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COPY No. 1 of 14

Prime Minister

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DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

Andrew Turnbull Esq
Private Secretary
10 Downing Street

6 May 1985

Dear Andrew

SOCIAL SECURITY REVIEW: PENSIONS

Further to you letter of 1 May, I attach three notes prepared by officials here following discussions with Treasury and DTI.

The notes are

- Annex 1: a description in more detail of the proposal for a more extended phasing out of SERPS which emerged from the meeting on 1 May.
- Annex 2: tables showing the effects of this proposal on employment costs, the PSBR and take-home pay; and the pensions which people at different ages and earnings levels could expect
- Annex 3: a commentary on the questions listed as (i)-(iv) and (vi) in your letter. The Treasury will be providing a separate note on (v).

I enclose copies of this letter and the notes for others attending tonight's meeting.

Yours
Steve

S A GODBER
Private Secretary

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ANNEX 1

NEW PENSION FRAMEWORK AND TRANSITIONAL PROVISIONS

1. The present structure of SERPS (including provision for contracting-out) will remain unchanged for people retiring before April 2000. No men now over 50 or women now over 45 will lose their pension expectations from SERPS. The combined National Insurance contributions for people in this age group will be 1 per cent higher than now, at 20.45 per cent; but for those who are contracted-out a lower rate will still be payable - 16.45 per cent on all liable earnings. This will be the same rate as for the rest of the workforce, who will no longer be in SERPS, once the new arrangements are fully operational in 1989/90.

2. For people below 50 and 45, SERPS will be phased out, and a new occupational pension framework to replace it will be phased in, during 1987/88 and 1988/89. When fully in place, the new arrangements will require a joint employer/employee contribution to an occupational or personal pension of not less than 4 per cent, of which the employer must meet at least 2 per cent. All employees with earnings above the lower earnings limit for National Insurance contribution liability, except for very new ones, will be covered by this requirement. SERPS will be phased out, and the new arrangements phased in, as follows:

- in 1987/88 the rate of accrual of SERPS will be reduced by a third, and a minimum joint occupational/ personal contribution of 2 per cent will be required;

- in 1988/89 the SERPS accrual rate will be reduced by a further third and the minimum joint contribution requirement will go up to 3 per cent;

- from 1989/90 SERPS will go altogether and the full 4 per cent joint contribution will be required.

Pension rights accrued under SERPS will be honoured, with their value preserved in real terms.

3. The upper earnings limit will apply to National Insurance contributions as announced in the Budget, ie to employees, but not employers contributions. The stepped National Insurance contribution rates for low earners announced in the Budget are also continued. The figures assume no upper earnings limit on contributions to the compulsory scheme.

ANNEX 2

REPLACEMENT OF SERPS BY 3-YEAR PHASED INTRODUCTION OF MINIMUM PRIVATE PENSION CONTRIBUTION; SERPS PRESERVED FOR OLDER WORKERS

A. OVERALL IMPACT ON PUBLIC EXPENDITURE AND PSBR

(£ billion)	1987/88	1988/89	1989/90
<u>Public Expenditure</u>			
- savings agreed by MISC 111	- 0.3	- 0.5	- 0.5
- higher public sector employers' NICs	+ 0.1	+ 0.2	+ 0.3
- *higher public sector pension contributions	0	+ 0.1	+ 0.1
Total public expenditure	- 0.2	- 0.2	- 0.1
<u>Revenue</u>			
- lower rate rebates	+ 0.5	+ 0.5	+ 0.5
- tax relief on contributions	- 0.1	- 0.2	- 0.3
- NICs: private sector	0	- 0.1	- 0.3
public sector	+ 0.1	+ 0.2	+ 0.3
- higher public sector pension contributions	0	+ 0.1	+ 0.1
Total Revenue	+ 0.5	+ 0.5	+ 0.3
Total PSBR	- 0.7	- 0.7	- 0.4
of which:			
MISC 111	- 0.8	- 1.0	- 1.0
SERPS	+ 0.1	+ 0.3	+ 0.6

* This assumes that public sector employees not now covered are brought into (new) schemes at the minimum required level.

