Econ Pol

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 30 June 1980

The Rt Hon Lord Soames, PC, GCMG, GCVO, CBE
Lord President of the Council
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Whitehall
LONDON SW1A 2AZ

Dear Christopher

PENSIONS ENQUIRY: GOVERNMENT EVIDENCE

I have reflected carefully on the view you expressed in your letter of 23 June. I still feel that we should offer some background explanation on the lines of the paper I sent to you, and it does not seem to me that this will either point the enquiry in the wrong direction, or go unreasonably beyond exposition of the considerations which led to the enquiry.

I can, however, accept all the amendments suggested in the separate letter from your Private Secretary, being in general improvements which I welcome.

.... Accordingly, I am sending an amended version (of which I attach a copy) to the Enquiry. I am sending a copy of this letter and the enclosure to the Prime Minister.

Yours ever

Geoffrey

GEOFFREY HOWE

BACKGROUND TO THE ENQUIRY

The Government's decision to set up this enquiry reflects deep concern, shared by Parliament and much public opinion, over the cost and value of fully inflation-proofed pensions, after the experience of several years of very rapid inflation. The problem is particularly troublesome because full inflation-proofing has been for some years applied generally - and in some important cases statutorily undertaken - for public sector employees; but it has been very rare - and perhaps never guaranteed - in private sector schemes. The differences are underlined by the fact that many public sector schemes are not funded, and where funded have in a few cases been financially assisted by the Government. Private sector schemes have to be commercially operated, may be subsidised in case of difficulty by parent employers, but are more plainly exposed to financial limitations and constraints. Meanwhile the self-employed and others lacking occupational pension schemes are limited to whatever returns they can obtain through use of commercial savings media. This note sets out the background to the Enquiry, and the reasons which led the Government to set it up, without expressing views on the subject matter of the Enquiry.

Information about Pension Schemes

There is a very wide variety of pension schemes, not only in the private sector, but also in the public sector. The great majority, in both public and private sectors, conform to a broad pattern in which a full working career is recognised by the award of a pension of a value around two-thirds salary at or around the close of the career (typically paid in a mixture of immediate lump sum gratuity and subsequent regular pension payments). The many detailed variations of career qualification, method of calculation of the pension in relation to salary, special death, family or other provisions and contribution arrangements reflecting these differences, although important in themselves and in making comparisons, are unlikely to be germane to the object of the enquiry. In general, there are recognised actuarial methods for evaluating such matters and there are no particular differences of technique or approach between public and private sectors.

A good deal of information could readily be supplied about the many public sector schemes, covering some 5 - 6 million present employees (and many of their predecessors, now pensioners) in direct Government service, or employed by local authorities, nationalised industries and other public bodies. It is estimated that some 6 - 7 million employees (and their predecessors, now pensioners) are members of private sector pension schemes. The Government has less comprehensive information about them.

The History of Inflation-Proofing

In the decades before 1970, the practice of awarding pensions in relation to final salary became widespread, with the majority of private pension schemes adopting this principle which had in general already developed in the public sector. It was, however, rare for any systematic provision to be made to maintain the value of pensions after retirement. Subsequent developments in public sector pensions are set out in evidence submitted by the Civil Service Department, which describes the main legislation on which inflation-proofing of "official pensions" is now based.

Other pension schemes in the public sector are not directly governed by this legislation, but the same or similar provisions have in practice been adopted by all under the varying legislation, agreements, pension fund rules, etc., with which they operate. The ability of funded public sector schemes, of which there are many, to meet the commitments involved depends on the management of funds, the willingness and ability of the industry or authority concerned to give any necessary financial support, and in a few cases on assistance from Government.

