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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

FOLLOW-UP TO THE SCOTT INQUIRY: PROGRESS REPORT OF
THE OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS

Memorandum by the Chancellor of the Exchequer and the
Lord President of the Council

We attach the Progress Report of the Official Committee on the Value of Pensions, and the covering note by the Chairman of the official committee.

2. The Progress Report makes it clear that the Official Committee cannot yet put forward definitive recommendations. It has identified a number of possible courses of action for further exploration (paragraphs 71 and 72) and, particularly in view of the complexity of the issues and the conflicting nature of much public comment, seeks guidance from Ministers on several underlying assumptions (paragraph 73). Our own views on the issues raised in the report are as follows.

Scope

3. We believe that whatever we may eventually decide should so far as possible apply to all public sector groups which enjoy index-linking, not only those in the public services. There would

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certainly be difficult problems in making any changes bite everywhere, but these problems must be carefully studied (paragraphs 19 to 24). This is partly a question of equity; it would be difficult to defend treatment which was evidently discriminatory either on benefits or on contributions. But clearly also the gain to the Exchequer would be greater the wider the field over which changes operated.

Should both benefit and contributions options be considered?

4. We also agree that officials should be asked to undertake further examination of changes in benefits as well as changes in contributions. We do not think that one necessarily excludes the other. But we need to ensure that whatever we do is defensible and consistent. If we do decide to change benefits we must be aware of:

(a) the statements we made during the 1979 General Election campaign (summarised in the Annex to this paper);

(b) the political consequences of offending 2½ million actual and another 8 million potential recipients of index-linked public sector pensions; and

(c) the need for primary legislation.

5. We must also consider whether we should be willing to contemplate action removing or modifying the right to inflation proofing both for existing pensioners and in respect of service before the date of any change in current arrangements (paragraph 74). If we are not willing to contemplate this, the effects - and in particular, the potential savings - of any change in benefits would be so long delayed as to raise doubts about the value of proceeding down this route at all.

Courses to be further considered

6. We endorse the "short list" of possible courses recommended by the Official Committee for further study (paragraph 71).

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Relation with possible new arrangements for settling pay

7. The future work of the Official Committee will need to take account of possible developments in the arrangements for settling Civil Service pay; but we do not think that it need be delayed on that account. The problem, if such it is, is virtually confined to the Civil Service; and it is in any case more natural to take account of the value of pension benefits in settling pay, than to try to change pension arrangements to take account of any developments on the pay side. A change in the basis on which contributions are calculated might make it desirable for salaries to be fixed gross and a specific deduction made for pension contributions.

8. We seek the agreement of our colleagues to these conclusions.

G.H.
S.

10 July 1981

CHANCELLOR OF THE EXCHEQUER

OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS

I attach the Progress Report of the Official Committee on the Value of Pensions; all interested departments were represented on the Committee, which met under my chairmanship.

2. A summary is at the front of the report. It sets out some possible courses of action, and the considerations relevant to them, and seeks guidance from Ministers for future work.

3. We think it necessary to establish guidelines in this way before reaching detailed conclusions for the following reasons:-

(a) The strands of public disquiet which led to the setting up of the Scott Inquiry are difficult to disentangle and evaluate and do not consistently point to a particular pattern for possible new arrangements.

(b) The main public service pension schemes are designed for the varying circumstances of many hundreds of thousands of employees and pensioners; they have a long and complex history, and are mostly governed by extensive primary or subordinate legislation; changes in their terms need careful preparation and, in many respects, negotiation.

4. We are therefore proposing a restricted range of options for further study, as follows:

(a) A straight increase in contributions (Course I), perhaps coupled in the case of the Civil Service and Armed Forces with a move to a formally contributory scheme (like nearly all other public sector schemes). It might be possible - though the negotiations would

certainly be difficult in parts of the public sector - to levy contributions at a rate of 10% or so in the Civil Service and its equivalent in other services, compared with the present 8% in the Civil Service and 5 - 7% (for different benefits in some cases) in most other public services.

- (b) Restricting pensions increase financed by the Government or employer to average private sector practice (Course IV); this might be combined with a scheme (Course II) in which the difference between average private sector practice and full inflation-proofing was financed by a pay-as-you-go contribution from employees.
- (c) Restricting pensions increase by a cut-off point (Course VI), which might be expressed in a variety of ways, such as an absolute percentage figure, a proportion of inflation, a proportion of inflation above a threshold, etc.
- (d) A discretionary power (for use in exceptional circumstances and within a predetermined limit) to increase pensions by less than the rate of inflation (Course VII).

5. These are all in a sense representative options, each covering a spectrum of possibilities. It will be useful, therefore, to obtain not only confirmation (or otherwise) of the selection of options for further work, but also guidance, so far as that is practical at this stage, on which particular lines are regarded as the most promising.

6. Paragraph 72 lists those options to which it seems less worthwhile to devote further efforts, given that some selection is necessary.

