Ref. A01475

PRIME MINISTER

Inflation-proofed Pensions

(E(80) 16 and 18)

BACKGROUND

E(80) 2nd Mtg Item 2,

At the last discussion on 23rd January (E(80) 1st Meeting, Item 5) the Committee considered a proposal by the Chancellor of the Exchequer that a group of "wise men" should be asked:-

— January 15

(a) To comment on the economic assumptions used by the Government Actuary in valuing public service pensions.

(b) To set a subjective price on the "guarantee" of index-linking enjoyed by public service pensioners.

(c) To advise how "job security" might be valued.

2. The Committee deferred a decision because of the doubts expressed by Sir Kenneth Berrill about the wider effects of a change in the Government Actuary's assumptions on the real return on investment for the occupational pensions industry.

3. The point raised by Sir Kenneth Berrill is discussed in Annex 2 to the Chancellor's paper E(80)16. This suggests that a change in the economic assumptions - especially the assumed real rate of return on investments - could have a significant effect on the liabilities of existing pensions funds (paragraph 6 of Annex 2 equates a 1 percentage point reduction in the assumed rate of return with £1 billion extra annual contributions in the private sector and £$\frac{1}{2}$ billion in the public sector) but doubts whether relatively small changes in the assumptions would have much effect in practice. It is a question of degree: small changes would not cause problems but would not save much money; big changes could be very damaging but are unlikely because the Government Actuary's assumptions are in the middle of the range adopted by his professional colleagues elsewhere.

4. The main thrust of the Chancellor's paper is to argue for a limited degree of deindexing of public service pensions for two years "during which we could try to work out a more satisfactory long-term arrangement" (paragraph 3 of E(80) 16).

Unfortunately the Chancellor nowhere explains what sort of review he has in mind - though given the wide range and complexity of public sector pension schemes, it is to be doubted whether anything less than a Royal Commission would be able to do the job satisfactorily or carry conviction.

5. In addition to limiting his proposals to a two-year period, the Chancellor also advocates:-

(a) Limiting deindexing to those in receipt of public service pensions to the amount by which the pension exceeds £1,000 per annum.

(b) Excluding the nationalised industries even where, as in the case of the Post Office and British Rail, the pensions paid are subject to the provisions of the 1971 Pensions Increase Act.

6. The Minister of State, Civil Service Department's paper argues strongly against the Chancellor's proposals. His arguments are mainly political - the numbers of people involved, past commitments and the anomalies the Chancellor's proposals would create - for instance, that they would penalise soldiers, policemen and nurses but not gas workers, postmen, bus drivers or coalminers - or their senior staffs. He also points out that action on "contributions" would bring a much greater return to the Exchequer (£200 million a year for each 1 per cent additional contribution) than would the Chancellor's proposals (£50 million a year if the £1,000 cut-off is used, or £100 million a year if all public service pensions were cut).

7. In addition the Paymaster General has sent you a note on some of the mechanical problems to which the Chancellor's scheme would give rise. It suggests that the idea of a cut-off at £1,000 a year is administratively impracticable.

8. You will want to try and bring this particular subject to a conclusion at this meeting. To this end you might want to take your colleagues through the following questions:-

(a) Are "deindexing" and "increased contributions" mutually exclusive? Mr. Channon argues that they are (on the grounds that you cannot ask people to pay more for a "guarantee" which manifestly they would not have). The Chancellor is equivocal but appears to think it may be possible to deindex first and seek to raise contributions afterwards. Mr. Channon appears to have a certain logic on his side: it is not easy to see how one could ask people to contribute more for the certainty of the index link at the moment when legislation was being passed to remove that certainty. A prior decision here would simplify the rest of the discussion.

(b) Is deindexing politically achievable? It requires legislation: would the legislation carry enough support?

(c) Assuming that deindexing remains an option, do the Committee:

(i) Agree that it should be limited in amount and time as suggested by the Chancellor (up to 5 percentage points a year for two years)?

(ii) Agree that it should be applied only to the better off pensioners? The key questions here are perhaps justification - the better off have contributed in proportion to that pay, no less than those not so well off - and saleability to Parliament. The alternative is to deindex all public service pensions though this would enhance the anomalies referred to below.

