

CONFIDENTIAL

Ref. A03983

PRIME MINISTER

---

Inflation-proofed Pensions

OP(C(81) 3)

BACKGROUND

The decision to set up the Scott inquiry into inflation-proofed public sector pensions was taken by the Ministerial Committee on Economic Strategy at its meeting on 20th February last year (E(80) 7th Meeting, Item 1). In summing up the Committee's discussion at that meeting you said:

"The Committee agreed that the most fruitful approach, in the short term at any rate, would be to preserve index-linking of public service pensions but to increase the contributions required from those in work".

2. In arriving at its decision the Committee was influenced by the specific commitments to preserve index-linked public service pensions which had been given in the course of the Election campaign, by the number of beneficiaries involved - over 5 million public sector workers currently entitled to index-linked pensions and approaching  $2\frac{1}{2}$  million index-linked public sector pensions actually in payment - and by the view that the "contributions route" appeared to offer quicker and easier benefits to the Exchequer than any measure of deindexation.

3. It is also relevant that very large numbers of private sector employees are - though they may be only dimly aware of the fact - at an early stage in the process of building up an entitlement to earnings-related index-linked pensions under the terms of the Social Security Act 1975 - a process which will be complete by 1998. As this process goes forward, the index-linking of pension benefits will come to be seen less as a difference between the public and private sectors than as a difference between the employed person and the self-employed (and to a lesser extent between the higher and lower paid in private employment).

4. The terms of reference of the Scott inquiry (reproduced in their report) required the Committee to look at two aspects of public sector pensions:

- (a) the assumptions and methods used by the Government Actuary;

CONFIDENTIAL

CONFIDENTIAL

- (b) the additional value to be placed on the relative value of security in the full inflation-proofing enjoyed by public sector employees compared with those in the private sector;

and, in addition, to advise on how to assess the relative job security enjoyed by employees in the private and public sectors.

5. The Scott Committee have not been able to set a definite arithmetic valuation upon the security provided by guaranteed inflation-proofing, such as could be carried through into the processes of wage determination. They have instead worked over the methodology for establishing the right level of contribution for an inflation-proofed pension, and have established, in the case of the Civil Service pensions scheme, a range within which they think the answer will fall (from rather less than the present deduction to about 5 percentage points above that deduction). They make it clear that the particular point in the range which may be chosen is critically dependent on the assumptions used to operate the scheme, in particular those about the future course of inflation and the future real rate of return on investment (the lower the real rate of return is assumed to be, the larger the contribution required).

6. On the substance of the issue, there will be a number of very difficult issues for the Government to consider, following the Scott report:

- (a) What real rate of return on investment should be assumed for calculating the deduction to be made from "true rates" for civil servants in respect of pension contribution?
- (b) Should the same real rate of return be assumed for other public service and public sector pension schemes, including those that are contributory?
- (c) Should there be greater standardisation of pension contributions within the public sector, or between the public sector and the private sector?

It is relevant here that the deduction from "true rates" in respect of pension contributions for civil servants is already among the highest of the contributions required from other public service employees (and higher than the average rate in the private sector). A combination of

CONFIDENTIAL

CONFIDENTIAL

standardisation with increased contributions for inflation-proofing could involve considerable increases in contribution rates in other public service schemes - and a complex set of negotiations and alterations to legislation and to pensions schemes.

- (d) As Scott emphasises in his report, the deduction to be made from Civil Service pay on account of pension benefits including inflation-proofing represents the difference between Civil Service pension benefits and those of their analogues within the Pay Research system; this being so the calculation of the deduction depends critically on the continuance of the PRU system itself. Is the paper right in assuming that the suspension of pay research makes it impracticable to make progress with the process of adjustment suggested by the Scott Committee in the current pay round? What are the implications for the future of pay research, and for the future of Civil Service superannuation arrangements?

7. All these problems are for future consideration. The present paper addresses itself largely to procedural questions:

- (1) When should the Scott report be published?
- (2) What should the Government say on publication?
- (3) What arrangements should be made to carry the work further?

8. Presumably the Cabinet will agree to publication as early as convenient - about the end of January.

9. Paragraph 15 of the paper suggests a series of initial comments. They do not go very far, and it may be for consideration whether it would make better sense at this stage for the Government to say nothing of substance at this stage, so as to give time to see how Parliamentary and public reaction develops in the light of the report.

10. As to the arrangements to be made for further considering these matters and for arriving at conclusions, the paper by the Chancellor and the Lord President suggests:

- (a) the possibility of a study by the Treasury and Civil Service Select Committee, and

CONFIDENTIAL

CONFIDENTIAL

(b) urgent studies within Government of the handling of increases in contributions (and the separate Scott recommendation of the provision of index-linked bonds to private pension funds).

11. A study by a Select Committee would spend much time going over the same ground that the Scott Committee have already traversed; but it could be a means by which Parliamentary opinion could be helped to focus on the issues of substance.

12. As to studies within Government, they will involve all Departments responsible for public services or public sector organisations. It would be possible to use the new Committees on pay in the public services, but this subject is distinct and I believe that it would be better not to try to put the slightly longer-term pensions problems alongside the shorter-term problems of pay management. I should therefore propose the establishment of a Committee of officials, under Treasury chairmanship, to report to the Ministerial Committee on Economic Strategy.

13. There are two other issues of substance: the valuation of relative job security, and the issue of index-linked bonds.

14. On the issue of valuing relative job security, the CSD will maintain that job security is one of the "unquantifiables" for which they already obtain credit in the negotiations on Civil Service pay and which they would hope to continue to bring into the reckoning in the future. If the Cabinet want to pursue the issue further, you might ask the Lord President of the Council to put in a paper for future consideration.

15. On index-linked bonds you could say to the Cabinet that this is not a new proposal, and is one which has to be considered in the context of wider questions of market management. It therefore falls within the Chancellor of the Exchequer's responsibilities for monetary policy and market management.

#### HANDLING

16. You will want to ask the Chancellor of the Exchequer and the Lord President (in that order) to introduce their paper, and then open up the discussion to colleagues, with special reference to the following points:

CONFIDENTIAL

CONFIDENTIAL

- (a) The most urgent task will be to seek agreement on the line to be taken by the Government when the report of the Scott Committee is published. For this purpose you may like to take your colleagues through the sub-paragraphs of paragraph 15 of the paper, and to discover whether there is a basis for agreement on these lines, or whether it is best to go for a totally non-committal stance.
- (b) You will want to judge, in the light of the discussion, whether it is realistic to publish the report at the end of this month or whether, with a little more time, the Cabinet might wish and be able to agree a more positive public stance.
- (c) You will want to get a view on the desirability or otherwise of involving a Parliamentary Select Committee in the next stage of the operation (see paragraph 11 above).
- (d) You may like to indicate how you propose to arrange for the ongoing work within Government (see paragraph 12 above).

ReA

ROBERT ARMSTRONG

14th January, 1981

CONFIDENTIAL