The practice in private pension schemes varies a great deal. As already mentioned, full inflation-proofing has been rare during the past few years of rapid inflation; and guarantees which could be regarded as the equivalent of the statutory commitment in relation to some parts of the public sector are unknown. Nevertheless, many private pension schemes have recognised the problems of declining value of pensions and have adopted one, or often a combination, of two approaches:

- a guaranteed regular annual enhancement of pensions, typically of the order of 3 per cent per annum; and

- discretionary enhancement at annual or less frequent intervals, depending on experience of inflation, on the state of the pension funds and frequently on the willingness of the parent employer to provide financial support to strengthen the funds.

Comprehensive information is not available about how much pensions have in practice been increased. But the review by the Government Actuary in the course of the 1980 Civil Service pay research exercise indicated that the analogue employers (excluding those providing full index-linking automatically or with no provision for discretionary increases) had on average increased pensions in payment by between 50 and 55 per cent of the actual increase in the cost of living over the previous five years. In that period, prices approximately doubled, so that, on average, pensions had lost value to the tune of 20 - 25 per cent.

Relevance of State Pension Schemes

Present State Pension Scheme arrangements go back to the Social Security Pensions Act 1975 and the Social Security Act 1975, which have an important bearing on the subject, particularly for the future. This legislation provides for a flat-rate basic State pension and, for employees, an earnings-related additional pension. The earnings-related additional pension is related to an individual's earnings up to a limit - about one and a half times average earnings - in each tax year from 1978-79. The amount payable by way of additional pension under the State schemes will be based on the best 20 years of earnings in a person's working life from 1978-79, revalued in line with the historic movement of average earnings over the period. The amounts awarded by way of additional pension will initially be relatively small but will build up over the first 20 years of the scheme.

Employers with occupational pension schemes which provide pensions at least as good as the State earnings-related additional pension can contract out of the scheme. Public service pensioners generally are contracted out. People contracted-out of the State scheme receive the State basic pension however.

The Social Security Acts provide for the basic and earnings-related additional State pensions to be increased annually at least in line with prices. (Prior to 1980, the basic pension had to be increased in line with earnings or prices, whichever was the more advantageous.) Other occupational schemes are not required to inflation-proof their pensions but the State pension payable to people who have been contracted-out is increased to inflation-proof that part of the occupational pension which corresponds to the earnings-related additional State pension which would have been payable if the employee has not been contracted-out. On this basis, in just under 20 years, basic State pensions and, as far as employees are concerned, an additional earnings-related pension either from the State or from an occupational pension scheme will effectively be guaranteed on an inflation-proofed basis throughout the community. The inflation-proofing of occupational pensions other than public service pensions will however only be guaranteed up to a certain level as indicated above. In the case of a married man on average earnings these provisions will provide inflation-proofed pensions for him and his wife totalling about half-pay.

The Impact of Recent Developments

Provisions in private pension schemes of the kinds described immediately above were introduced against the background of persistent inflation at a rate of a very few percentage points annually, in line with experience before the past decade. They might well have been adequate to secure maintenance of value of pensions during retirement. It is indeed likely that the implicit expectation of this underlay the general public acceptance and all-Party support in Parliament when the 1971 provisions for regular inflation-proofing of many public service pensions were enacted.

A totally different situation arose with the very rapid inflation of the 1970's accompanied by a persistent decline in rates of return on investment in real terms. Many private pension funds needed to call on parent employing companies to augment their financial resources on actuarial advice. Within the limits of such financial strengthening as could be obtained, full maintenance of value of pensions after retirement was rarely possible and the cumulative effect of several years of unfavourable experience has resulted in very large discrepancies between the initial and current value of a high proportion of pensions under private schemes. Even more marked has been the erosion of value of annuities and investment yields available to those relying on commercial savings media. This has in turn meant that the discrepancy in treatment of those retiring from public and private employment has grown rapidly, and that public attention and criticism has focussed on this sharply. Criticism is addressed to the problems of: the cost of inflation-proofing of public sector pensions; the special value of security of pensions value enjoyed by public sector pensioners; and the question whether these costs and values are adequately reflected in employee contributions and overall remuneration in the public sector. These points are dealt with in the following sections of this note.