7. The possibilities suggested for further work include changes in benefits as well as changes in contributions. Ministers will wish to consider, among other things, the

consistency of this with statements made by Conservative spokesmen during the 1979 Election campaign. The Committee did not feel it was its function to interpret such statements; a collection of relevant material has, however, been made, and can be provided. Subject to that, we think it desirable to retain at this stage at least one option each relating to benefits and contributions so as to provide potential flexibility at the negotiating stage. For example, if employees were unwilling to pay the appropriate price for indexing, action on the benefits could be offered as an alternative.

Relation with arrangements for settling Civil Service pay

8. It is not possible to ensure that a particular price for pension benefits is being truly paid unless there is a mechanism which can determine what pay rates would be in the absence of such benefits. This has existed in the Civil Service and continues in the Armed Forces, but not elsewhere in the public sector. The proposed inquiry into Civil Service pay and the scope of its terms of reference are relevant to this. It is difficult to know how to proceed until further progress has been made in settling the current Civil Service dispute; meanwhile, it should be possible to carry the pension question further as an issue on its own.

Timetable

9. The timetable will depend very much on the pattern of Ministerial decisions. We would aim to do the further work necessary to enable initial decisions to be taken during the summer. In view of statements by the Prime Minister when the Scott Inquiry was set up, and later when its report was published, formal consultation with other public sector employers and with staff interests would probably be necessary. Broader public consultation - perhaps in the form of a consultative document - might also be sought.

10. I am reporting in the same terms to the Lord President of the Council. Since other Departments have been involved in the work, their Ministers also will expect to be consulted before decisions are taken.

H M Treasury
5 June 1981

Richard Dixon
P V Dixon

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OFFICIAL COMMITTEE ON THE VALUE OF PENSIONS : PROGRESS REPORTINDEX AND SUMMARYPart A - Introductory

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The purpose of this progress report is to expose the issues raised by the Scott Inquiry and the index-linking of public sector pensions; to outline possible ways of dealing with them; and to secure Ministerial guidance regarding future work. In particular, guidance is sought on the objectives which Ministers wish to achieve and which of the possible courses of action we have identified they consider to be the most promising (paragraphs 1-3).

Part B - Scope

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Study should extend to the public sector as a whole, and not be confined to the Civil Service (paragraphs 4-6).

Part C - The Scott Inquiry and Related Issues

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Public disquiet has stemmed mainly from comparisons between public and private sectors created by indexation; and the cost of index-linking. So far as such points are well-founded, they do not necessarily entail that any action should be on the benefit rather than the contribution side; the Scott report was confined to the latter. Both types of action are considered in the report (paragraphs 7-10).

Part D - Pension Schemes and the Impact of Inflation

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The Scott report saw the preservation of the real value of pensions as a desirable social objective. It has never been the intention that pensions should be eroded with time: that is the fortuitous effect of inflation. For a variety of reasons inflation has affected public and private sector schemes differently. Assumptions for the future are needed as a basis for determining contributions to funded schemes and valuing the comparative benefits of pay-as-you-go schemes. Index-linked gilts, as well as helping to make indexed pensions practicable for schemes dependent on funding, will facilitate the valuation of indexed benefits; but they are not yet sufficiently established or widely available to provide solutions on their own (paragraphs 11-18).

Part E - Public Sector Pensions Schemes

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It is necessary to take account of variations within the public sector in the Government's responsibility for, and control over, pensions schemes; and in its financial involvement

(paragraphs 19-21). Arrangements for negotiating pay are also relevant; again, they and the Government's role in them vary widely (paragraphs 22-24). Any new arrangements should be adaptable and easy to administer (paragraphs 25-26). There would be attractions in making the Civil Service and Armed Forces schemes formally contributory (paragraph 27). Changes in contributions and benefits could be related to each other for negotiating purposes, but ultimately the choice between these approaches is crucial both for individuals and for the Government (paragraph 28).

Part F - Possible Changes (Contributions)

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It would be difficult to rely on more severe actuarial assumptions as the sole means of achieving substantially higher pension contributions (notional or actual); but the actuarial approach can be used to reinforce other approaches (paragraphs 29-35). It might be realistic (Course I - paragraphs 36-40) to aim at securing pension contributions in the public services of the order of 10 per cent (instead of the present 5-8 per cent). An alternative (Course II - paragraphs 44-46) would be to require a part of pensions increases (e.g in excess of average practice in the private sector) to be financed by employee contributions on a pay-as-you-go basis.

Part G - Possible Changes (Benefits)

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Possible changes discussed are (Course III - paragraphs 48-50) purely discretionary increases; (Course IV - paragraphs 51-52) increases limited to average private sector practice, which would probably have to be estimated in arrears; (Course V - paragraph 53) increases paid from surpluses in real or notional funds; (Course VI - paragraphs 54-56) containing increases below a cut-off point fixed in advance; (Course VII - paragraphs 57-58) a power, presumably subject to Parliamentary procedure, to hold increases below the rate of inflation within some pre-determined limit; (Course VII - paragraphs 59-61) to give smaller increases to larger pensions; or (Course IX - paragraphs 62-64) to use an alternative index.

