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I really must discuss this before deciding. The matter is of considerable moment now.

PRIME MINISTER 25 October 1985

SERPS

I attach two notes on SERPS. I am afraid that they are rather technical, but this is an inherently technical subject.

How SERPS Works, based on a Treasury note, attempts to summarise SERPS in two pages.

The second note is about changing SERPS. DHSS, Treasury, and the Policy Unit have been working away on various options since the last MISC 111 discussion. It would be very helpful to have a preliminary reaction from you now, before concrete proposals are put to MISC 111 next Thursday.

~~Any preliminary views may help to close off blind alleys.~~

David Willetts

DAVID WILLETTS

Prime Minister

Yes – it would be useful to have a preliminary reaction from you. But I am puzzled by the figures for total savings on page 3: the changes listed here seem to have very little different effect from those proposed by Mr Fowler at Misc 111 on October 15. To be pursued on Monday.

DRN
25/10.

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CHANGING SERPS

Saving Money by Reducing the Value of the Additional Component

At present, SERPS gives you a pension worth 25 per cent of your earnings, accruing over the 20 best years. It is likely that Norman Fowler will propose reducing it to 20 per cent of earnings, accruing over a working life - though with protection for mothers not earning, and the disabled. This is tougher than the option he put to MISC 111, which kept 25 per cent accrual. The savings would be:

		£bn
2013	2023	2033
1.5	4.0	8.0

These are the biggest single savings on SERPS, and I support them for that reason. But you should be aware of one potentially tricky political problem.

In the spring we were worried about people retiring before the year 2000, and successfully resolved that problem by keeping full SERPS for them. But we have now hit a snag affecting people who retire _after_ that, because the Green Paper said we would honour everyone's SERPS entitlements that have already accrued. But if we change to the new system, we can only achieve large savings if SERPS rights for people retiring in the next century are accrued from 1978 at the new slow rate. One way round this would be to introduce an elaborate two-speed system giving full accrual for the period 1978-88, and a much slower rate of accrual thereafter so as to get to the same end point. But that would be an administrative nightmare. My recommendation is that we accept that the slower rate of accrual of SERPS for people retiring in the next century will apply back to 1978.

The second main proposal for savings is that widows and widowers should inherit half the pensions of their spouses, rather than the full pension as at present. This would match normal occupational provisions, and the indications are that the pension lobby would accept this. Widows and widowers, of course, retain their rights to their own pension. This would save:

Perhaps people could have the option to buy additional rights within SERPS for widows. This might help reduce criticism.

2013	2023	2033 £bn
0.8	1.4	1.7

A more generous provision for widows and widowers of two-thirds of earnings would be politically easier, but reduce the savings to:

2013	2023	2033 £bn
0.6	0.9	1.1

Shifting some of the Burden of Price Protection to Companies

At present the burden of price protecting the GMP after retirement falls on us. We could save money by giving private schemes responsibility for financing the first 3 per cent of inflation-proofing of the contracted-out GMP. This would save:

2013	2023	2033 £bn
--	0.3	0.6

These savings look so small because they are on top of the savings from lowering the GMP, and the two effects interact. We could achieve larger savings of:

2013	2023	2033 £bn
0.1	0.5	0.9

by putting on companies the burden of meeting the first

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5 per cent of inflation. This would be better, but risks a row with the CBI, and their complaints about the extra burden on contracted-out firms would tend to undermine our efforts to make contracting-out more popular.

Total Savings

This gives a package consisting of slowing the rate of accrual, half inheritance for widows, and 3 per cent inflation-proofing of GMPs by companies. It generates useful savings:

			£bn
	2013	2023	2033
Current forecast cost of SERPS	9.6	15.7	23.1
Savings from possible package *	-2.3	-5.7	-10.3
Revised cost of SERPS	7.3	10.0	12.8
* compared to savings proposed by Mr Fowler on October 15	-2.9	-5.8	-9.5

But this exercise has never been just about savings. The crucial objective is to encourage private pensions. Making SERPS less generous helps. So do the other possible measures discussed below.

Administrative Incentives to Contracting-Out

At the moment, any pension schemes is closely scrutinised by the DHSS and the Inland Revenue, to check it meets a complicated set of conditions, before it is allowed to contract-out. The DHSS and Revenue are working on a a simpler, off-the-shelf package to make it easier to contract-out. This fits neatly with our initiative to ease burdens on industry.

Money purchase schemes are to be allowed to contract-out for the first time, and again the objective is to establish a streamlined procedure to cut down work for employers and speed approval by the Revenue and the Occupational Pensions Board.

Financial Incentives to Contract-Out

At the moment, the contracted-out rebate is 6.25 per cent. The Government Actuary is likely to recommend in his quinquennial review that the rebate be reduced to about 5.5 per cent in 1988, because funds are making such a good return on their assets, and so smaller extra contributions are needed to meet their pension commitments. Cutting the value of SERPS entitlements will also lead to a reduction in the contracting-out rebate, as companies need to fund a less generous pension. On the other hand, the shift of the burden of inflation-proofing pensions to companies will require higher contributions from them, and so an increase in the rebate. The overall effect is likely to net out at a contracted-out rebate of about 6 per cent.

We should be trying to increase the contracted-out rebate as far as is politically sustainable to give companies and individuals a greater incentive to take out their own private pension, and to penalise more heavily those who stay in SERPS. The Chancellor is worried about the political costs of increasing the contracted-out rebate above the current level. That would mean the main contribution rates going up, which will reduce take-home pay and increase the cost of employing everyone who stays in SERPS just at the time when we are anyway reducing their entitlements. They will be paying more for less. But at the very least, we should aim to keep the rebate up at its current level rather than allowing it to fall.