The Problem of Cost

A good deal of work is done in the public sector on actuarial costing of inflation-proofed pensions. The contributions to nationalised industry pension funds are based on costings which include inflation-proofing and, within the public service, the Governmen Actuary undertakes regular costings of the teachers' and NHS notional funds, in which he considers it right to draw attention to the accruing liability for inflation-proofing.

The most systematic and frequent costing in the public sector is that done by the Government Actuary in relation to the Civil Service scheme. This is also the most systematic attempt to relate the total cost-including inflation-proofing - to what the employee pays, through the pension deduction applied to the non-industrial Civil Service. (During the past year or so, a similar concept has been applied to certain other public service employees.)

Separate notes are being submitted; by the Civil Service Department explaining the principle of comparison which is the basis for determining overall remuneration of the non-industrial Civil Service; and by the Government Actuary explaining how he makes the pension calculations which are then incorporated in Civil Service pay determination.

The methods adopted by the Government Actuary - indeed the whole process - have come under criticism. There was discussion of this, now in some respects out of date, in Chapter VI of the Eleventh Report from the Expenditure Committee of the House of Commons, published 25 July, 1977. The enquiry team will want to examine carefully the approach adopted by the Government Actuary, who will be able personally to supplement the published information already available in the sequence of reports he has made in relation to successive Civil Service pay settlements.

The Problem of Value

In principle, the approach enshrined in the arrangements for handling Civil Service pay aims to cost the net additional benefits of Civil Service pensions on an appropriate comparison, and then charge the employees in the Civil Service a corresponding contribution (through notional deduction from salary), so that the total package of remuneration for the civil servant and for the outside employee with whom he is compared is the same, taking career service and pension into account together. It must be for consideration, however, whether this concept, however accurately the costing is done, adequately incorporates the value to the recipient of an inflation-proofed pension. The essence of the problem is one of security. In theory, the public servant has no absolute guarantee of an inflation-proofed pension, because it can be revoked by Parliament at any time, and no Parliament can bind its successors. However, the public servant is perceived - and may perceive himself - to have a degree of security which is not available elsewhere. Many members of private pension schemes might be eager to obtain such security, by the payment of a higher pension contribution during their working careers, if the opportunity were available to them: in practice it is not so available because, although many private schemes have accepted inflation-proofing up to retirement, by linking pension awards to final salary, post-retirement inflation-proofing is not offered. The important question is whether the security conferred by full inflation-proofing should be regarded as having a value to the potential beneficiaries over and above any average actuarial cost.

Conclusion

The appraisal of any additional value to the potential beneficiary of the security of inflation-proofing cannot be carried out by straightforward objective calculation. This is an area in which judgment is needed, and this enquiry has been established in the hope of obtaining such judgment.

Attention has been focussed in this note on the non-industrial Civil Service, solely because that is an area in which an explicit attempt has been made, at least partially, to tackle the problem of the cost and value of inflation-proofing. In other areas of the public sector, there is a wide variety of contributory and non-contributory arrangements, with or without further notional account taken of pension values in determining pay, and in most of these other areas the present arrangements go back in history some years and have not been adjusted during the last few years. It is the Government's intention, in the light of the findings of this enquiry, to reconsider present arrangements for public sector pensions generally. It cannot be clear in advance whether extensive changes will be thought appropriate, or whether such changes would be more appropriately made in the structures of pension schemes, contribution arrangements, or pay determination, or through different methods in different cases. Any future proposals on these lines will of course be matters for careful discussion, and where appropriate negotiation, by the managements and staff associations and unions concerned.

The close connection between pay and pensions as part of overall remuneration is obvious. To the extent that any changes may be desirable, the Government would like to be in a position to embark on them as soon as possible, and has asked that the enquiry should be completed within a short space of time so that its findings can be available well in advance of the major public sector pay negotiations of 1981.

H.M. TREASURY
30 June, 1980