Part H - Financial Implications

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The financial estimates are subject to heavy reservations and qualifications (paragraph 65). In the very long term, once benefits and contributions are in the right relationship, changes to one would be offset by changes in the other; but initially contribution changes are likely to be bigger in their effects. Whether the large immediate savings to be sought from higher contributions could be maintained would depend on pay determination systems and how they were operated (paragraph 66). The smaller initial savings from reduction in benefits could, in the case of the Civil Service, be more than offset for several years by associated reductions in employee contributions (paragraphs 67-69).

Part J - Future Work

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The options need further study before final decisions are taken. It is desirable - and essential if early decisions are required - to narrow down their range. For negotiating purposes it is desirable to have available at least one benefit and one contribution option. We envisage further study of those underlined in the text of F and G above (paragraphs 70-72). This assumes that courses involving changes in benefits as well as those involving changes in contributions are acceptable; that changes should in principle affect at least all the public services alike, and not just the Civil Service; that any changes will have to be justified on reasonably objective grounds; and that there would not be reserved rights in respect of past service. These assumptions need to be confirmed or modified (paragraphs 73-74).

Annexes to the Report are also attached as follows:

- A. Recommendations of the Scott Report
- B. Details of Main Public Sector Pension Schemes
- C. Private Sector Pension Schemes.
- D. Pensions (Increase) Legislation before 1971

REPORT

A. INTRODUCTORY

1. We were set up with the following terms of reference.

"To examine the issues raised by the report of the Committee of Inquiry into the Value of Pensions under Sir Bernard Scott and report to the Chancellor of the Exchequer and the Lord President of the Council".

2. The Scott recommendations are summarised in Annex A. We have concentrated on those numbered 1-4. All relate to the valuation of pension benefits and to the way in which this is taken into account in determining pay (ie through contributions, whether actual or, as with the present Civil Service arrangements, through a reduction in gross salary), as was required by the Scott committee's terms of reference. We have not regarded ourselves as precluded by our terms of reference from examining courses of action involving possible changes in benefits as well as contributions, but we have done so only in the context of inflation-proofing and its cost; proposals which call in question the basic structure of public service pensions (e.g by changing the method of calculating basic benefits) we have treated as outside the terms of reference.

3. Our initial work has identified a wide variety of approaches to the issues. Therefore we ask Ministers for guidance concerning the objectives they wish to achieve and which types of approach they consider most promising. Possible courses of action then need to be worked out in greater detail for decision.

B. SCOPE

4. Although public discussion has focussed very largely on the Civil Service, the questions raised by index-linking do not apply solely, or even mainly, to the Civil Service. All public service pension schemes (indeed, nearly all public sector schemes) give index-linked benefits, but the Civil Service accounts for only 16 per cent of the total numbers. Annex B gives summary details of the main schemes involved.

5. Moreover, the Civil Service is virtually alone in having had a system of determining pay and pension contributions consistently taking formal and explicit account of the value of pensions, including index-linking.

6. Much of our work has been directed towards the case of the Civil Service, partly because Scott also concentrated on it, partly because the Government is directly responsible

as employer, and partly because, as with the setting up of the schemes in the first place, the Civil Service is perhaps the natural leader. There is, however, a strong case for applying the principles across most or all of the wider public sector, though it must also be borne in mind that Ministers do not directly control the terms of many such schemes.

C THE SCOTT INQUIRY AND RELATED ISSUES

7. The Scott Inquiry was set up in response to the following main points of public disquiet.

- (a) It has been argued that the cost to public funds of index-linking pension benefits is excessive.
- (b) It is sometimes argued that it is wrong in principle to index pay and related benefits, such as pensions, because indexation creates inflexibility and insulates those who benefit from it against economic circumstances.
- (c) It may be thought unfair that members of public sector pension schemes should be assured that their benefits will be fully protected against inflation, whereas other people, e.g. members of private occupational schemes or the self-employed, rarely enjoy protection on the same scale, and virtually never have an assurance of it.

8. In considering these arguments the following facts are relevant.

- (a) In 1980-81 the total expenditure on Civil Service retirement benefits was about 17½ per cent of the pay bill, of which 11½ per cent was accounted for by basic benefits and 6 per cent by (cumulative) pensions increase. Corresponding figures in other services were local government 12½ per cent (8 per cent basic, 4½ per cent pensions increase); NHS 8½ per cent (5½ per cent basic, 3 per cent pensions increase); teachers 14 per cent (8 per cent basic, 6 per cent pensions increase). The variations between services are mainly a reflection of different ratios between pensioners and active staff.
- (b) Private sector pension schemes are discussed in Annex C; most give some form of protection against inflation after retirement; and the State scheme provides protection in respect of the guaranteed minimum pension provided by contracted out pension schemes. Practice varies widely; but the Government Actuary's Department estimated in the most recent non-industrial pay research settlement that the private sector analogues gave on average 50-55 per cent protection. The Government would in any event have to provide some form of pensions increases for all the public services. The current annual additional cost of full inflation-proofing in the Civil Service, beyond average good private sector practice, is of the order of 3 per cent of the pay bill.

