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FROM: E KWIECINSKI

DATE: 11 January 1983

MR MONGER

cc PS/MST(R)

Mr Moore

Mr Robson *Ms. Seaman.*

Mr French *Mr. Ridley*

Mr Isaac/IR *Mr. Harris*

FINANCIAL SECRETARY'S HOLIDAY THOUGHTS ON PENSIONS

... I attach the Financial Secretary's paper: "Holiday Thoughts on Pensions".

... Also attached is the Institute of Directors' paper 'A New Approach to Pensions'.

The Financial Secretary's initial comment on the latter is that it seems to make things a bit too complicated:-

- 1) NIC's - would be compulsory but not tax deductible
- 2) Superannuation contributions - would be compulsory but tax deductible.
- 3) The "RPF" contributions - bringing the employee up to say 15% of his income, would be tax deductible but compulsory.

He suggests that the IoD paper should be considered alongside his own. He would welcome your and copy recipients early comments.

A handwritten signature in black ink, appearing to be "E Kwiecinski".

E KWIECINSKI

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## HOLIDAY THOUGHTS ON PENSIONS

One of the difficulties we come up against in our discussions on pensions is the undesirability of allowing more than the minimum number of people arriving at pensionable age with pension entitlements less than the level of supplementary benefit. First, we hope they will all have a NI pension, and we make contributing to that compulsory. Second we hope as many as possible will have an occupational pension too: we give them tax relief, if contracted out, and make it (more or less) compulsory for them to contribute.

2. We do this because it costs a lot in SB if they have to have their pensions "topped up". [I believe the figure is £700m - confirm please!]

3. Surely the time is coming when we should make the NI pension at least equal to <sup>basic</sup> SB levels? I would be grateful to know what this would cost, but there are two ways by which we could pay for it.

- a) we could increase NI contributions to cover the cost of it;
- b) we could end tax relief for contributions to private occupational pension schemes (£900m) and use this money to top up the National Insurance Fund; or

c) we could do a combination of both.

Furthermore, there would be a gross cost of such an increase in pension, and a net cost - because there would be more tax paid on the increased pensions. It is the net cost that matters.

4. To do this would of course be politically popular; but equally it is undesirable, in that it would be a further transfer of income from earners to pensioners. But read on!

5. It must be right to treat all contributions to pension entitlement the same way for tax purposes. For NI contributions, and graduated contributions, to come out of taxed income, and occupational pension contributions to come out of untaxed income, is an anomaly indeed, [made worse by the quasi-compulsory nature of the latter].

6. If superannuation contributions were voluntary, the combination of that and of no tax relief, would doubtless reduce the scale of occupational pension provisions. This would mean a reduced transfer of income from earners to pensioners, offsetting the increase identified in para 4.

7. In two changes - increasing the NI pension to SB levels, and removing tax relief for occupational pension contributions would thus be more or less self-balancing - both in revenue terms, and in terms of the shift of resources from earners to pensioners. In other words, what they would result in would be an increase in the mandatory minimum level of pension, at the expense of the *help* given

to those who want to increase their pension above the minimum.


8. But it unlocks some doors to do this. It enables us to be indifferent to whether people save over and above the NIC or not. It enables us to dismantle the pension funds over time, and return the savers' capital to the saver, and to introduce much more freedom to people to deal with their own money as they will. It begins to take away the bias in favour of Institutions.

9. It could also open the way to the "private money box", discussed at our meetings on this subject. It would work something like this:-

- a) employees could contract in to the graduated pension scheme, or out of it. The contracted in would continue much as at present, but contracting in would be voluntary for the individual;
- b) contracted out employees would get no tax relief on their contributions to their occupational pension scheme, but would still get their employers' contributions, tax deductible for the employers, and treated as a tax free addition to wages for the employers;
- c) contributions, employees' and employers', to pension funds would be on a contractual, but individual basis. Each employee would have his own fund, in trust, as it were. His fund's income would remain

tax exempt, but the ultimate ownership would be his. Whether we should require him to keep it in trust for a specified number of years, or until he reaches a certain age, or until retirement, is a question for discussion. But according to whichever route we decided to adopt the capital would ultimately become his own nest egg. He would be free to blow it; invest it and live off the proceeds, or to buy an annuity. He would be taxed on the income (unearned) from the capital however invested; but not taxed on the realisation of any capital sum.

