cc: Mr. Wolfson
Mr. Hoskyns

Civil Service

PRIME MINISTER

INFLATION-PROOFED PENSIONS IN THE CIVIL SERVICE

The Association of Independent Businesses wrote to you criticising the smallness of the deduction from Civil Service pay - only 2.6% - which the Government Actuary recommended in his latest report for the value of Civil Service index-linked pensions (Flag A).

I now attach a draft reply (Flag B), a background note from CSD (Flag C), and a note explaining the 2.6% from the Government Actuary (Flag D).

The draft letter is rather bland. This is not because the CSD are altogether happy with the 2.6% deduction: on the contrary, they thought it was insufficient, and they are also unhappy that the Government Actuary has not managed to get a better public understanding of his methodology. However, CSD do not think it would be right - and I am sure in this they are correct - that the Actuary should be criticised in the first instance in a letter from you to an outside organisation.

The main reason, in my view, why the Actuary has come up with such a low figure is that the analogues outside the Civil Service which he has looked at are untypical for the economy as a whole. But this is in effect a criticism of the analogues which the PRU examines - since, under the Civil Service Pay Agreement, the Actuary takes the same analogues.

I think you will want a paper from CSD Ministers fairly soon on the PRU system and how they see it operating in the next pay round. PRU are already working on the re-evaluation of the analogues, and the sooner they are given any new guidance which Ministers may have in mind the better. In view of the link between PRU and the work of the Actuary on the pensions deduction, I suggest that they should also report on this aspect too.

Shall I ask CSD to prepare such a paper, to be taken in E Committee within the next month or so?

31 May 1979

TL

LORD PRESIDENT OF THE COUNCIL

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

29 May 1979

T Lankester Esq
10 Downing Street

Dear Tim,

In your letter of 21 May you sought advice on the reply to the letter dated 17 May from the Association of Independent Businesses to the Prime Minister. Although it does raise some of the wider issues involved in the index-linking of public sector pensions the letter concentrates on the method by which civil servants pay for pensions as described in the Government Actuary's recent report. The Civil Service Department looks to the Government Actuary to calculate the deduction from Civil Service pay on account of pension benefits. He is sending you direct the note which you requested but for convenience I enclose a copy of his letter.

2. It is vitally important to the operation of the pay research system that a proper adjustment should be made for comparative pension benefits, including index linking. It has become almost equally important that the calculations used for this purpose should be understood and accepted by public opinion. CSD Ministers will be considering shortly what more might be done to improve public understanding. In the meantime the Prime Minister may wish to send a fairly general reply to the Association's letter. A draft is attached.

3. The following is by way of background. In 1977 the Civil Service Pay Agreement introduced a number of changes to meet public criticism of certain features of the pay research system as a condition for its reactivation. In view of the extensive criticism of Civil Service pensions arrangements, CSD officials obtained the agreement of the unions to the reassessment by the Government Actuary of the deduction for differences in pensions benefits and to the publication of a report by him so as to enable interested parties and, in particular, outside actuaries to comment on his methods, This is the first occasion on which the assessment has been carried out on the basis of full evidence collected by the Pay Research Unit of the details of the pension provisions for the outside analogues seen in the pay research surveys.

4. Mr Bayliss says his Association is dissatisfied with the conclusions of the report for the following reasons:

a. no account is taken of the value of the assurance that Civil Service pensions will remain inflation-proofed.

Comment The Government Actuary bases his calculation on the assumption that inflation-proofing will continue. In fact it is always open to a future Government to legislate to change the basis of the pensions increases.

b. the analogue schemes are not typical of the private sector generally.

Comment this is not a matter for the Government Actuary who states (paragraph 3.3 of his published report) that the schemes are those attaching to the outside analogues the selection of which is the responsibility of the independent Director of the Pay Research Unit. His methods and the representativeness of the survey fields have been endorsed by the independent Pay Research Unit Board whose task it is to monitor the Director's exercise of his responsibilities.

c. the benefits have been expressed at the "new entrant contribution rate" which overstates the value to outside pensions of the State scheme.

Comment The Government Actuary gives in paragraph 5.2 of his report his reasons for this choice. His assessment is intended to value the benefits currently accruing, and these benefits will include a guaranteed minimum pension which the State scheme will inflation proof.

d. the economic assumptions imply a rate of inflation which may be too low.

Comment The choice of economic assumption, taking a forty year view, is very much an actuarial matter. We understand that the assumptions are in line with those used by other actuaries.

Yours sincerely,

Jim Buckley.

J BUCKLEY
Private Secretary

Civil Service Pay Research

Adjustment for Differences in Superannuation Benefits

Note by the Government Actuary

1. The Prime Minister has asked for a note explaining how I arrived at such a low figure as 2.6% for the adjustment for differences in superannuation benefits between civil servants and those in analogue employments. A copy of my report on this adjustment is attached; some salient features are summarized below.