- (c) This figure of 3 per cent relates to "emerging costs" (as discussed further in paragraph 35), and should not be taken as necessarily representative of the cost on a funded basis, though it happens to be about one percentage point below the Government Actuary's 1980 estimate (2.2%) of that part of the Civil Service "deduction" attributable to the greater degree of inflation-protection than found in the analogues.
- (d) While full inflation proofing is very rare in the private sector, and even then not a matter of right, a number of large employers have provided protection of the order of 80 or 90 per cent, and done so in relation to basic pensions at the rate of one-sixtieth of final salary for each year of service, compared with one-eightieth in most public service schemes (the difference, representing a lump sum benefit in the case of the public services, does not qualify for pensions increase). The cost of inflation-proofing a pension based on sixtieths is, of course, one-third greater than the cost of inflation-proofing a pension based on eightieths.
- (e) Some criticism is directed against increases in the largest pensions; but most public service pensions are small: in the Civil Service the average pension is £29 a week, and over half are less than £20.

9. Perhaps the most difficult argument to assess is that of fairness (paragraph 7(c) above). This may be taken in two senses.

- (a) It may be argued that, although pension arrangements may legitimately differ between public and private sectors, the total of remuneration (pay, pensions and other benefits) must be held in reasonable balance. Hence if public servants enjoy superior pension benefits, that is acceptable if, but only if, they pay an appropriate price for them. The problem here is partly that the determination of an appropriate price for pension benefits depends on assumptions regarding the long-term course of prices, earnings and real rates of return, on which views can and do differ widely and the outcome may differ from the assumptions. It is also that many people regard public sector pension benefits as something on which no objective price can be put, because fully comparable ones are not available in the market.
- (b) For these or other reasons, it may alternatively be argued that pension benefits in the public and private sectors should be brought as closely into line as possible.

10. The first of these two arguments would imply that attention should concentrate on setting an appropriate level of contributions from employees; the second that attention should concentrate on ensuring that the level of benefits paid to pensioners is appropriate. Both are defensible; and we have assumed that Ministers would not wish at this stage to

choose between them. We have considered a range of options, discussed in the body of this report, intended to meet in varying degree legitimate public concern regarding disparities between public and private sectors and the cost of public sector pension arrangements.

D. PENSION SCHEMES AND THE IMPACT OF INFLATION

11. A pension is part of the implicit contract of employment; and it is therefore important to both employer and employee to be able to assess its real value; with a very long term contract, some form of compensating for inflation, until it is brought down to low levels is the only way of satisfying that need.

12. Civil Service pensions have been paid very much on the present basis (equivalent - see paragraph 8(d) - to one-sixtieth of final salary) for 150 years; and they have been followed by the rest of the public sector. Until about the middle of the present century they were markedly superior to those in most of the private sector; but this was a matter of basic terms rather than of inflation-protection; their real value was maintained simply through the general absence of inflation. Recent years have seen a great increase of private sector pensions in both numbers and quality; so that, leaving inflation-protection aside, the benefits of public sector schemes are no longer notably superior.

13. The resources needed to pay pensions have to be provided in one way or another by the economically active part of the population, whether in the public or private sector, and whether on a "funded" or "pay as you go" basis. Irrespective of decisions on the public sector, the overall amount of these transfer payments will rise for some years as schemes mature. Pension funds provide a mechanism through which employers and employees can combine to create the necessary claims on the next generation; funding also provides a means of valuing, ie attaching a current price to, future pension benefits. But it is a convenience to be taken advantage of only if it is useful. The approach of the Scott Report was to value public service pensions on the basis of the contributions which would be necessary if they were funded.

14. The essential difference between public and private schemes, however, is not funding (which may or may not be applied in both public and private sectors), but the nature and certainty of the benefits. Public service pensions under present legislation are maintained in real terms - but provide for no improvement over this, for instance if earnings (as has been usual) rise faster than prices. Private pension funds, on the other hand, cannot guarantee inflation-proofing; but, like other private investments, they theoretically could secure a return which allows real improvement in benefits and, until the 1970s, often did. This disparity in the form of contract is not necessarily wrong. But the disparity in recent performance, as a result of the unanticipated acceleration of inflation, is a perceived inequity.