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A NEW APPROACH TO PENSIONS

A discussion paper prepared by  
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December 1982

## A NEW APPROACH TO PENSIONS

- 1.1 It is perceived that occupational pension schemes suffer from some defects, brought about by the monetary inflation rates of the past few years.
- 1.2 These defects can be summarised by stating that generally - except in the Public Sector - such schemes provide benefits in 'money-terms' rather than 'real-terms'. Also, they have been generally constructed in an era of more stable employment than recently experienced with, therefore, an ordering of priorities different from what now might be considered preferable.
- 1.3 This results in apparent penalties falling upon the 'early-leaver' and the 'pensioner' both of whom see a realistic value at the time of vesting becoming later an unrealistic benefit.
- 1.4 Legislation has been mooted as the answer to these problems. The Chancellor of the Exchequer, in a major speech to the National Association of Pension Funds, questioned the viability of the transference of assets from the active to the retired population. Legislation as generally understood, and as recommended by the OPB and the Scott Committee requires a greater transference, which is incompatible with the fears expressed by the Chancellor and the current ability of industry to finance.
- 1.5 The only way in which legislation can help is to direct the redeployment of existing resources earmarked for pensions, with the unpopularity stemming therefrom. Legislation directing the deployment of additional resources would inevitably fail in the current economic climate.
- 2.1 It is not so well known that the current operation of the Superannuation Funds Office of the Inland Revenue Authorities (SFO) in monitoring occupational pension schemes under the terms of the Statute, is a positive deterrent to people helping to solve the problems for themselves. Accordingly, there is a source of additional resource which is not fully utilised.
- 2.2 The relaxation of those controls could release the energies of the market-place to resolve the problems and enable the populace to more effectively provide for their old age themselves.
- 3.1 Some of the controls exercised by the SFO are more social in nature than fiscal. It is, for instance, a social decision that a retired employee

shall have a lower income than a non-retired employee and the existing imposition of a two-thirds limit, with the concomitant plethora of variations and regulations attaching thereto, seems to be an unscientific hang-over from the early part of the 19th Century.

- 3.2 The fiscal undertone is of little consequence. That undertone stresses the fiscal inequity of a person transferring present highly-taxed income to more lowly-taxed retirement income. This argument had some force, but not very much, when penal marginal rates of personal taxation applied. With the continued reduction in the levels of personal taxation, the argument becomes increasingly insignificant.
- 3.3 It must be accepted that there should properly be fiscal controls. The authorities should ensure that the input to pension provision is reasonable; namely, where tax relief is provided there should be fiscal control over the amounts of the employer's contributions and those of the contributing person. The only other area of fiscal control necessary is to regulate the amount of tax-free benefit emerging from the pension arrangement.
- 3.4 None of the other myriad of controls exercised by the SFO are primarily fiscal in nature - such as a limit on the amount of taxable pensions that can be provided; limits on amounts transferred to a widow or other dependant; benefits on leaving service and/or death.
- 4.1 An apparently simple solution is to 'set the people free' and allow market forces to operate in an uncontrolled manner. Unfortunately, this does not seem practical and some control in order to guide the enormous resource utilisation will continue to be necessary. For instance:-

if existing occupational schemes were to become de-institutionalised, through outlawing compulsory entry, vast numbers of employees would opt out of pension provision placing an even greater burden on social security provision;

a movement away from the present institutionalised method to personal provision must inevitably involve a move from a benefit-orientated provision to one that is contribution-orientated, thus ultimately creating even greater problems;

there would be inexorable pressure for benefit levels even higher than the present two-thirds which (particularly in the Public Sector) already leads to retirement incomes equal to, or in excess of, pre-retirement earnings.

- 4.2 It has to be recognised that solutions lie only in the area of either additional resource allocation or the re-allocation of existing resource. To alter the method, i.e. to move from final-pay benefits to contribution-based money purchase achieves no increase in the totality of the provision; if one happens to achieve more than the other then a greater resource allocation is involved. What such a move does is to re-allocate the resource by arriving at a different order of priorities.



4.3 If such a different order of priorities is required, then that can be achieved under existing arrangements. The only thing stopping such re-allocation is a lack of desire to do so. To pretend that by using the same resource better results can be achieved through a different method of construction, is a 'con trick' that will be exposed through the passage of time.

5.1 It can be argued that the current resource deployed for pensions is too great. Future cost trends are worrying. Yet pressures abound covertly if not overtly for yet further deployment in such areas as:-

- indexation of pensions in payment (Scott Committee)
- indexation of deferred pensions (Occupational Pensions Board)
- flexible and equal retirement ages (House of Commons, Select Committee)
- sex equality (EEC and EOC)

5.2 To meet such ever-growing needs of society it seems that, so long as re-allocation is impracticable and additional resource is not generally available, those needs must to a greater extent be placed upon the individual. By creating an environment enabling the individual to voluntarily transfer some of his current earning capacity to provide additional retirement income at his expense, the burden of resource utilisation is more evenly spread where it is required.

6.1 Thus, solutions lie not in one or other extreme but in finding a way to more effectively marry the advantages of the two extreme systems of institutionalised benefit - orientated schemes and personal contribution-based schemes.

