Original file CF to AR

C.F. to [illegible]

cc HMT, DHSS, CSD, Ian Gow

10 DOWNING STREET

THE PRIME MINISTER

22 January 1980

Dear Peter,

Thank you for your letter of 19 December expressing particular concern about the economic effects of the present system of funding public sector pensions and with which you enclosed an interesting paper on pension funding. You wrote in similar terms to Geoffrey Howe. I am replying for both of us.

Your paper covers the problems associated with the financing of occupational pensions in both the public and private sectors. As the paper rightly points out, it is primarily for the private sector to make its own decisions about pensions provision. I therefore propose to confine any detailed comment to the effects of switching to pay-as-you-go in the public sector. However, before dealing with this specific question I would like to make a number of general points.

The present pattern of pensions provision in this and other countries is largely a matter of economic and social history. Thus, the Pay-as-you-go (PAYG) systems currently operated in France and Germany were introduced as a result of periods of catastrophically high levels of inflation which undermined totally these countries' ability to capitalise pension liabilities. (The current level of pension provision in France and Germany of course derives from the generally higher level of

/wages

wages and salaries which they are able to pay as a result of their superior post-war economic performance, rather than PAYG per se.) The British experience has been different. Admittedly we have seen in the last decade the development of a worrying gap between the yields on pension funds' assets and the rate of wage and price inflation. This has caused the present disparity between the pension benefits available in the public and private sectors and lies at the root of much of the concern expressed about inflation proofing of public service pensions. However, though these developments are worrying, they are in no way comparable with the devastating problems which led to the adoption of PAYG in other European countries. They certainly do not justify a wholesale switch from the present system of pension funding to PAYG, with all the attendant disruption which such a switch would entail.

This brings me to my second point. Pension funding involves taking a very long-term view of the growth of pension liabilities and the investment income and contributions required to finance that growth. There are almost bound to be periods when the liabilities will grow faster than the rate of return on invested funds. Provided, however, that these periods are not prolonged, or the gap between the growth in liabilities and assets does not become too large, this does not call into question the underlying rationale for funding. Here I would take issue with the figures which you quote about pension funds' performance over the last fifty years. Data on the performance of individual funds are not readily available (certainly not for the period back to 1929) but what evidence there is tends to suggest that up to 1970 the yields on the pension funds' main assets (equities and government stock) have on average exceeded or at least kept pace with the growth in final salaries. Moreover, even though the 1970s have not been a happy period from the point of view of pension fund performance, it is important not to exaggerate the impact of the poor returns on investment on the growth in

/contributions

contributions in recent years, which is as much a reflection of the increase in the general level of wages and the trend to scheme benefits linked to final salary schemes.

One final general remark: I agree with you that if the trend evident in the 1970s were to continue then the viability of the present system of funding occupational pensions would be threatened. But this would be only one, albeit serious, manifestation of the unsatisfactory performance of the British economy. The real solution lies in achieving a substantial improvement in our economic performance. I am bound to say that there is little to suggest that a general switch to PAYG would contribute significantly to the achievement of this vital goal as there is no evidence to indicate that the existence of funding or the need to make good deficiencies has in the past been the cause of lack of investment in productive industry.

I now turn to the specific question of the effects of switching public sector pension funds over to some system of PAYG. At the outset I can assure you that we have given very full consideration to the possible benefits to be derived from such a switch. Unfortunately, the economic impact would be minimal. The essential point is that switching to PAYG would not, as you imply, create additional resources but merely affect a redistribution of the pattern of income or financing. (This conclusion is unaffected by the existence of inflation-proofing for public sector pension schemes.) There would, I accept, be a substantial reduction in the Public Sector Borrowing Requirement. But this would be exactly matched by a reduction in the funds available for investment. The markets would thus quickly recognise this as purely a cosmetic move. More importantly, because pension funds invest only a proportion of their money in gilt-edged stock there would be a shift in the relative demand and supplies of different forms of securities. As the reduction in supply of financial assets would be concentrated on public sector securities, while the reduction in

/demand

demand would be spread between private and public sector liabilities, the result would be a reduction in interest rates on public sector securities relative to the yields on liabilities of the private sector. The price of equities would therefore be depressed making it more difficult and expensive for the private sector to raise new capital. This would run counter to the basic thrust of our policies which are aimed at re-ordering the public sector's affairs so they place less of a burden on the private sector.

There is another important consideration in respect of those public sector bodies, such as the nationalised industries, whose activities involve a significant element of trading and which are competing with the private sector. In these cases the existence of some system of funding pension liabilities ensures that the public sector is competing on all fours with the private sector and that decisions about employment reflect the full costs of employing labour at the time at which they are incurred.

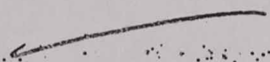
You will gather from what I have said above that we do not consider that there is a case for the wholesale switching of funded public sector pension schemes over to a system of PAYG. I would, however, add that I share the concern expressed in your paper about the growing concentration of assets in the hands of institutional investors, such as pension funds. As you are no doubt aware, there has been a very considerable volume of evidence submitted to the Wilson Committee on this subject and we shall therefore be looking forward with considerable interest to what the Committee's Final Report will have to say on this. Whatever the outcome of these deliberations I must stress that we do see valuable economic and social benefits from encouraging the widest possible participation by individuals in the ownership of real and financial assets. The declining trend in personal shareholdings is therefore worrying. The substantial cuts in direct taxation announced in the Budget are

/but a

but a first step in restoring personal incentives to save and build capital. We recognise that further measures will need to be taken if the present trends are to be modified.

Yours ever

Margaret



Peter Hordern, M.P.