15. Inflation has drastically disturbed the institutional arrangements in both sectors. In the case of the private sector, it has eroded the value of past savings in pension funds and therefore created an unintended gap between the values of pensions in money and in real terms which has been bridged in some cases by deficiency payments or ad hoc topping up. In the public services, where pay-as-you-go rather than funded schemes are more frequent, employers have maintained the real value of pensions, but they have done so by means of "pensions increases", treated as being distinct from "basic pensions" and sometimes even financed by different authorities.

16. Nevertheless, although inflation redistributes systematically in favour of borrowers (eg mortgagors and the government) it does not necessarily make it impossible for pension funds (which depend on lending) to maintain the real value of benefits. The crucial question is the extent to which the inflation is anticipated and reflected in interest rates and other financial returns. The real rate of return, net of inflation, was negative during much of the 1970s. But, since the period of a pension contract may last 60 years or more (taking contribution and benefit periods together), it is necessary to take a very long term view of economic variables - short-term deviations, provided they do not turn into long-term ones, can be coped with. Clearly, nobody can predict what rates of return will be far into the future; but some assumptions are needed in order to do the arithmetic at all, reflecting a reasonable view of what can be expected in the very long run. This is necessary not just for inflation-proofing but also for securing and valuing even the basic benefits of a funded scheme.

17. The market flotation of index-linked bonds is useful in a pensions context because it provides both a more certain store of value than existing securities and also a guide to the expected real rate of interest. It enables pensions to be secured in real terms for those prepared to pay the price, so that indexation need not in future be confined to the public sector. We do not, however, think that the fact that such bonds are now available - and we recognise that the main reason for their issue was a monetary one - has yet much reduced the difficulty of the problems we have to tackle. The initial issue of £1 billion is small in relation to the assets and liabilities of the pensions industry; and it will not permit index-linked benefits to be offered at all widely. Moreover, the market in the bonds will initially be small and it is confined to certain institutions. Although it is too early to make a firm judgement, the allotment at par perhaps suggests that 2 per cent is a reasonable view of the minimum real return expect by pension funds (this is lower than that normally assumed by actuaries) - the fact that other investments are being bought by pension funds when the indexed gilt is yielding over 2 per cent implies that to those who buy them the possibility of doing better outweighs the risk of doing worse. If ultimately these and similar bonds become widely available and markets become accustomed to them, they could provide a more reliable indication.

18. Thus neither the public sector nor the private sector can yet be said to be coping with the disturbance of inflation so far as pensions are concerned. In the public sector the retention as separate concepts of "basic pensions" and "pensions increases" has given rise to anomalous financing arrangements; in the private sector those responsible for pensions have been slow to recognise and adjust to the low real returns being obtained (and apparently expected) on investments. The Scott report saw the preservation of the real value of pensions as a desirable social objective - which would be impaired if action were taken on benefits but would remain intact if it were taken on contributions - but one whose full cost has yet to be recognised.

E. PUBLIC SECTOR PENSION SCHEMES - GENERAL CONSIDERATIONS

(i) Range of schemes and financial arrangements

19. As noted in paragraph 4 above and Annex B, nearly all public sector pension schemes offer index-linking. It is convenient to divide them into four main groups.

Group 1:

Schemes for employees of central government (Civil Service, Armed Forces, NHS).

Group 1a:

Office-holders whose pensions are provided by the State (MPs, Ministers, the Judiciary).

Group 2:

Schemes for employees of other public services (school teachers, local government employees, police, fire service).

Group 3:

Schemes for employees in the rest of the public sector (mainly nationalised industries and other public corporations).

20. The Exchequer naturally bears the full cost, net of any contribution from members, of all benefits, including pensions increase, provided by schemes in Groups 1 and 1a. But it is also involved in the finances of certain schemes in the other groups. In particular, it bears the full cost of pensions increase in the teachers' schemes; it contributes, through the RSG, to the cost of the local government, police and fire schemes; and it contributes, under specific statutory arrangements, to the cost of the miners and railworkers schemes.

schemes in Group 2 are of course a charge on local taxes, and those in Group 3 a charge on consumers, to the extent that the Exchequer does not itself pay for them.

21. It is clearly desirable that the basis of any Exchequer contribution to the costs of public sector pensions schemes should be consistent. It would not, for instance, be easy to defend a situation in which the Government ceased full inflation-proofing for its own employees, while meeting its full cost in other schemes providing otherwise similar benefits.

(ii) Negotiating arrangements

22. For all schemes in Group 1 the Government settles the terms after discussion with staff or receipt of advice as may be required. In addition, it lays down the terms of the major schemes in Group 2. However, it is not the employer of members of schemes in Group 2; and its ability in practice to insist on a change in terms, at any rate if both employers and employees objected, is open to question. There would also be difficulties with schemes in Group 1a. There is a link with the point discussed in paragraph 20 above: even if the Government could not secure a change in benefits or contributions which it considered justified, it might nevertheless limit its own financial contribution.