2. The deduction covers benefit differences only; contribution differences are dealt with elsewhere in the pay research process. It was obtained by valuing the benefits currently accruing to serving civil servants and those accruing to their outside analogues. It does not take into account the benefits being paid to current pensioners, as the pay comparisons relate to those in service now.

3. The actuarial basis must have regard to long-term prospects, as civil servants now serving may not retire for a very long time and may live for many years after retirement. One must look to 40 years or more of the future, not at the immediate past. The basis assumes that the yield on investments (including capital appreciation as well as interest) will exceed the rise in prices by 3% a year and the rise in the general level of earnings by 1½% a year. The gross rate of interest in money terms was taken at 9% a year and this implied inflation rates of about 6% a year in prices and 7½% a year in earnings. It must be emphasized that these are long-term averages and do not represent the rates expected in the near future. It was assumed that higher rates of inflation would be accompanied by higher rates of interest.

4. The main reason why the deduction is much lower than many would have expected lies in the information the pay research exercise revealed about pensions increases in analogue schemes. (See paragraphs 4.6 & 7 of the report). Though few outside schemes promise full protection against inflation, in practice many analogue schemes have given a high degree of protection even in recent years; the comparison is not between the civil service giving full protection and analogue schemes giving none, but between full protection on the one hand and considerable protection on the other.

5. Analysis of analogues showed that over 20% of their schemes - probably almost all public sector - gave full index-linking. About 25% gave fixed increases, commonly 3% per annum, of whom over half provided for discretionary increases on top.

About 45% provided for discretionary increases only, and under 10% made no provision. Schemes which gave discretionary increases covered about 60% of the rise in the cost of living on average. One-third of all analogues gave 80% protection or more.

6. Where a scheme is contracted-out, the Guaranteed Minimum Pension will receive full price protection through the State scheme. For the balance of pension over this level, it was assumed that any fixed percentage increase would continue to be given, and that, in relation to the Retail Price Index, employers would give the same discretionary increases as in the recent past. This implies that analogue pensions in excess of guaranteed minimum pensions would receive about 70% of full protection or, taking guaranteed minimum pensions into account, nearly 80% of full protection.

7. The remainder of the deduction arises from other differences between civil service and analogue benefits. Analogue schemes often have larger national insurance offsets and higher retirement ages but better death benefits than in the civil service.

Government Actuary's Department
London WC2

23 May 1979

Civil Service

DRAFT LETTER FROM THE PRIME MINISTER -

P Bayliss Esq
The Association of Independent Businesses

Thank you for your letter of 17 May about the Government Actuary's recent report relating to Civil Service pensions. Although you touch on some of the wider aspects of public sector pensions arrangements, you seem to be mainly concerned about the extent to which civil servants pay for their pensions.

~~2.~~ To avoid any misunderstanding I should perhaps point out that the 2.6% deduction for net differences in benefits is only one of several deductions from Civil Service pay required by the pay research system to reflect differences between the pension arrangements of civil servants and those with whom their pay is compared. In addition to this deduction there are deductions for the extent to which the outside pension contributions exceed the 1½% paid by male civil servants in respect of family benefits. The combined effect of all these deductions varies from grade to grade but is usually in the range 6% - 8%. The average contribution in the outside schemes concerned is 4.1% of total pay.

~~3.~~ Many of your comments on the report relate to the way the Government Actuary has exercised his independent professional judgment on actuarial matters. He is the Government's professional adviser in this field but the publication of his report will enable other actuaries to comment on these matters. Indeed the whole purpose of publishing the report was to permit a wide-ranging and informed debate by the actuarial profession of the Government Actuary's assumptions and methodology. This will help us to ensure that proper comparisons are made and that the pay research system is understood and accepted as fair by all concerned, including the taxpayer. The Government attaches great importance to both these objectives and I therefore very much welcome the interest shown by your Association.

4. Your letter also includes some more general recommendations of your Association. Before 1971, public service pensions were increased to take account of inflation at frequent intervals though not annually. This required repeated special legislation which was costly and inconvenient. I do not see that any useful purpose would be served by a return to this ad hoc system, which has also, as you know, been replaced in State pension arrangements by statutory provision for regular increases each year. As to your second recommendation, which recalls the views of the Expenditure Committee, the commitment to publish the Government Actuary's report will enable outside actuaries to examine the assessment he has made.

5. Your third and fourth recommendations invite the Government to take direct responsibility for inflation proofing private occupational pensions. The inability of private occupational pension schemes to maintain the real value of pensions arises essentially from the relatively poor performance of the British economy over recent years. Inflation is but one symptom of the underlying weaknesses which this Government is committed to rectifying. Only by dealing with these deep-seated problems will it be possible to bring about a sustained increase in the real living standards of all members of our society, including pensioners. An important element in our policies is, of course, the enforcement

of strict controls over public expenditure with the objective of restoring an acceptable balance between the claims of the public and private sectors over our economic resources. Against this background I would hope that you will accept that Exchequer underwriting of occupational pensions generally, which can only add to public spending, would not usefully contribute to the achievement of our long-term objectives.