Targetted Incentives to Contract Out of SERPS

We have been looking at special incentive schemes to encourage contracting-out. Two options are:

i. **A special incentive for the low-paid.** If you earn less than £130 a week, you get the full £6 contracted-out rebate available to somebody on £130 a week. This can then be put towards a personal portable pension or an occupational scheme. The attraction of this is that it gets at the group which is predominantly contracted-in to SERPS. Out of the 9 million people in SERPS, 1.7 million have earnings under the LEL; and another 6 million have earnings between the LEL and £160 per week.

ii. **A special rebate of, say, an extra 2 per cent for the next 5 years for new schemes that contract-out of SERPS.** This focusses specifically on new contracted-out arrangements. It could also go to individuals who opt for their own personal portable pension instead of the company scheme. It has the advantage of directly encouraging new private pension provision. But if the rebate only lasts the first 5 years, it might not have much of an effect. There might also be administrative complications in defining the coverage of the new scheme. And it might encourage exactly what you want to avoid - companies setting up separate new schemes for the second-class blue-collar employees who are currently in SERPS.

Young People

We are still working on the basis that saving for a second pension must be compulsory for everyone aged over 16. I appreciate the argument for compulsory pension provision in general. But it would be politically feasible to make saving for a second pension voluntary for people under 25. We would exclude them from SERPS (giving them and their employers the lower contracted-out rate) and give them incentives to private pension provision if they wished.

Such a measure could be attractive, as:

- It would ensure that any young people wanting a second pension would start saving privately. This gets the right habit going at first.

- It makes young people cheaper to employ.

If you like this idea, I would go to departments to see if we can develop a workable scheme.

<u>Knowing the Value of your own Pension</u>

We are looking at a scheme for every member of the pension fund to get a triennial report of the value of his pension. Unfortunately, there is a risk the DHSS option will restrict this to the value of accrued pension rights. But we also want people to know the value of their share of a pension fund. Recent calculations by an independent consultant suggested that the assets of pension funds were currently worth about £130 billion - at least £30 billion more than the pension rights they had to fund. So Roy Hattersley could waste £30 billion of savers' money in his National Investment Bank before anybody had their pension rights affected (though the discretionary awards clearly would be).

So we must publicly state the asset value of pension funds as well as people's accrued entitlements.

<u>Conclusion</u>

It would be useful to have your guidance on the following points:

- 20 per cent lifetime accrual under SERPS

- half or two-thirds entitlement for widows

- 3 per cent or 5 per cent GMP responsibility for companies

- the case for increasing the contracted-out rebate

- special incentive schemes for the low-paid or for new schemes

- exemptions for the under 25s

- knowing the value of your pension.

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HOW SERPS WORKS

1. There are two calculations that matter in SERPS: the Additional Component (AC) and the Guaranteed Minimum Pension (GMP).

Contracting-in: The Additional Component

2. If someone is contracted-in to the state scheme, he or she earns an Additional Component (on top of the basic pension) of one-eightieth (or 1.25 per cent) of their "relevant earnings" for each year, to a maximum of 20 years. "Relevant earnings" are those between the Lower Earnings Limit, currently £35.50 a week, and the Upper Earnings Limit, current £265 a week. Other earnings are disregarded. The "relevant earnings" for each year are revalued to a common price basis using an index of average earnings, and the best 20 years are used in calculating the pension.

3. Multiplying the one-eightieth accrual rate and the best 20 years rule gives the maximum possible Additional Component - 25 per cent of average earnings (loosely referred to as 25 per cent accrual). Years out of work or on low pay do not pull that average down, provided you have at least 20 years of good earnings. Once the pension is awarded, it is indexed in line with the RPI.

Contracting-out: the Guaranteed Minimum Pension

4. If someone is contracted-out of SERPS, then the occupation scheme of which he or she is a member undertakes to pay a Guaranteed Minimum Pension. The formula for calculating the GMP is also based on "relevant earnings" for each year, revalued to a common basis using an index of average earnings. The accrual rate ensures that the maximum

GMP that can be earned is still 25 per cent of relevant earnings, as for the Additional Component (AC).

5. But there are also differences from the AC calculations. The GMP is calculated on lifetime average earnings, so years out of work or on low earnings can drag the average down. Nor is the GMP indexed once the pension is awarded. It remains a fixed cash sum (often a nominal part of a larger, occupational pension).

6. Once the contracted-out pension is in payment, DHSS work out, each year, what the pensioner would have been entitled to if he had been contracted-in. This inflation-proofed Additional Component is compared ith the GMP being paid by the employer, and the balance is made up by the DHSS and paid direct to the pensioner, along with his basic retirement pension. So contracted-out pensioners indirectly gain the benefit of the generous SERPS provisions.

The Contracted-out rebate

7. The contracted-out rebate is the amount which the Government Actuary estimates should, on certain assumptions, be invested by an occupational scheme to fund the GMP liability. Changes in the GMP formula would affect the rebate because they alter the amount of funding that is necessary.

8. National Insurance rates currently stand as follows:

	Contracted-In	Contracted-out*	Value of Rebate
Employer	10.45	6.35	4.10
Employee	9.00	6.85	2.15
Total	19.45	13.20	6.25

* Between LEL and UEL