whether to modify the existing system.

Course III Purely discretionary increases

48. Pensions increase in the private sector is frequently provided on a partly or wholly discretionary basis. In principle , such an approach would go a long way towards meeting the criticisms set out in paragraph 7 above. Whether it did so in practice, and in particular whether it reduced the cost of pension increase, would depend on the size of the discretionary awards.

49. However, it would very much alter the nature of a pension from being a contractual obligation for services rendered to a discretionary payment subject to the political process. It would seem inequitable that the government, by allowing inflation, should be able to reduce its obligations, and a discretionary system of this kind would be likely to be deeply unsatisfactory to employees. There would be acute and conflicting pressures in the press, in Parliament, and from pensioners. Private sector schemes are not similarly exposed.

50. Experience before 1971, when pensions increase was on a discretionary basis, shows that pressures arise for special (and anomalous) treatment for "hard cases", such as small pensions or older pensioners. Annex D gives a brief account of what happened before 1971 : there is no reason to suppose that the subject would prove any easier to handle if increases were once again made fully discretionary.

Course IV Increases based on private sector practice

51. An alternative would be to base pensions increases on average private sector practice. This would be widely regarded as fairer than the present system; and the cost of pension increase would be substantially reduced, since post-award increases in the private sector have in recent years averaged about 50-55 per cent of inflation and divergences could well continue in future; but, correspondingly, the civil service's "deduction" from pay would need to be lower than at present. Self-evidently, the system would be closer to private sector practice, and would adapt itself automatically to changes in that practice.

52. The extent and basis of pensions increases currently given by private sector schemes vary widely; and evidence about them could be collected only in arrears. It would be possible to reduce some of the resulting difficulties by collecting information over, say, the previous 5 years, and increasing public service pensions by the appropriate proportion of the current inflation rate; but the evidence would still be in arrears and open to dispute. A more

substantial objection to this approach, however, is that the model for the public services would be an inadequately funded and performing private sector pensions industry (see paragraph 18); this objection could be partly met if there were provision for topping up financed by additional contributions (see paragraph 44).

Course V Pensions increase paid from surpluses

53. Increases could be paid from the surpluses emerging in actual or notional funds. This would be demonstrably "what could be afforded". The attraction of this course is its apparent similarity to private sector practice. However, there are substantial technical drawbacks:

(a) Only the local government scheme is actually funded; and, even there, the pension funds do not bear the cost of pensions increase (which is paid by the rate fund on a pay-as-you-go basis). The NHS and teachers schemes are notionally funded; but they are deemed to be invested solely in fixed interest securities, which is inappropriate to a fund offering index-linked benefits; and the funds do not bear the cost of pensions increase. No other major public service scheme is funded. If actual rather than notional funding were adopted, massive funds would be involved; investment policies would raise political questions and the monetary consequences would need attention. It would be necessary to devise or revise funding bases for all public service schemes; and this process, which would raise numerous contentious issues (including the appropriate valuation assumptions for the establishment of the fund, and the level of contributions), would largely determine what could be paid by way of pensions increase for some years. It would offer critics an easy target from all directions.

(b) Pensions increase in many private sector schemes is at least partly financed by employers, through ex gratia contributions or maintaining contribution levels which could be reduced if no more than the contractual benefits were paid. It would be difficult to exclude the possibility of such ex gratia contributions in the public services; but, once it was admitted, it would take the system back towards either purely discretionary increases or increases matching average private sector practice.

Funding would also theoretically permit a more individual approach, approximating to the treatment of the self-employed. This would, however, imply a "money purchase" rather than "final salary" basis and create discrepancies with the usual type of private occupational schemes. It would be very complex; and, in so far as such an approach would call basic benefits in question, rather than pensions increases, it falls outside our terms of reference.

Course VI A cut-off point

54. Although the Scott Report said that the Committee had assumed that in the last resort there would be a limit to the rate of pensions increase, this seems essentially to reflect the technical point that to allow for hyper-inflation would distort the valuation processs: a very high cut-off point is adequate to meet this argument.

55. In order to have practical significance in current circumstances, a different type of cut-off would have to be chosen. There are various possibilities. Examples might be:-

(a) a fixed percentage figure, such as 10 per cent;

(b) a fixed proportion of the rate of inflation; since this would guarantee the erosion of pension benefits, the uncovered proportion would need to be limited -possibly to no more than, say, 20 per cent of the rate of inflation in a given year;

(c) full inflation-proofing up to, say, 10 per cent, with one half or two thirds protection thereafter.

56. All such approaches would tend to reduce the cost of pensions increase. They would however, be inflexible. And it is not obvious that they would be fairer than the present system, as between public and private sectors: there is no evidence that the private sector applies a cut-off of this nature. There is also a dilemma. If the cut-off operates so as to make significant savings, it is certain to generate heavy pressure for discretionary increases. Furthermore, if there were substantial changes in general economic circumstances, it might be necessary to change the system itself, in which case this would not be a stable solution. A cut-off therefore serves the limited purpose of saving money, in an unpredictable but inflexible way, when inflation is high. It would seem arbitrary and unjust to employees, who would not know the limit of real income they might lose, while the question of equity vis a vis the private sector would be a matter of chance.