(iii) Agree that the nationalised industries should be excluded despite the anomalies this would create? The problem is that many nationalised industry schemes are funded and not amenable to Government control.

(iv) Agree that the time bought should be used to examine public sector pensions in depth? If so, how should this be done? A Royal Commission?

(d) If attention concentrates on the "contributions" route do the Committee:-

(i) Think that "wise men" should be set to work at once? It is out of the question now that the "wise men" could report in time for their views to be taken into account in the negotiating timetable for this year's Civil Service pay round. But they could report for next year; or the CSD might seek to negotiate a temporary abatement in this April's pay settlement, so that any adjustment following the "wise men" could be implemented later in the year. The latter course would be akin to staging.

(ii) Think there is any other route? For example, could the idea of the "wise men" be dropped and a negotiation be entered into with the staff under which they would trade an abatement in pay this year (and in subsequent years) for a real guarantee of the preservation of index-linking? It could well be that, if asked, many civil servants would prefer to pay more for their pensions if by doing so they safeguarded index-linking. But is any Government able to give such a guarantee, given that what one Government does can be undone by its successor?

(e) How would any increased contribution by civil servants be reflected in other public sector schemes? These schemes vary enormously and while some may move by example, others will require a negotiated change with the unions concerned and/or legislation. A good deal of the basic factual information exists in Whitehall, and Ministers might find it helpful to commission a factual analysis as a basis for second-stage decisions.

9. Although you will no doubt wish to keep Ministers to the basic questions, a number of hares may well run. Points on these are:-

(a) Index-linked pensions cost civil servants only 2.6 per cent of salary. Not so. The 2.6 per cent represents the valuation of the difference between full index-linking and the 60 per cent index compensation achieved in the analogue schemes. Actual Civil Service contributions - partly through abatement of basic pay - are about 7 per cent. And we understand that the Government Actuary will be increasing his valuation of the extra index-linking this year to 3.8 per cent - making a total contribution in excess of 8 per cent. This compares with the 6 per cent contributed by Members of Parliament, the 5-6 per cent contributed by local government employees and the 5 per cent contributed by mineworkers. It will put Civil Service contributions at the upper end of the range of public sector practice.

(b) An index-linked pension is "priceless". True in the case of an individual trying to buy a pension from an insurance company. But misleading when large numbers are involved on a "pay as you go" basis. After six years of severe inflation the Government's contribution to this year's Civil Service pensions will be about 10 per cent of the wage bill. Comprehensive information is hard to come by, but a survey conducted for the TSRB and reported in their Tenth Report in 1978 (Table 9), showed that the average contribution by employers for the pensions benefits of senior executives in private industry exceeded 20 per cent of the salaries of those concerned, while the employee's contribution averaged 3 per cent. (The comparable averages in nationalised industries were 12.8 and 6.5.) Of course these figures relate to the better paid but we believe the 10 per cent Government contribution for all its staff to be no higher than the generality of private industry's contributions to its pension schemes.

(c) Index-linking gives disproportionate benefits to higher-paid public servants. Again hard information is difficult to come by but interesting tables are to be found on page 51 of TSRB 10. These show that, if superannuation benefits are measured in terms of lifetime salary, senior civil servants do rather better than their private sector counterparts - perhaps 20 or 25 per cent better - though the differences may be accounted for by higher contributions and lower retirement age. But the startling discrepancy is with senior officers of the Armed Forces and members of the judiciary whose pension "take" is almost double that of both their private and public sector counterparts. In the case of the Armed Forces the discrepancy almost certainly derives from the lower retiring age applicable to Service appointments.

HANDLING

10. You will want to ask the Chancellor of the Exchequer to introduce his paper and the Minister of State, Civil Service Department, to introduce his. Thereafter I suggest you might find it convenient to take your colleagues through the questions outlined in paragraph 8 above.

CONCLUSIONS

11. Very much subject to discussion, but probably emerging from the answers that your colleagues give to the questions you will pose. If the politics of deindexing are thought to be too difficult, a review by "wise men" of the value to be attached to the unquantifiable "guarantee" of index-linking for the purpose of calculating contributions would at least show that the Government was determined to look seriously at the problem, even if it could produce no results for this year's Civil Service pay round.

p.p. ROBERT ARMSTRONG

19th February, 1980