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cc Mr. Mount  
Mr. Vereker

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R. SCHOLAR

Prime Minister (2)

INDEX-LINKED PENSIONS

*You may like to see Alan Walters' commentary on the Chancellor's views. Mes 21/5*

1. I have seen the Chancellor's memorandum to the Prime Minister of 19 May. I readily concede that there may well be practical objections, which are quite overriding, to my suggestion of opting-out. But what concerns me is that the arguments put forward by the Chancellor are often inconsistent, sometimes contradicted by common observation, and occasionally illogical.
2. Let's begin with paragraph 2. My argument was simply that if we charged the public employers on a full actuarial basis the cost of indexed pensions, we should allow those who wished to contract out. Automatically the contractors-out would get pay which was the same as those who contract in, but the deduction would not be made for the pension scheme. But since employees and potential employees in the Civil Service would now have an opportunity which hitherto they lacked, one would expect that the public service package would, on the average, be more attractive to them. This would enable us to have lower gross wage rates in order to secure this same quantity and quality of labour. Therefore the gross pay cost would be lower. Therefore the cost of the public servants would be lower.
3. It is true that if there are a very large number opting out, then the cash costs today may increase somewhat. But this would be more than offset by the reduction in future obligations. The last sentence of paragraph 2 seems to imply that today's cash cost should be our sole criterion, whereas, in all other decisions, we assess in terms of the net present value. This decision also should be made in terms of net present value and not in terms of current cash outflow. I suspect a lot of our problems are caused by incurring large future obligations on public expenditure in order to reduce a small cash expense today, "mortgaging the future".
4. In paragraph 4 the Chancellor says that most people who would wish to opt out would be the young who would in fact go into the National Insurance scheme. This may well be true, especially if, as at present, the scheme is designed to tax the young for the benefit of the old. But then that is a problem of getting the scheme actuarially fair. In any case I think it is important for the young to be able to opt out.

/Many of them

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any of them would prefer to save in order to buy a house or some other asset, or to produce and nourish a young family. The perceived rate of return of the young on housing, family, etc, may be considerably greater than their appreciation of some distant pension income. The Chancellor's proposals preclude them using their savings in what they perceive to be the most desirable way. (Incidentally it is also one of our policies to develop home ownership and to encourage parental responsibility and family development.)

5. In paragraph 4 the Chancellor says that people might not abide by their agreements. There would be political pressure to pay off those who have opted out. But people who had opted out could buy indexed linked gilts. There is certainly no logical argument for saying that they should have a double compensation. The situation is quite different from that in the Seventies; now indexed gilts are available to all. Then they were not, and analagous arguments are quite misleading.
6. In paragraph 5 I think the Chancellor is wrong. The fact that one has an option to buy in or stay out, means that the contribution is simply the price of the indexed pension. If that price is fixed by the authorities at full actuarial value, then that is the supply price of an indexed pension. And the demand will adjust and take up that indexed pension accordingly. If, however, there is no choice, and one must take it up, then of course the indexed pension is a joint commitment with the job and the salary attached. Then the price is for the job, salary, pension combination and there is no separate price.
7. In summary, I find the Chancellor's detailed arguments largely unacceptable or irrelevant. But I do accept that practical difficulties, which I cannot foresee and which may well appear, could conceivably rule out the issue of optional take-up of pension. But I still believe that the fundamental proposition is correct: increasing the opportunities to workers will in general bring forward a larger supply or better quality for a given price. That still seems to me a good principle of employment or procurement.