Course VII Power to increase pensions by less than inflation

57. A different approach would be to maintain the link with inflation but to take power (which would be exercised only infrequently and would presumably be subject to some form of Parliamentary procedure) to make increases less than the rate of inflation in any particular year within some pre-determined limit. This limit could be defined in various ways: for example, up to 5 percentage points, or up to one-third of the annual rate of inflation. Pensioners would then have an assurance of protection against inflation, except in circumstances where Ministers were prepared to defend an explicit decision to give less. The same objections would apply as to other discretionary systems; but to a lesser degree because of the extent to which the discretion would be circumscribed.

58. Such an approach would increase the flexibility of the system, and tend to reduce its cost. Whether it would increase fairness between public and private sectors would depend on how it was administered. Moreover, if there were a period of restraint on pensions increase, followed by some years of full inflation-proofing, differences would build up between new and old pensions - there would be pressure for special treatment of older pensioners, as there was before 1971, and this could quickly lead to complexity.

Course VIII Smaller increases for larger pensions

59. It would be possible to provide full inflation-proofing up to a certain level (eg the basic State retirement pension), with smaller increases above that. The prime aim of such a measure would be presentational. There is no evidence that the private sector generally provides better protection on small pensions; for some top hat schemes the reverse may be the case. Unless the taper began at a very low level, there would be little effect on cost.

60. This option would discriminate against those not only with high earnings, but also with long service or who had saved through the purchase of added years; it could be argued to be a form of income redistribution more appropriate to the tax system than to a pension scheme. Moreover, there are many people receiving more than one public service pension from different sources, as a result of two or more periods of service with different employers (or even with one employer); there would be no way of aggregating such pensions for the purpose of tapered increases. If it were thought necessary to give special treatment to male pensioners aged between 60 and 65 (who would not be receiving the State retirement pension), further complexity would result.

61. This approach would accordingly do little to meet the criticisms set out in paragraph 7 above. However, if the presentational advantages were thought to outweigh the substantial administrative cost, it could be combined with other options discussed in this section.

Course IX An alternative index

62. One of the objections levelled against inflation-proofing on the basis of prices is that it leads to an increased proportion of national resources going to pensioners if real earnings decline. It also leads to what are widely regarded as anomalies between pensioners retiring at different dates.

63. There is therefore attraction in linking pensions increases, instead, to an index of earnings. This would contribute to fairness as between pensioners and others, though it

would not necessarily reduce the gap between public and private pensioners. There are several possibilities.

(a) Parity

This concept is applied to public service pensioners in most European countries; it links pensions increases to increases in the earnings of the pensioner's former employment. It might be impracticable to do this precisely, because of changes in grade structure etc; but equivalent mechanisms could be constructed. This course would automatically solve the theoretical problem of indexed pensions being capable of overtaking current salaries. It would prevent pensioners increasing their share of national income in a recession. There are two main objections. First is simply cost: it would almost certainly be more expensive than the existing system because, in spite of some years recently when real earnings have not risen, the expectation must surely remain that in most years earnings will rise faster than prices. Secondly, it could produce substantial differences of treatment between the pensions of different public services in a way that would be hard to defend: it might, for instance, be decided to increase the relative pay of the police in order to improve recruitment; there is no obvious reason why the pensions of those who had already retired should be correspondingly increased.

(b) Link with a general earnings index

A link with earnings, either nationally, or in the public services as a whole, would avoid the second of the objections mentioned above. But the question of cost would remain - it is surely plausible to expect real earnings to rise over time, in which case it will be more expensive to index in relation to earnings rather than (as now) prices.

(c) Lower of earnings or prices

By contrast, a link with whichever was the lower of earnings or prices in any particular year could be expected to reduce costs, particularly if the link was with public service (rather than national average) earnings.

64. Of the options considered in the preceding paragraph, the last is the only one likely to be cheaper than the present arrangements. It does, however, suffer from important drawbacks. It would leave a substantial difference between public and private sector practice. It would, nevertheless, be a clear worsening of existing pension terms. If the criterion oscillated between earnings and prices depending on which was lower in any particular period, there would be little logic in the result; but if the time period were extended, so that one took whichever gave the lowest cumulative result, this would be likely to be the price basis and the Government would have gained nothing for the loss of good will from the change, which would have exacerbated the difficulty of increasing contributions if Ministers were to consider such a course appropriate.

H. FINANCIAL IMPLICATIONS

65. At this stage, only a broad indication is possible of the likely financial effects of the various courses discussed in paragraphs 36-64 above. Any assessment of costs is subject to many imponderables, notably future movements of pay and prices. And it is important to identify savings net of additional expenditure that may as a result be incurred elsewhere: a reduction in pension benefits, for example, might necessitate an increase in pay either gross or through reduced employee contributions. The thrust of this report is that the balance between contributions and benefits in public sector schemes could be altered in the Government's favour by raising contributions or reducing benefits (or a combination of the two): ultimately it ought not to make a financial difference which route was followed, though there might be a difference in practice reflecting how far each approach could be pursued in the particular circumstances. However, it is in the nature of pension schemes - especially those based on funding, notional funding or (as in the case of the Civil Service) having employee contributions calculated as if funded - that the financial consequences of ultimately self-balancing changes occur first on the contributions side. The pattern in practice will reflect the extent to which changes on both sides are related to each other; but, on the basis of the courses discussed in this report, the scale of contribution changes would initially be likely to be bigger than that of benefit changes, as shown below.