23. The arrangements for negotiating pay are also important in this context. If Ministers decided that it was appropriate to raise employees' contributions, they could, at least de jure, achieve such a result in all major public service schemes. This would have some value on its own. But for employees in schemes in Group 2 it would be for local rather than central government to ensure that the increase in contributions was not sooner or later offset by increases in pay. Even for members of schemes in Group 1, unless their pay was determined by a formal process of comparability, once the initial reduction in net pay had taken place, it would be possible to say no more than that the value of pension benefits, including pensions increase, had been taken into account in pay negotiations - it would be up to the government to make the best bargain it could in the circumstances.

24. As for the members of schemes in Group 3, most of the nationalised industry schemes are funded and have a substantial financial and organisational independence. The Government has no control over either pension terms or pay negotiations. To ensure that pension terms were changed would require specific and contentious legislation; and nationalised industry managements would vary in their resistance to increases in contributions being offset by increases in pay.

(iii) Adaptability to changing circumstances

25. Major divergences between pension arrangements in public and private sectors produce criticism and misunderstanding and could inhibit labour mobility; other things being equal,

there is much to be said for bringing the two sectors closer into line. But private sector practice is not static. Moreover, economic circumstances change; and it is far from certain that any changes introduced into current arrangements will seem appropriate in 10 or even 5 years time. Any new arrangements therefore need to be adaptable as requirements change. But, since pensions represent delayed payment for services rendered (paragraph 11), adaptability needs to be distinguished from flexibility to pay less than the contracted benefits (though there may be argument about what these are).

(iv) Administrative simplicity

26. There are some 2½ million public sector pensioners, in widely varying circumstances. Any changes that may be made must be administratively feasible. Other objections apart, attempts to discriminate between different categories of pension or pensioner, if taken far, could rapidly lead to unworkability.

(v) The contributory principle

27. Most public service pension schemes involve actual contributions from employers, but this is not the case with the main Civil Service scheme or with the Armed Forces. Although the pay of civil servants is reduced on account of their pension benefits (and the same approach is followed in the Report of the Armed Forces Pay Review Body), they are widely believed to "pay nothing for their pensions". The presentational drawbacks of this may be thought to justify making the Civil Service and Armed Forces schemes formally contributory in respect of all benefits. The argument is strengthened if changes in contributions are made following the Scott recommendations, since experience shows that public opinion is unlikely to believe that adequate adjustments have been made solely through the process of pay determination. Although the Civil Service unions have not yet expressed a view collectively, it seems probable that they would welcome a formally contributory scheme. However, further study of the implications (including those for staffing) is required before decision.

(vi) Changes involving contributions or benefits

28. Paragraphs 29 to 64 below discuss possible courses of action which Ministers might wish to take against the considerations discussed in paragraphs 11 to 27 above. For convenience, they are divided into changes affecting contributions and changes affecting benefits. This does not mean that changes from the two categories could not be combined; and there are in fact two options, one from each category (paragraphs 44 and 51 below), which are closely related. Changes in both benefits and contributions would involve complex negotiation. Although ultimate choice may be necessary, there is, however, advantage in keeping both options open at present. If pursued to the negotiating stage, it would give

increased scope and, for instance, enable the government to suggest lower benefits if its objectives on contributions were not met; or to offer smaller increases in contributions in exchange for lower benefits. The concept of fairness can be applied to either approach, but in different ways (paragraphs 9-10). Ministers should be aware also of pre-election statements. The two approaches are very different in effect: for the government there are big differences in the profile of costs (paragraphs 65-69); for public servants the balance between generations is affected (paragraph 18). Furthermore, if it were decided that changes were to apply from a current date and that acquired entitlements were to be protected, the financial balance for the government would swing more strongly in favour of changing contributions rather than benefits (paragraph 74).

F. POSSIBLE CHANGES - CONTRIBUTIONS

29. The report of the Scott Committee dealt with the valuation of pension benefits and suggested, in the particular context of the Civil Service, a range of values. It is natural to suppose that the right way forward is to decide the correct figure within the range, deduce the consequences for pay or pension contributions, and proceed accordingly.

30. It is difficult, however, to get a conclusive result from this approach.

- (a) Actuarial valuation assumptions, as has been said, relate to very long periods, and therefore tend to be stable. By the time observed changes in trend are established, it is already late to adjust. There is no objective way of establishing in advance which set of assumptions will actually be fulfilled.
- (b) The Government Actuary in evidence to Scott said he would welcome greater outside scrutiny of his work in the context of the Pay Research machinery, including his assumptions for valuing the Civil Service scheme (we agree this is desirable); but in practice his assumptions are likely to remain fairly close to those commonly used by the actuarial profession. It would of course be possible for the Government to postulate different assumptions; but it would be hard to make arguments justifying the particular ones chosen. Furthermore, it would no longer be possible for the Government Actuary to act as adviser to both sides in Civil Service pay negotiations on the basis of assumptions imposed by only one side.
- (c) Moreover, to impose pessimistic economic assumptions would have other implications: it could affect the terms for contracting out of the State pension scheme; and it would imply (perhaps correctly) that most private sector and nationalised industry pension schemes were grossly under-funded.

