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CABINET

PUBLIC SECTOR PENSIONS

Memorandum by the Chancellor of the Exchequer

In the Manifesto we said:

> "In the next Parliament we shall continue to protect retirement pensions and other linked long term benefits against rising prices. Public sector pensions will also continue to be protected on the basis of realistic contributions."

This makes explicit the Government view expressed in more guarded terms in the debate on the Scott Report on 22 October 1982. We are now committed to maintaining index linked pensions but only on the basis of realistic employee contributions.

2. We have already made considerable progress. The main fast accrual schemes, armed forces, police, and firemen, have had their contributions raised to about 11 per cent. The House of Commons has voted a contribution rate of 9 per cent for the Parliamentary scheme. We must now consider how to apply the policy to the other groups, particularly those on normal accrual schemes, Civil Service, teachers, National Health Service, local government, and employees of numerous fringe bodies. There are other groups, such as judges, prison officers and mental health officers, to whom special considerations apply.

3. I seek the agreement of colleagues that:

a. the financing arrangements of public service schemes should be reformed to bring out more clearly the total costs of the benefits provided and how they are split between employer and employee. (Making the Principal Civil Service Pension Scheme contributory, on which I have put forward detailed proposals separately in correspondence, is an essential element here);

b. all public service pension schemes should be reviewed, in association with the Treasury, to settle and introduce appropriate realistic contribution rates;

c. we should start from 8 per cent (the current amount deemed paid by civil servants) as the "realistic" contribution rate for normal accrual schemes.

4. The attached note sets out the main considerations in greater detail.

5. I fully appreciate the difficulties which colleagues will face in negotiating and introducing higher contribution rates. However, there will never be a better time. Those concerned have been fairly warned by the Manifesto, and we can exploit the momentum created by the earlier changes, including the recent change in the Parliamentary scheme. We can suggest that if the employees are unwilling to pay realistic contributions, then we would consider as an alternative reducing the level of benefits, including index linking. This is, of course, unlikely to be attractive to them, but it could strengthen our tactical position. While it is not essential that all the increases in contributions should be implemented simultaneously, I think we must reach a decision now on the action we propose to take in relation to each group. I believe it would be a mistake to postpone increasing the contribution levels until all the other problems had been resolved.

6. My proposals refer only to the public service pension schemes over which the Government has direct control. Since 1971 the terms of nationalised industry schemes, including employee contributions, have not been controlled by the Government. Therefore we shall shortly need to consider how to make the nationalised industries follow the public services' lead.

7. If colleagues agree with the proposals set out in paragraph 3 above, I suggest that my officials, in conjunction with other interested Departments, be asked to prepare a detailed programme of action, building on Appendix 2 of the note below, and to report back to Ministers with specific proposals for moving forward in each of the areas to be tackled. While individual Departments should remain responsible for conducting negotiations in their own areas, a degree of central involvement is clearly needed, if only to ensure consistency of approach, and the Treasury seems best placed to provide this. I suggest that when Parliament returns we should announce our intention to proceed in the way proposed, in accordance with the Manifesto.

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Treasury Chambers

9 September 1983

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Public Service Pensions

This note sets out some of the main considerations in greater detail.

Financing

The subject has been vitiated by lack of published information and by the complexity of the financing arrangements. Although the Scott and Megaw reports and the publication of a long Parliamentary Answer on 19 October 1982 helped to combat some of the misapprehensions, the present arrangements are still unnecessarily complex and in some cases seriously misleading. The Civil Service was previously deemed to have made an "effective contribution" to the cost of pensions through the pay research arrangements, but since 1980 it has been impossible to measure precisely what that contribution is. In the case of the National Health Service (NHS) and teachers' schemes, the costs of pensions increase have been financed directly by the Exchequer, so giving a distorted view of what the employer and employee contributions to the notional funds are paying for. Furthermore the notional funds are deemed to be invested exclusively in gilts, so raising suspicions that the actuarial measurement of the costs is unfair.

2 The following principles ought to be applied to all schemes:

a the full costs of the benefits provided, including pensions increase, should be measured regularly;

b the schemes should be measured in the same way as they would be if the contributions were invested in real funds as in the private sector with the costs of pensions increase included;

c the way in which the costs are split between employer and employee should also be made clear.

3 In the case of the Civil Service this means moving to a contributory scheme as recommended by Megaw. In the case of the teachers and NHS it means altering the basis of the present notional funds so that they are deemed to be invested in the whole range of investment media available to real funds. In the case of local government schemes, which are funded but where the funds do not provide for the payment of pensions increase, it probably requires the full funding of all

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future liabilities. In all cases the cost of pensions increase needs to be included as part of the total benefits. Treasury proposals on these matters have been put to the departments concerned.