Effect of increasing contributions

66. Subject to such qualifications, there are potential large savings (running to several hundred £ million a year) to be obtained through higher contributions, mainly outside the Civil Service:

(a) In principle, the financial effect of making Civil Service pensions contributory, with men paying 8½ per cent, (paragraph 27) would be neutral in the long run: net pay would be slightly reduced, offset after a time by slightly increased pensions. There would however be a net saving in the short term: about £40-50 million in year 1, declining to some £20 million by year 5. The effect of making armed forces pensions contributory would be similar, except that the figures would be smaller

(b) A further increase in contributions of 2 per cent for the Civil Service (Course I, paragraphs 36-40) would raise about £90 million in a full year, provided, in the absence of pay comparability, it were not offset by a corresponding pay increase. If all public service employees' contributions were increased to 10 per cent, the gross saving (in contribution income) would be around £700 million a year. But is is unrealistic to suppose that no offsetting pay increases would be conceded. The net savings are therefore likely to be substantially less than the gross ones, particularly where pay negotiations are outside the Government's direct control.

(c) If there were a partial switch to pay-as-you-go contributions (Course II, paragraph 44) serving public servants would bear just under half the inflation-proofing bill. For the Civil Service, this would amount to some 2½ per cent of pay. But civil servants already pay around this amount for the extent to which they have better inflation-proofing than their analogues; this is fortuitous, but implies that there would be no net saving for the Civil Service. Adopting a similar procedure for the other public services would broadly have the effect of raising their employee contributions to the level currently paid by the Civil Service: first year saving around £300-400 million gross, again offset by any pay increases that might be conceded.

The figures in (a) and (b) are additive; (c) is alternative to (b).

Effect of cutting inflation-proofing

67. The initial savings from reducing benefits would be lower than those from increasing contributions; for the Civil Service only they are shown in the following table on various short-term assumptions about inflation and pensions increases. On the assumptior that Civil Service pay continued to take account of comparative pension benefits, the table also shows the increase in pay which would follow such a worsening of pension arrangements; this is subject to the following qualifications:

(a) it is based on the assumptions used by the Government Actuary in 1980 - more conservative assumption would point to lower paid increases;

(b) if Civil Service pay ceased to take explicit account of comparative pension benefits, the pay increases shown here might not occur; but they would no doubt be sought by unions in negotiation.

CIVIL SERVICE SUPERANNUATION: 1981-82 TO 1983-84

£ million 1980 survey prices

	10% inflation			7% inflation		
	1981-82	1982-83	1983-84	1981-82	1982-83	1983-84
A. 80% indexation (saving)	-	-3	-14	-	-2	-10
[Offsetting pay increase (1%)	-	+38	+38	-	+38	+38]
B. Half indexation (saving)	-	-9	-35	-	-6	-25
[Offsetting pay increase (2%)	-	+72	+72	-	+72	+72]
C. Nil indexation (saving)	-	-18	-70	-	-12	-50
[Offsetting pay increase (5%)	-	+188	+187	-	+188	+187]

68. Thus, the short-term effect of abandoning index-linking, while continuing to take account of pensions in pay determination, would, subject to the qualifications above, be an immediate increase in net expenditure. This would, however, be transitional: in the longer-term - after 5 years or so at 10 per cent inflation, longer at lower rates - the net effects would be relatively small.

69. The above table may be related to the options discussed earlier. Course IV (increases based on private sector practice) might broadly equate to half indexation (line B) until the relative performance of private sector pensions improved. Course VI (a cut-off point) and VII (power to increase pensions by less than inflation) would be likely to be nearer line A (80 per cent indexation). The figures apply only to the Civil Service. The gross savings on pensions for the whole public service would be about four times the savings shown. It is not possible at this stage to say how far this would be offset by pay increases: there would not be an automatic link, as hitherto in the case of the Civil Service; and, as contributions outside the Civil Service are low already, there would be less scope for their erosion.

J PROPOSED FUTURE WORK

70. Even the necessarily summary account in this report indicates the complexity of the subject and the wide variety of possible courses of action. Before main decisions can be taken, it will be necessary to investigate selected courses in greater depth in the light of the detailed arrangements for different schemes, the legislative implications, the effects of negotiating arrangements, and likely financial effects. It is highly desirable -in fact, indispensable if Ministers look for early decisions - to narrow down the range of courses for detailed consideration.

71. For the reasons in paragraph 28 we envisage that Ministers will wish us to examine further at least one course involving changes in contributions and one involving changes in benefits. We suggest the following "short list".

Course I (straight increase in contributions)

Course II (a partial switch to "pay as you go" contributions)

Course II could be coupled with Course IV (increases in pensions based on private sector practice) and could be made a variant of the same approach. Both Course I and Course II offer the possibility of substantial savings; and action on contributions is the most natural way of following up the Scott Report.

Course VI (a cut off point)

Although this has significant drawbacks - not least, the difficulty of choosing the cut off point - it has been widely canvassed as a possible course of action.

Course VII (power to increase pensions by less than inflation)

This would significantly increase the flexibility open to Ministers; it carries substantial drawbacks, but perhaps less than those of Course VI.

72. The following are not on our "short list".

Course III (purely discretionary increases)

In our view, the difficulties and anomalies produced by a purely discretionary system (going beyond Course VII), eg as operated before 1971, are strong arguments against reviving this approach.