31. There is therefore a limit to the increase in contributions which could be secured with the actuarial approach. There are so many variables that it is impossible to arrive at a definitive conclusion. Nevertheless, table 4 in paragraph 104 of the Scott Report analysed the sensitivity of the calculations in relation to changes in each of the main assumptions and this showed the key importance, as already suggested, of the assumptions relating to the real rate of return on investments. The argument that contributions are too low in the public sector is essentially an argument that actuaries (and this includes the actuaries of private sector schemes as well as public ones) have been too optimistic in their assumptions in this respect.

32. The figures at the pessimistic end of the Scott range are based on a real return of zero. This is not the lower limit of what would be possible. Brealey and Hodges (Annex 7 of the Scott Report)* arrived at negative rates of return for both fully and partly index-linked schemes. While theoretically possible, however, this would be an extreme conclusion bearing in mind that one is looking at a long period ahead, since:

- (a) There is no obvious historical precedent for negative rates of return except in the last decade; and there are artificialities (for instance large use of short-term fixed interest securities) in the portfolios constructed by Brealey and Hodges in order to simulate an indexed bond (which did not then exist).
- (b) The indexed bond now floated does not point to a negative rate of return.
- (c) If real rates of return were negative, funding as a concept would be called in question, since contributions for funded schemes would have to be higher, as a proportion of salaries, than the emerging cost (also as a proportion of salary) of the pensions actually being paid, assuming a stable level of workforce. Funding, as opposed to pay-as-you-go, would become a financial penalty; and valuation of pension benefits on a funding basis would be of doubtful relevance (the more extreme public comment, indicating very high figures for the "actuarial" value of public service pensions, seems to miss this point).
- (d) The Scott Committee thought the assumption of a real rate of return of less than zero implausible.

33. For these reasons and others (eg the interdependence of some of the assumptions) we think that the range of valuations suggested by Scott can be taken as realistic, ie that the pessimistic end of the range is pessimistic enough for policy purposes. We now turn to what the implications would be.

* See also footnote on page 12.

34. At the pessimistic end of the Scott range, the "normal contribution rates" (for employer and employee combined) were of the order of 36 per cent for the civil service and 24 per cent for the analogue benefits, a difference of some twelve percentage points. In terms of employee contributions this would have indicated an increase in the "deduction" from civil service pay from 3.8 per cent to 8½ per cent, pointing to an increase in the total effective employee contributions of civil servants from 7.9 per cent to 13½ per cent of pensionable pay. On this basis it might, at the outside, be right to ask civil servants to pay about 4½ per cent per annum of their salaries more than at present.

35. However, this could result in some rather unrealistic conclusions in terms of "emerging cost". The emerging cost of the civil service scheme (ie the cost of pensions currently in payment, including pensions increase, as a proportion of the total pay bill) is of the order of 17-18 per cent, and likely to reach a peak of about 25 per cent in the late-1980's before falling back later. A 13½ per cent employee contribution would leave the employer paying only about 4 percentage points of the current emerging cost. As against this, the typical private sector employer is paying about 12 per cent of the pay bill into the pension fund. Although the figures are not strictly comparable, this is bound to influence what is negotiable. Thus the conclusion on Scott is useful but limited - an increase in contributions which can be made without implausible implications in terms of the sharing of emerging cost is likely to be within the range suggested by Scott, and the Scott arguments will be helpful in justifying it.

Course I Straight increase in contributions

36. The Scott Report conclusion that in 1980 the total effective employee contribution for the Civil Service was 7.9 per cent compares with contributions in the range of 5-7 per cent by other public servants (apart from the Armed Forces for whom the corresponding figure for their earlier pensions is now 11 per cent). Given the harmonisation of benefits in recent years, there seems no good reason for this wide range of civil contribution rates, and levelling up to the Civil Service rate would seem justified. In the light of the Scott Report, it would be reasonable to go further and seek a general increase in contribution rates. There is no objective way of determining the "right" contribution, and negotiation would be involved. But there would be advantage if public servants were seen to be paying significantly higher contributions for their better benefits, as compared with the private sector; and, within reason, public servants themselves would accept this.

37. If Ministers considered that higher contributions were justified as their main response to the Scott Report, it seems unlikely that an increase of less than 2 per cent for the Civil Service (10 per cent in all) would be seen as an adequate reaction to public concern. A higher figure, on the other hand would be difficult to justify in negotiation. It would be

argued that the present rate had been assessed by the Government Actuary on assumptions widely applied by the actuarial profession - even taking a percentage point off the expected real rate of return, making it 2 per cent, would add only 1 per cent to the required contributions; also that, with an employee contribution of 10 per cent, serving civil servants would be meeting some 56 per cent of the currently emerging cost of the scheme and about 60 per cent of the normal contribution rate as assessed by Government Actuary in 1980 (this latter figure compares with a typical employee share of one-third or 4 per cent of gross pay in the private sector). Therefore, while 10 per cent is not the limit of what might properly be sought in negotiation, and even higher figures might be possible, it is as much as we think it realistic to take as a planning figure. Any figure agreed would be subject to periodic review.