B. 'BURDEN' ON ECONOMY

('Burden' is measured as in Chancellor of Exchequer's letter of 22 April 1985)

	1987/88 £ million
Private sector employers	300 loss
All employees	200 loss
Self-employed	No change
PSBR	100 loss
Total Burden	600 loss

	1988/89 £ million
Private sector employers	300 loss
All employees	400 loss
Self-employed	No change
PSBR	300 loss
Total Burden	1,000 loss

	1989/90 £ million
Private sector employers	200 loss
All employees	500 loss
Self-employed	No change
PSBR	600 loss
Total Burden	1,300 loss

C. EFFECTS ON DIFFERENT SECTORS

(£ billion)	1987/88	1988/89	1989/90
Effects on private sector employers' costs			
Extra NICs	0	- 0.1	- 0.3
Contributions to private schemes	+ 0.3	+ 0.5	+ 0.6
Gross increase in employers' costs	+ 0.3	+ 0.4	+ 0.3
Less tax relief	0	- 0.1	- 0.1
Net increase in employers' costs	+ 0.3	+ 0.3	+ 0.2

	1987/88	1988/89	1989/90
Effects on private and public employees			
Extra NICs	0	0	0
Contributions to private schemes	+ 0.3	+ 0.5	+ 0.7
Gross increase	+ 0.3	+ 0.5	+ 0.7
Less tax relief	- 0.1	- 0.1	- 0.2
Net increase (ie reduction in take-home pay)	+ 0.2	+ 0.4	+ 0.5

Effect on self-employed	
Extra NICs	
Less tax relief	UNCHANGED
Net increase	

D. EFFECTS ON CONTRACTED-IN AND CONTRACTED-OUT

(i) - 1987/88

(£ billion)	Contracted-out	Contracted-in	Total
Effects on private sector employers' costs			
Extra NICs	+ 0.2	- 0.2	0.0
Contributions to private schemes	0.0	+ 0.3	+ 0.3
Gross increase in employers' costs	+ 0.2	+ 0.1	+ 0.3
Less tax relief	0.0	0.0	0.0
Net increase in employers' costs	+ 0.2	+ 0.1	+ 0.3
Effects on private and public employees			
Extra NICs	+ 0.2	- 0.2	0.0
Contributions to private schemes	0.0	+ 0.3	+ 0.3
Gross increase	+ 0.2	+ 0.1	+ 0.3
Less tax relief	0.0	- 0.1	- 0.1
Net increase (ie reduction in take-home pay)	+ 0.2	0.0	+ 0.2

D. EFFECTS ON CONTRACTED-IN AND CONTRACTED-OUT

(ii) - 1988/89

(£ billion)	Contracted-out	Contracted-in	Total
Effects on private sector employers' costs			
Extra NICs	+ 0.3	- 0.4	- 0.1
Contributions to private schemes	0.0	+ 0.5	+ 0.5
Gross increase in employers' costs	+ 0.3	+ 0.1	+ 0.4
Less tax relief	- 0.1	0.0	- 0.1
Net increase in employers' costs	+ 0.2	+ 0.1	+ 0.3
Effects on private and public employees			
Extra NICs	+ 0.4	- 0.4	0.0
Contributions to private schemes	0.0	+ 0.5	+ 0.5
Gross increase	+ 0.4	+ 0.1	+ 0.5
Less tax relief	0.0	- 0.1	- 0.1
Net increase (ie reduction in take-home pay)	+ 0.4	0.0	+ 0.4

D. EFFECTS ON CONTRACTED-IN AND CONTRACTED-OUT

(iii) - 1989/90

(£ billion)	Contracted-out	Contracted-in	Total
Effects on private sector employers' costs			
Extra NICs	+ 0.4	- 0.7	- 0.3
Contributions to private schemes	0.0	+ 0.6	+ 0.6
Gross increase in employers' costs	+ 0.4	- 0.1	+ 0.3
Less tax relief	- 0.1	0.0	- 0.1
Net increase in employers' costs	+ 0.3	- 0.1	+ 0.2
Effects on private and public employees			
Extra NICs	+ 0.6	- 0.6	0.0
Contributions to private schemes	0.0	+ 0.7	+ 0.7
Gross increase	+ 0.6	+ 0.1	+ 0.7
Less tax relief	0.0	- 0.2	- 0.2
Net increase (ie reduction in take-home pay)	+ 0.6	- 0.1	+ 0.5

E. LONG TERM BENEFIT EXPENDITURE SAVINGS FROM PHASING OUT SERPS

	(1) Cost of full SERPS	(2) Cost of present proposals	(3) Savings from phasing out SERPS (Col 1 - Col 2)	(4) Additional cost of phasing compared with discontinuing SERPS
	£ billion 1984/85 prices			
1988/89	0.8	0.8	Nil	Nil
1993/94	1.8	1.8	Nil	0.3
2003/4	5.5	4.3	1.2	1.3
2013/14	11.2	5.3	5.9	1.3
2023/24	17.6	4.8	12.8	0.8
2033/34	25.3	3.0	22.3	0.4