Course V (pensions increase paid from surpluses)

In practice, this would have little advantage compared with Course IV, and suffers from serious technical difficulties.

Course VIII (smaller increases for larger pensions)

Such attractions as it may have seem limited to presentational ones: by itself it could not contribute substantially to lower costs, greater fairness or more adaptability. It could, however, be combined with other courses involving changes in benefits if Ministers saw advantages justifying the administrative and other objections.

Course IX (an alternative index)

Simply changing the index to which pensions increase was related might be regarded as an inadequate recognition of public concern; most of the options would be at least as expensive as the present system.

73. The discussion in this report and the selection recommended above incorporate a number of important assumptions; it would be helpful if Ministers could indicate that they regard these assumptions as acceptable or, if necessary, how they should be amended:-

(i) We have assumed that not only courses involving changes in contribution arrangements but also those involving changes in benefits are open for consideration. This implies:

(a) that Ministers do not regard past statements as precluding changes in benefits;

(b) that they would be prepared to promote the primary legislation required to make changes in the inflation-proofing of public service (and possibly public sector) pensions.

(ii) We assume that Ministers would start from the presumption that any changes should in principle affect at least all the public services alike, and not only the Civil Service. (The position of the wider public sector will also need to be considered in greater depth). This implies that Ministers do not rule out such possibilities as:

(a) changing the terms of public service pension schemes over the heads of employers and employees; or

(b) altering the terms of Exchequer support for certain public sector pension schemes; or

(c) taking all practicable steps to influence pay negotitions to secure a genuine increase in contributions from public service employees.

(iv) We have assumed that it will be necessary to justify the eventual decisions in an objective way.

74. Finally, account needs to be taken of the fact that public servants have taken particular courses (eg accepting or remaining in their jobs) or entered into financial transactions such as the purchase of added years, with the Government's approval or encouragement, on the basis that index-linking would continue. In the public services, entitlement to pensions increase rests solely on an Act of Parliament, which can always be amended or repealed by another Act (as has happened recently with the State pension scheme); this falls short of a guarantee, and the existence of one has been denied by Government spokesmen. Nevertheless, it would appear to many as a breach of faith if inflation-proofing were not continued at least in respect of pensions already in payment or earned by service up to the date of change. If such arguments were accepted, it would greatly reduce any savings to be achieved by altering benefits (as opposed to contributions). For the purpose of presenting this report, the financial calculations assume that any changes would be applied to all categories of people who might be affected.

Annexes attached:

A. Recommendations of the Scott Report.

B. Details of Main Public Sector Pension Schemes.

C. Private Sector Pension Schemes.

D. Pensions (Increase) Legislation before 1971.

5th June 1981

(1)

CONFIDENTIAL

Prime Minister

Do you wish to raise this at one of your regular meetings with the Chancellor?

Or do you prefer not to intervene?

MES 27/11

Yes - I agree with John's views see paper note.

MR. SCHOLAR

cc: Mr. Hoskyns

PUBLIC SECTOR PENSIONS

I have been keeping you informed of the progress of the work of the official group which has been following up the remit from E last summer to produce further details of the four possible courses of action, and the developments at Ministerial level between the Treasury and the erstwhile CSD. The Chancellor has now, I understand, decided on the recommendation he wishes to put to his colleagues; and although the time has still not yet come when we have to put all these rather detailed papers to the Prime Minister, there is an important procedural point.

The minimum necessary background is as follows: the official group has identified four possible courses of action, which are summarised in the Annex to this note. The first two, (a) and (b), involve an increase in contributions from employees; the second two, (c) and (d), involve a limitation on the indexation. The official group refrained from recommending as between the contribution route or the benefit route, while pointing out that the financial arguments pointed clearly towards increased contributions, and that there would be a risk of losing a case under the European Convention on Human Rights if the indexation benefits for which existing pensioners had paid were withheld. Before the abolition of the CSD, Lady Young proposed to the Chancellor that the Government go for course (b), i.e. an increase in contributions.

I understand that, following discussion among Treasury Ministers and officials, the Chancellor has now decided to put round a paper to E - which the Cabinet Office now tell me may be taken on 10 December - recommending that the Government take action on both contributions, in the form of course (b), and on benefits, in the form of a 7% upper limit with discretion to go higher if the Government so wish.

/ I am not

CONFIDENTIAL

I am not here concerned with the merits of the Chancellor's proposal, although when the time comes, and when I have had a chance to consult others concerned within No. 10, I should certainly advise strongly against this proposition. My present concern is that, having sat through the discussions in the official group, I know that a recommendation along these lines will be strongly opposed by the Chancellor's colleagues representing other public service groups, as well as (if he accepts Departmental advice) Mr. Tebbit. Colleagues will certainly want to argue that there is an element of unfairness, as well as an absence of benefit in public expenditure terms, in restricting the benefits if you have already taken steps to ensure that those benefits have been properly paid for. John Hoskyns will also wish to advise the Prime Minister on the political desirability of a course of action which, while possibly generally commending itself to those who do not work in the public services, will certainly strongly antagonise the roughly 5 million employees in the public sector who are members of occupational pension schemes providing inflation-proofed pensions, and their spouses.

I think, therefore, that it is highly desirable that the Chancellor clear his lines with the Prime Minister before putting his proposals to E. You may feel that the right course of action would be to draw the Prime Minister's attention to this issue and suggest that she have a word with the Chancellor at her next meeting with him.