7.1 Freedom from some existing controls could pave the way to solutions. For instance, an employed person may now apply 15% of his Schedule E earnings for pension provision - in addition to the contribution made for him by his employer. In a contributory pension scheme such employee may be paying 5 or 6% - leaving 9 - 10% that he can, if he so chose, apply to solve the problems of a money pension versus a real pension. Why employees do not do so is because:-

- (i) There is, even now, a general unawareness on his part because an active market is constrained by the SFO requirements.
- (ii) Some employers are not prepared to offer a facility and even many of those who do fail to actively promote it.

- (iii) Even the aware employee will often be reluctant to contribute up to the maximum currently allowable for tax, in the fear that the application of the SFO benefit limits may deprive him of any benefit therefrom - which, of course, they can do. As an illustration, a pension scheme may quite properly be established with a retirement age of, say, 60 providing a full two-thirds pension. But if the scheme is established with a retirement age of, say, 65 and the employee is retired (early) at 60 his pension must be proportionately reduced. Yet it is just in this area, with unemployment at current levels, that there could be benefit in encouraging employees to contribute to build-up an adequate early retirement pension to meet such redundancies.

7.2 It is suggested that a free market, but not an irresponsible one, should be allowed to develop to enable people to more freely make additional provision for their old age. This would have the twin objectives of

- (a) enabling a move towards the solution of the problems confronting occupational pension schemes in their present form and
- (b) diminishing the ultimate demands upon the State which will otherwise arise from inadequate personal provision.

As an encouragement to this end, it would not be unreasonable to require, as a condition of exempt approval, every occupational pension scheme to provide for the facility of additional voluntary contributions. That facility could further embrace a range of choices, such as investment in the fund itself, a Building Society, Unit Trust, etc.

7.3 In essence, it is suggested:-

- (i) that occupational pension schemes should continue in broadly their present form;
- (ii) that all the institutional investors, Banks, Insurance Companies, Building Societies, Unit Trusts, etc. should be allowed to accept, in a specially segregated fund contributions from individuals specifically ear-marked for 'retirement provision', e.g. a Retirement Provision Fund (RPF). Contributions to such RPFs would be rolled up gross - as for occupational pension schemes and retirement annuities at present, with the contributions fully allowable for tax.
- (iii) that (as at present) every employed person may contribute as level annual payments or single payments from time to time, a proportion of his earnings - over and above what an employed person is required to pay to his Company's scheme - up to a fiscal percentage (whether or not the present 15% is the right level is a detail for later consideration). The benefit from such RPF can arise only as a retirement benefit upon proof of retirement.

Where part of the benefit is paid as untaxed cash, a monitoring system would be established to ensure that the totality of such cash did not exceed the prescribed limits. Otherwise, the benefit would be paid as taxable income to the employee and/or his dependants, without limits applied thereto. If it is considered essential to retain the 'two-thirds limit' - and owing to the extravagant provision in the Public Sector that may be the only practical way to prevent even further extravagant provision - it would be necessary to have a further monitoring provision to ensure that the totality of the benefit did not exceed that limit.

- (iv) Furthermore, it is recommended that the Social Security Statutes should then be reviewed to enable/encourage a part of redundancy payments (or other lump sums) to be directed into an RPF. It is scandalous that the present statutes positively encourage redundant employees to fritter away such payments and to then become a burden on the State.

8.1 The creation of such a wider free market could have a significant effect in translating the burden of retirement provision away from the State and Corporate bodies and create the educational environment that is necessary. The problems of such a radical development may be briefly summarised as:-

- (i) Primary legislation would be involved as what is proposed falls outside the principles of Finance Act 1970. And, certainly any amendment to the Social Security Statutes would be a significant development.
- (ii) The total taxable income would exceed the arbitrarily imposed two-thirds limit and its concomitant controls unless monitoring controls are introduced. In any event Section 32 of the Finance Act 1981 has itself undermined this particular control.
- (iii) Inevitably, comparisons will be drawn between employed and self-employed persons. The former could enjoy the benefits of an occupational scheme as well as making their own provision in respect of excess allowable contributions. This hardly seems an insuperable barrier and, perhaps, simply means that the retirement provisions for the self-employed are inadequate.
- (iv) The creation of such a free market may undermine the existence of occupational pension schemes - through, for instance, employees seeking to opt out and totally provide for themselves, although by doing so they would forego substantial benefits. Such a development would be unfortunate and should be resisted, as the criteria in seeking to solve problems would be thwarted. Any such development should therefore be geared to preserving the effectiveness of such schemes and not in their replacement.

- 9.1 This paper outlines an idea which to some may be seen as a radical one. However, tinkering around with what exists at present is unlikely to solve the problems and more far-reaching solutions have to be found. It is accepted that considerable detail would need to be considered in furthering this idea.
  
- 9.2 If it is not practical to seek the additional resource from employees, then a determined educational campaign needs to be embarked upon, leading perhaps even to legislation, to achieve a re-ordering of the priorities allocated within the present resource capability. To allow other methods to start to impinge as apparent panaceas will inevitably lead to a situation of 'the best of both worlds' which must involve additional resources.

D.C. BANDEY

9th December 1982