F. COMPARISONS OF PENSIONS FROM SERPS AND PRESENT PROPOSAL

1 Age in 1987/88	2 Final earnings	3 Full SERPS	4 Full pension (preserved rights)	5 Compulsory pension with rate of return over prices of 3½%	6 Total pension including SERPS	7 2½%	8 Total pension including SERPS
			£ per week at 1984/85 prices				
I MAN ON £200 p.w. - 4% contribution							
25	354.8	74.4	10.4	55.0	65.4	44.4	54.8
35	308.6	64.7	16.9	32.4	49.3	26.2	43.1
45	268.2	56.1	20.0	15.3	35.3	15.0	35.0
51	254.2	53.3	22.4	10.7	33.1	10.6	33.0
52	250.6	52.5	52.5	Not applicable			
55	233.2	43.9	43.9				
II MAN ON £100 p.w. - 4% contribution							
25	177.4	29.3	4.10	27.5	31.6	22.2	26.3
35	154.3	25.5	6.66	16.2	22.9	13.1	19.8
45	134.1	22.1	8.0	7.7	15.7	7.5	15.5
51	127.1	21.0	8.84	5.4	14.2	5.3	14.1
52	125.3	20.7	20.7	Not applicable			
55	116.6	17.3	17.3				
III WOMAN ON £100 p.w. - 4% contribution							
25	177.4	29.3	4.1	18.6	22.7	15.1	19.2
35	154.3	25.5	6.66	10.0	16.7	8.5	15.2
46	132.4	21.8	8.00	4.8	12.8	3.4	11.4
47	130.6	21.5	21.5	Not applicable			
55	116.6	12.5	12.5				
IV WOMAN ON £50 p.w. - 4% contribution							
25	88.7	6.76	0.95	9.3	10.3	7.6	8.6
35	77.2	5.88	1.53	5.0	6.5	4.3	5.8
46	66.2	5.04	1.84	2.4	4.2	1.7	3.5
47	65.3	4.97	4.97	Not applicable			
55	58.3	2.88	2.88				

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ANNEX 3

ISSUES RAISED AT MEETING ON 1 MAY 1985

<u>Contributions to National Insurance scheme and Compulsory Scheme</u>

1. The assumptions about the structure of contributions are set out in the description of the proposal in Annex 1.

2. The minimum level of contribution to the compulsory scheme has been taken as 4%. The figures in Annex 2 reflect this. But, of the 4%, ½% is required to cover the cost of survivorship (widows') benefits for those under pension age. Only 3½% goes towards the pension payable at retirement.

3. A contribution level of 5% would produce higher pensions and reduce the proportionate cost of administration. But it would add to employers' and employees' costs. A contribution level of 3% would have opposite effects: less cost but lower pensions. However, a 3% contribution would leave substantially more people requiring means-tested help.

4. The effects of different contribution levels on the numbers requiring help under the new income support scheme which will replace supplementary benefit are estimated below:

NUMBERS RECEIVING SUPPLEMENTARY PENSION

OPTION	SUPPLEMENTARY PENSIONERS IN:		
	1985-86	1994-95	2035-36
1. Full SERPS continued.	1,630,000	970,000	100,000
2. SERPS replaced compulsory contributions of:			
(a) 5%	1,630,000	1,050,000	250,000
(b) 4%	1,630,000	1,115,000	300,000
(c) 3%	1,630,000	1,250,000	500,000

Note: assumes prices upratings of benefits.

5. The framework in Annex 1 assumes that the upper earnings limit for National Insurance cotributions applies, as announced in the Budget, to employees but not employers. The framework also assumes no limit for the new compulsory contributions. This is certainly simpler. But it also takes account of the fact that the great majority of higher earners will already be covered by qualifying pension arrangements so that in practice they will not be affected. On the other hand, introducing a limit(eg at 1½ times average earnings as for National Insurance contributions) might make the proposal more acceptable to those employers who have criticised the abolition of the UEL for employers' contributions in the Budget.

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ADMINISTRATION OF THE COMPULSORY SCHEME

1. Administration of the compulsory scheme will be kept as simple as possible. The aim will be to use and build on machinery which already exists in the DHSS and Inland Revenue for tax approval of schemes, supervision of those which are contracted-out from SERPS, and the collection and checking of national insurance contributions (NIC). The system will build on the DTI White Paper proposals for investor protection. Officials of DHSS and DTI are exploring how this would work in practice.