J.

24 November 1981

ANNEX

POSSIBLE COURSES OF ACTION IN RESPECT OF PUBLIC SECTOR PENSIONS, IN ACCORDANCE WITH THE CONCLUSION OF E COMMITTEE ON 15 JULY

(a) Course A: An increase in employee pension contributions from their typical level of 5-7% in the public services to something significantly higher.

(b) Course B: A partial switch to "pay-as-you-go" contributions, under which members of index-linked schemes would pay a separate special charge directly related to the emerging cost of pensions increase.

(c) Course C: The imposition, in one form or another, of an upper limit on post-award increases in pensions.

(d) Course D: A discretionary power to increase pensions by less than the rate of inflation.

CONFIDENTIAL cc Mr. Scholar

Econ Pol.

MR. HOSKYNS

MES.

Official Study of Public Sector Pensions

I sent you a progress report on 25 September of the work of the official group which was looking at the follow-up to the Scott Report. The report has now been considered by the Chancellors of the Exchequer and Duchy of Lancaster, and Lady Young has proposed to the Chancellor of the Exchequer a draft paper for E (possibly to be taken on 10 November) which invites agreement on the second contribution option that I described in my earlier note - levying an additional specific charge for index linking, related to the current cost of indexation. She has also recommended legislation in 1981/82, and making the Civil Service Pensions Scheme fully contributory by 1984. The two Chancellors discussed this paper this morning, and (rather as officials had feared) the Chancellor of the Exchequer dissented: he wants action on both contributions and pensions, and a limitation on the benefits in the shape of a 7% cut-off for the annual pensions increase. He is also opposed to making the Civil Service scheme contributory, even though it will reduce take-home pay by 1%.

I had a word with Michael Scholar about whether we should now show some of these papers to the Prime Minister. There are major issues here, in which the Prime Minister is known to be interested. There is potential massive public expenditure saving, and there are also important political considerations, not least the way in which action on the benefits side would be regarded by 1.6 million public service pensioners, most of them with spouses. But we agreed that since the two Chancellors have some way to go before reaching a common position for E, and in view of the Prime Minister's other current preoccupations, we would leave it another week before asking her to focus on these issues.

30 October 1981

CONFIDENTIAL

Econ Pol

NBPM

Chancellor of the Duchy of Lancaster

Civil Service Department
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cc A Duguid
J Vereker

From the Private Secretary

29 October 1981

John Kerr Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1P 3AG

Dear John,

FOLLOW-UP TO SCOTT REPORT

Our two Chancellors are to meet tomorrow at 1100 to talk about the handling of this. The Chancellor the Duchy thought it might help to focus discussion if you had a copy of the attached draft joint paper which our two Ministers might circulate to colleagues for discussion at E Committee on 10 November. The Chancellor of the Duchy thinks the paper has about the right approach although she is not, of course, committed to the detail.

Because of the important consequences for the Commons, I am copying this note and the draft paper to Nick Huxtable in the Lord President's Office, as well as to Michael Scholar (No.10) and to David Wright (Cabinet Office).

Yours sincerely,

Jim Buckley.

J BUCKLEY

DRAFT JOINT PAPER FOR E COMMITTEE

INDEX-LINKED PENSIONS: FOLLOW-UP TO THE SCOTT REPORT

Note by Chancellor of the Exchequer and Chancellor of the Duchy

Introduction

E Committee last considered this on 15 July (E(81)24th Meeting) and concluded that:

a. the assumption should be that any changes made would apply to all public sector groups with index-linked pensions;

b. any legislation would have to be taken through Parliament in the 1981/82 Session (with consideration being given to use of the 1982 Finance Bill); and

c. the options to be examined for the final round should be:

- Option A: a straight increase in contributions to a unified level of 9% or 10%;

- Option B: leaving the existing contribution structure broadly unchanged but levying in addition a specific charge for index-linking related to its current cost and private sector practice;

- Option C: An automatic cut-off on the degree of indexing in any year;

- Option D: a discretionary power, subject to Affirmative Resolution, to increase pensions by less than inflation in any year.

2. The report by the Official Committee on the Value of Pensions (E(81)?), which has been circulated separately, examines these options in the light of our earlier comments. A public statement is expected of us soon and we now need to reach agreement on what to do. Despite the complexity of the subject, the possible courses are now reasonably clear. The choice between them remains difficult. Our views are as follows.

Scope

3. Quite apart from other problems, the need for early legislation rules out tackling nationalised industry pension schemes in a direct manner. We must therefore concentrate - at least initially - on the public services (remembering, as the report shows, that the biggest savings will come from tackling all the public services and not just the Civil Service: indeed the bulk of the potential savings come from bringing the contributions of the other public services up to the level effectively paid now by the Civil Service.)

Contributions or benefits?

4. We must choose between action on contributions (options A and B) and on benefits (Options C and D). It would be very difficult to ask the Civil Service, the nurses, the teachers etc to pay more for their pensions when at the same time we are proposing to reduce the amount of index-linking. Our view is that we should concentrate on contributions. It would bring in the largest amount of money (up to £500m. - depending on the assumptions a range of between £300m-£600m - in a full year against only £30m. from cutting benefits by one percentage point) while offending the smallest number of people. And it would be consistent with the statements we made at the time of the Election (see the Annex to E(81)78). It is also the course most likely to be accepted by the staff as equitable.