4 These proposals differ from proposals under discussion in 1981 and early 1982 to impose a "special charge" on employees related to the emerging costs of the index linking of the pension of their retired colleagues. The current proposals avoid the potentially sharp redistributive effects between pensioners and those in work which the earlier proposals might have given rise to if high inflation were ever to recur.

5 Public service employees ought to see it as in their own interests to devise more open financing arrangements.

Employee Contributions

6 The table at Appendix 1 shows where we stand at present on the main schemes. Unfortunately the schemes have been valued at different times, under different conventions, and they cannot be exactly compared in detail. However, as can be seen, the most important difference is between the 8 per cent paid by the Civil Service and the 6 per cent paid by teachers, NHS, and local government for similar benefits. If the policy is to be coherent, all these normal accrual groups should be put roughly on a par (though there might be a lower rate for manual workers), and the Government will not want to reduce the present Civil Service rate of about 8 per cent. The "realistic" contribution rate for normal accrual schemes should therefore be around 8 per cent. In the case of the teachers, NHS, and local government, this would mean an increase of 2 percentage points, (representing a reduction in net pay of less than 2 per cent after tax is taken into account) but there might be small differences among the schemes depending upon new valuations.

Public Expenditure

7 The estimated employee contributions in 1983/84 of the 3 main normal accrual groups whose contributions are at present 5% or 6% was £1100 million. A 2 per cent increase therefore represents a potential expenditure saving of about £400-£500 million (depending upon what is decided for manuals) which is the sum at risk if the

policy is not carried through (although there is an offsetting loss on the revenue side of £130-£160 million). Since the responsibility for paying these pensions rests with local and health authorities, the savings take the form of reducing the employer's contribution below what it otherwise would be. We will have to consider in each case how we can ensure that this benefit is carried through to central government expenditure.

8 In practice, decisions to change pension contribution rates are likely to be taken simultaneously with annual pay increases. We will have to bear in mind the effects of increasing the employee pension contributions when we consider the provision to be made in our expenditure plans for public service pay. Attached as Appendix 2 is a note on the probable timing and effects of such decisions. However it will be important to maintain the position that the employee pension contribution is a part payment for benefit, not a reduction of pay as such.

A) Schemes for which 'realistic' employee contribution rates are now decided.

Fast accrual	Employee Contribution	Overall Value	Ratio of Columns 2:3
Armed Forces officers	11 %	34.1	32 %
other ranks	11	19.8	56
Policemen	11	38	29
Firemen [all increased by 4%]	10¾	38	28
Intermediate rate accrual			
MPs [increased by 3%]	9	22	41

B) Main schemes for which 'realistic' rates have yet to be determined.

Normal Accrual			
Civil Service	8	20	40
Teachers	6	20.5	29
NHS non-manuals	6	19.5	31
NHS manuals	5	17.5	28.5
Local Government non-manuals	6	18.5	32.5
Local Government manuals	5	17.5	28.5

Estimates of new entrant costs which have been made at different times and on differing assumptions. They are therefore not directly comparable.

The deemed contributions of the Civil Service and Armed Forces are as calculated by Scott and by the Armed Forces Review Body.

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A. Timing and Impact on Public Expenditure Decisions

(i) Civil Service

A contributory scheme is unlikely to be in place before April 1985. The intention is that the public expenditure effect should be broadly neutral since the pay increase which is implied by a move to a contributory scheme will be offset by the inflow of contributions. Cabinet will be considering separately the provision to be made in public expenditure plans for 1984-85 for Civil Service pay.

(ii) National Health Service

The earliest date from which the changes could operate would be the pay settlements in the 1985-86 round. Any expenditure consequences can be taken into account in the 1984 PES.

(iii) Teachers

The report of a GAD valuation of the Teachers Superannuation Scheme for England and Wales is expected shortly; it is likely to call for an increase of the order of 2 per cent in total contributions. It leaves out of account the wider proposals set out in this paper, but would none the less provide an opportunity to seek some increase in the teachers' contribution, possibly with effect from April 1984. However the timing of the implementation of the report's finding will require further consideration, since the sums involved are large and provisional decisions have already been taken and announced on the planned level of local authority current expenditure for 1984-85. Besides, GAD will not report on the Scottish scheme until 1984.

(iv) Other Local Authority Groups

It seems unlikely that any change can be made until the 1985-86 pay round, so this is a point to be taken into account in the 1985 pay negotiations and in the 1985-86 rate support grant.

(v) Fringe Bodies and Other Groups

The Treasury will discuss the changes that are needed with the departments concerned.

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