Requirements of the scheme

2. All occupational pension schemes have to be scrutinised and approved by the Inland Revenue Superannuation Funds Office before investments and income can be tax-exempt and contributions to them qualify for relief. This scrutiny will be the principal means of ensuring that participating schemes are bona fide.

3. Schemes which are contracted-out from SERPS will satisfy the conditions of the compulsory scheme automatically. Appropriate parts of the present supervisory machinery operated by the Occupational Pensions Board and DHSS' Newcastle Central Office can be kept in place to ensure that they continue to do so. This machinery could also provide a back-up check on new schemes if necessary.

4. Pay-as-you-go public service schemes will be safeguarded and not subjected to onerous checks. All that they will be required to provide are undertakings that scheme benefits correspond with those to be obtained from the compulsory scheme.

5. An essential feature of the scheme is that employees will be able to opt for a personal pension instead of joining an employer's scheme. And employers will be able to meet their obligations by offering employees personal pensions. The minimum total contribution and the employer's share will be the same as for occupational schemes. For employees personal pensions will mean more choice and flexibility. For employers - especially small ones - they will offer a way of satisfying the requirements of the new arrangements without having to set up a scheme of their own.

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6. Industry-wide schemes would be another means of keeping down burdens on employers, particularly small ones. They would cater for frequent job-changers, who are disproportionately represented in industries with low coverage now, e.g. catering and construction.

7. Employers who wish to set up schemes will be able to do so either by establishing their own self-administered trusts or by making arrangements with life offices, friendly societies or other approved providers. The Green Paper will canvass a proposal that a wide range of financial institutions, besides insurers, should be permitted to offer pensions savings schemes. The list might include banks, building societies and unit trusts. Unless such bodies set up insurance company subsidiaries, insurance law will require them to sub-contract risk business (i.e. mainly survivors' benefits and the provision of annuities at retirement). Trustees of self-administered schemes and commercial providers will be required to supply employers with statements from appropriate professionals (e.g. lawyers and actuaries) that all statutory requirements are met. These statements will have to be kept by employers for inspection on demand by DHSS inspectors.

Operation

8. Employers will be required to deduct pension contributions from pay and pass them with their own contributions over to schemes. This requirement will extend to personal pensions taken as alternatives to membership of employers' own schemes. The contributions will be recorded on tax deduction documents, which are subject to end-of-year computer reconciliation at DHSS' Newcastle Central Office. The documents will be supported by confirmation from scheme trustees or commercial providers that contributions have been received. Again, this confirmation will be kept available for inspection on demand by DHSS. Computer reconciliation will show if pension contributions have not been paid for particular employees or have been paid at insufficient levels. Queries will be dealt with in just the same way as when these checks show non- or inaccurate payment of NIC - by telephone and written enquiries, and visits by DHSS contribution inspectors. The manpower cost for DHSS has been provisionally estimated to be in the region of 250+ staff.

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Flexibility and transfers

9. Because the new arrangements are based on money purchase principles, they will give people a new flexibility. Employees will be able to decide, according to their circumstances, whether take-home pay or savings are more important to them. Those with heavy commitments - e.g. younger workers with families - may choose to put only the minimum contribution into their occupational or personal pension. As they grow older and their commitments decrease, they may prefer to set aside more of their earnings towards their retirement (following the pattern already set by the self-employed). The new framework will give people the freedom and responsibility to set their own priorities.

10. An essential part of this flexibility is that pension rights should be readily transferable. Neither employers nor employees will welcome a system that leaves people at retirement with small amounts of pension from many different sources.

11. In practice, transferability should not be a problem. An advantage of money purchase arrangements is that they give individuals an identifiable sum of pension savings that they can take with them when they change jobs or switch into a different type of investment. Appropriate controls will ensure that unfair administrative charges do not eat into those savings when they are transferred. And employers could be enabled to transfer into a personal pension the accrued rights of a leaving employee with less than, say, five years' service who does not opt for this himself. The current Social Security Bill will take care of schemes that offer salary-related benefits, by giving leaving employees the right to transfer the actuarial value of their pension rights.

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DEPARTMENT OF HEALTH & SOCIAL SECURITY

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Telephone 01-407 5522

From the Secretary of State for Social Services

6/5/85

Dear ~~Duty Clerk~~

Herewith numbered and named copies of the officials' notes for tonight's meeting. I've sent copies for the Chancellor, Chief Secretary and Mr Heyhoe direct to Rachel Lomax

Yours

Steve Godber