5. As between options A and B we favour B (the special charge). Not only is it the simplest and therefore speediest course, it is the one under which public servants will demonstrably pay for the better inflation-proofing of public service pensions. Although this option cannot be applied directly to the nationalised industries, several of them already have employee contributions at about the level indicated under option B. Through the new monitoring arrangements, we shall be able to bring pressure for increased employee contributions on those industries whose pension funds get into deficiency over the next few years.

Legislation

6. Legal advice is that we cannot act through the Finance Bill. Separate legislation is inevitable for any of the options. It would be short but highly contentious. If we stand by the view that any legislation on this subject in this Parliament must be taken in the present Session, this raises acute difficulties for the Parliamentary timetable. We have

to decide whether we want a great deal of revenue in 1983/84 or prefer to maintain the existing legislative programme for 1981/82.

A contributory scheme for the Civil Service

7. We also need to decide whether to accept the advice of officials that the Civil Service Pension Scheme would be made fully contributory. The advantages are that many misconceptions about that scheme would be removed and the pensions contributions would be decisively uncoupled from the pay bargaining system. Contributions would be paid and seen to be paid. We might also save a little money. On the other side of the account, it would mean an apparent increase in pay in the year in which it was introduced - probably 1984. In fact, take-home pay would go down by about 1%.

Consultation

8. We are sure there must be some public explanation of our proposals and indeed, we are firmly committed to consult both employers' and employees' organisations. We are also agreed that any consultation should be the basis of firm proposals by the Government. If colleagues agree, officials could draft a document quickly with a view to publication before Christmas [and legislation as early as possible in the New Year.]

Recommendation

9. We invite the Committee to agree that:-

a. the preferred approach should be option B;

b. we should aim to legislate, for the public services alone, in 1981/82;

c. the Civil Service pension scheme should be made fully contributory, probably in 1984;

d. we should bring pressure on the nationalised industries to increase employee contributions where the new monitoring arrangements show that to be necessary; and

c. we should issue a consultative document containing firm proposals by the end of the year.

CONFIDENTIAL

RESTRICTED

Prime Minister

MLS 6.10.81

Econ Pol.

Chancellor of the Duchy of Lancaster

Civil Service Department
Whitehall London SW1A 2AZ
Telephone 01-273 4400

From the Private Secretary

5 October 1981

John Kerr
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1P 3AG

MG

Dear John,

The report of the Official Committee on the Value of Pensions is about to be submitted to our two Ministers and we need to consider how it should be handled. The Chancellor of the Duchy is clear that there would be advantage for everyone if, as with the progress report in July, the final report of the Official Committee could be submitted to E under cover of an agreed joint paper, making agreed joint recommendations, in the names of the Chancellor of the Exchequer and herself. If the Chancellor of the Exchequer shares this view, and given other commitments and timetable problems, it would seem desirable for our two Ministers to have at least a first discussion of the report before the Party Conference.

I am copying this letter to Clive Whitmore (No.10) and David Wright (Cabinet Office).

Yours sincerely,

Jim Buckley.

J BUCKLEY

RESTRICTED

5 OCT 1981

cc: Mr. Duguid
Mr. Walters

MA

PRIME MINISTER

E, 15 July: Public Sector Pensions

E is considering tomorrow the interim report of the official group which has been looking at the issues raised by the Scott Report on Public Sector Pensions, and the joint memorandum by the Chancellor and the Lord President (E 81 78) covering the report.

The official group has looked at possible changes in both contributions and benefits across the whole spectrum of public sector pensions, and has narrowed down its proposals for future work to the shortlist contained in paragraph 71 (Flag A). Further possible options, not recommended for further work, are contained in paragraph 72.

I am sure, having participated in the work of the group that prepared the report, that the options in paragraph 71 are the right ones, and I hope that E will endorse them. But there are three particular issues on which it would in addition be useful to have Ministerial guidance before further work is undertaken:

i) To what extent do Ministers feel bound by pledges made at the time of the Election? The addendum to the paper (Flag B) summarises these: on the surface they do indicate a continuing commitment to the principle of index linking, and if the Government does not wish to cut back on that commitment then the benefits route is closed, and further work should concentrate on changes in contributions.

ii) Do you agree that, as proposed by the Chancellor and the Lord President in their covering note, the scope of whatever is done about public sector pensions should include as far as possible all public sector groups which enjoyed index linking, and not just those in the public services? We do of course already have considerable difficulties in restraining wage costs in the nationalised industries, and

/ there should be

there should be no doubt that attempting to relate their pension benefits more closely to their contributions would complicate wage negotiations. But it is clear from the work of the group that it is in those areas that the greatest opportunity for financial savings arises, both because of the numbers involved and because of the greater extent to which the cost of pensions are met by contributions in the public services.

iii) There is a particular difficulty of possible overlap between further work by the group on Civil Service pensions, and the Megaw Inquiry. You will recall that Megaw's Terms of Reference do not specify the inclusion of pensions, but the formula - "taking account of other conditions of service and other matters related to pay" - certainly points Megaw in that direction. So I think further work ought to concentrate on non Civil Service public sector pensions (which are about 82% of the total anyway) and on evidence to Megaw about the Civil Service Scheme.

J.

14 July 1981

cc J Vereker
A Duguid
A Walters

CONFIDENTIAL

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

14 July 1981

PRIME MINISTER

TL
14/7

FOLLOW-UP TO THE SCOTT INQUIRY

I am very sorry that I cannot attend E Committee tomorrow.

I have, however, read Geoffrey Howe's and Christopher Soames's joint paper covering the progress report of the Official Committee on the value of pensions. I very much agree with their approach. In particular I think it is important to recognise that we are concerned with a very wide range of public sector groups who receive index linked pensions, not just the Civil Service and that any major adjustments to the benefits of the current scheme would have very widespread implications. Clearly the benefits end must be examined but I think it is right that work should concentrate on the area pinpointed by the Scott Inquiry, namely that the Government should make sure that contributions represent the true value of the benefits enjoyed by public service pensioners.

I hope we shall be able to announce within a reasonable period the outcome of our thinking on the Scott Report. The present uncertainty clearly allows mischief-makers to suggest that we intend to get rid of index linking and this is a factor, I am sure, in present attitudes among civil servants to industrial action.

I am copying this minute to other members of E Committee and to Sir Robert Armstrong.

PETER WALKER

CONFIDENTIAL

Ref A05256

PRIME MINISTER

Follow-up to the Scott Inquiry into the Value of Pensions
E(81) 78

BACKGROUND

In E(81) 78 the Chancellor of the Exchequer and the Lord President of the Council invite the Committee to endorse their recommendations for further work by the Official Committee on the Value of Pensions whose interim report is attached to their memorandum. They do not invite the Committee to take any definitive decisions at this stage.

2. The Scott Report was discussed by Cabinet on 15 January 1981 (CC(81) 2nd Conclusions, Item 5) when it was agreed that the Government should offer no comments on it at the time of publication, and that officials of the Departments concerned, under the chairmanship of the Treasury, should examine the issues raised and should report to the Chancellor of the Exchequer and the Lord President of the Council who would then make proposals to Ministers. The Scott Report was published on 5 February when, in a Written Answer (Hansard Col 173) you said:-

> "I should like to thank Sir Bernard Scott and his colleagues for their thoughtful analysis of the issues involved. Before taking any decisions on this problem, the Government will take account of the reactions to the report's analysis and findings."

The Government is not committed to take further action by any particular date and, while the Scott Report aroused interest when it was published, there is no strong public or Parliamentary pressure for early action.

3. The Official Committee have now produced their detailed interim report which is annexed to E(81) 78. The main issues are summarised in the Chairman's cover note and in the index and summary to the report itself. Since firm decisions are not invited at this stage, there is no need for the Committee to examine the official report in detail. What is needed is guidance on

whether officials are on the right lines and, therefore, on the questions summarised by the Chancellor of the Exchequer and the Lord President of the Council in their covering memorandum.

4. If approval is given to further work, on the lines recommended, the next step will be for the two Ministers to instruct the Official Committee to prepare detailed papers on the options recommended for further study, with a view to inviting the Ministerial Committee to take decisions on the next moves in about October or November. These decisions would be taken against the background of the latest development on the pay front. In the meantime there would be no consultations with the unions.

HANDLING

5. You might open the discussion yourself by emphasising to the Committee that they are not now being invited to take decisions on the issues set out in the report by officials. The object is to decide whether the Committee endorses the recommendations for further work with a view to decisions in the autumn. You might then ask the Chancellor of the Exchequer and the Lord President of the Council to speak to their paper. Unless any other Minister wishes to make general points, you might then take the Committee through the main questions in E(81) 78, which are summarised in the following paragraphs.

6. Is it accepted that any changes should, so far as possible, apply to all public sector groups which have index-linking? (Paragraph 3 of E(81) 78).

i. The point here is that (although the arrangements differ) in addition to the Civil Service there are indexed-linked pension schemes for the Armed Forces, the National Health Service, MPs, Ministers, the Judiciary, Teachers, Local Government employees, the Police, the Fire Service, the Nationalised Industries and other public corporations. (The details are summarised in Annex B of the report by officials.)

ii. Acceptance that, as a question of equity and to maximise the gains to the Exchequer, the arrangements should apply to public sector pension schemes generally, implies that Ministers are not ruling out such possibilities as -

a. Changing the terms of some public service and nationalised industry pension schemes over the heads of employers and employees, or

b. altering the terms of Exchequer support for certain public sector pension schemes.

iii. It should be noted that contributions are currently relatively higher for civil servants (8 per cent) than for most other public services (5-7 per cent); any attempt to increase contributions to a roughly common level would bite more on the other public service and sector schemes.

7. Should both benefits and contributions be considered? (Paragraphs 4 and 5.)

i. Scott was concerned only with contributions.

ii. The Committee will need to consider what weight to give to the statements made during the 1979 General Election campaign which are summarised in the Addendum to E(81) 78, which seem to point to the possibility of changes in contributions but not in benefits.

iii. If there were to be changes on the benefit front, primary legislation would be necessary in 1982-83; but, subject to clarification in the further work, if the changes were confined to contributions this could be achieved, at least in the Civil Service, by negotiation.

iv. There is a key question in paragraph 5 of E(81) 78 on whether the working assumption should be that any changes in benefits would apply to existing pensioners and in respect of service before the date of any change in current arrangements. That would be held to be tantamount to "retrospective legislation"; but without such an assumption the financial benefit of any change would be very long drawn out.

8. Does the Committee approve the short list for the study of further options which is recommended by officials in paragraph 71 of their report (subject to their decision on whether benefits should be further examined - paragraph 7 above)?

i. The options which were ruled out of the short list are summarised in paragraph 72 of the officials' report.

ii. In practice the short list is pretty wide-ranging, covering both contributions and benefits and variants of each.

9. Are there any difficulties over carrying forward this work in parallel with the Megaw Inquiry into Civil Service pay? (Paragraph 7.)

- You might ask the Lord President of the Council to advise on whether he sees any difficulties arising from -

i. The Megaw Inquiry dealing with pensions questions and so overlapping with the further work now proposed.

ii. Relations with the Civil Service unions if they feel that, on top of the current pay dispute, they are (as they could see it) attacked on the pensions front.

10. There is one other question which, while relevant, does not arise directly from the present papers: namely should officials be asked to consider whether the work they are undertaking has any implications for the present state retirement pension arrangements which are in the process of providing large numbers of private sector employees with earnings related indexed linked pensions?

CONCLUSIONS

11. In the light of the discussion you will wish -

1. To record conclusions with reference to the recommendations, summarised above, for further work by officials.

2. To invite the Chancellor of the Exchequer and the Lord President of the Council to make recommendations in the autumn in the light of the further work by the Official Committee.

RtA

Robert Armstrong

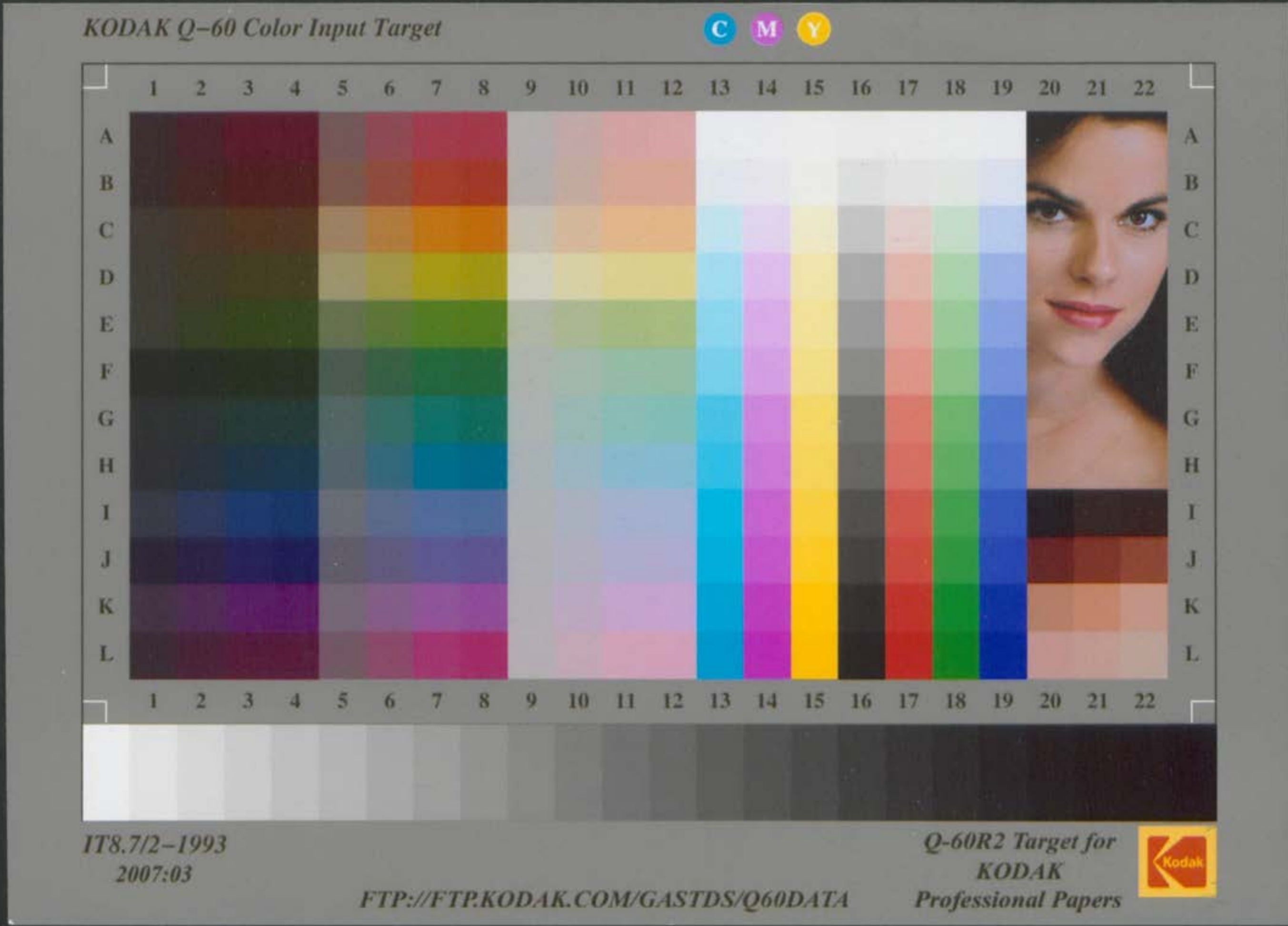
14 July 1981

PART 2 ends:-

4.6.81

PART 3 begins:-

10.7.81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