38. A variety of arguments may be deployed to justify a higher rate of contribution than at present. They do not in themselves imply any scientific basis for a 10 per cent or higher contribution, but might be made with some force in the course of negotiation in support of such an objective.

- (i) Public servants might be expected to pay a higher proportion of the total cost than their private sector counterparts because the advantages of indexation include not only its measured value but also the security of knowing there is protection. In the calculations of Bealey and Hodges* this was worth about half a percentage point on the real rate of return, ie half a percentage point also on contributions.
- (ii) The Government Actuary has recently strengthened his actuarial basis for some purposes, eg the pensions of the Armed Forces, assuming a 2½ per cent rather than 3 per cent real rate of return; this also would imply an increase of about ½ per cent in Civil Service contributions. There could be certain sets of assumptions not wholly outrageous (such as 2 per cent real rate of return and double figure inflation) which would imply a 10 per cent contribution rate, though it would be difficult to substantiate a case on these grounds alone.
- (iii) The pension advantage over the private sector generally is greater than the advantage over Pay Research analogues. In particular, Scott recommended that public sector analogues should be excluded, which would add a small amount to the Civil Service contribution. This argument will, however, need to be carefully formulated in relation to whatever comparisons are adopted in future for civil service pay.

* B&H's basic theory, which is a distinct issue from that of low or negative interest rates, is that a lower rate of interest should be used to calculate the discounted value of Civil Service benefits than of analogue benefits, hence putting a relatively higher value on the former, because the real value of index-linked benefits is less uncertain than the real value of non-linked benefits.

- (iv) Existing comparisons based on jobs do not take sufficient account of the pension losses suffered by job changers in the private sector insofar as these reflect higher labour turnover.
- (v) Some minor and inexpensive improvements in schemes might be offered.
- (vi) If contributions were not raised as proposed, the arguments for reducing benefits would be strengthened.

39. If civil servants were persuaded to agree pay contributions of around 10 per cent of gross pay, it would be hard to defend not levying employee contributions in other public sector schemes which were equivalent (taking into account any differences between the schemes) - indeed, levying similar contributions in other services would probably be necessary in order to secure agreement for the Civil Service. It would be much more difficult to achieve this with the other public services because of the bigger increases in contributions (without improvement in benefits) implied. The arguments in paragraph 38 could be deployed with differing force in each service, but the main thrust would have to be that the value of an index-linked pension had become apparent only in the last few years; that it would be inequitable for the groups concerned to pay less than Civil Servants; and that the greater increase simply reflected the extent to which benefits were undervalued in the other public service schemes.

40. In the light of this, the difficulties to be aware of with this approach are the following:
- (a) Opposition to such increases in contributions, certainly outside the Civil Service, and possibly within it in the absence of pay comparability, might be strong; even the current contributions of the Civil Service are (just) within the Scott range. If not negotiable, increases would have to be imposed with perhaps adverse implications in terms of industrial relations.
 - (b) It is not easy to argue for a particular point in the Scott range and the scope for argument about whether a "proper price" was being charged for benefits would remain.
 - (c) The savings, particularly in services not controlled by central government might be eroded by subsequent pay increases. Certainly the difference between employee contributions in the public services (around 10 per cent) and the private sector (on average little more than 4 per cent) would be large and hard to sustain.
 - (d) If the Civil Service scheme were converted into a contributory one, the establishment of gross pay figures to replace net ones could be misrepresented as a pay increase (see paragraph 27).

- (e) An increase in contributions explicitly related to pensions increase would make it even more difficult subsequently to depart from index-linking.

Course II A partial switch to "pay as you go" contributions

41. The approach under Course I was to estimate what the cost of pensions was likely to be and to ensure that employees made appropriate contributions in advance. But that would still leave the possibility of the outcome being different from that assumed and the actual cost being more or less than forecast. An alternative approach, therefore, is to relate contributions more directly to the costs as they emerge (which is how indexed pensions are financed in France). This implies that the employees' contribution should be a variable one. This approach gets over problems caused by inflation, provided that pensions and salaries move in step. But it is liable to produce bizarre results if for demographic, economic or policy reasons there are shifts in the numerical balance between those working and those retired, or changes in the levels of benefit for which the retired are eligible. This will be the case with many of the relatively new public service schemes, including that for the NHS, as retirees progressively have more years of reckonable service; the civil service scheme, by contrast, is mature; but both it and, for instance, the teachers' scheme might become temporarily unbalanced as numbers are reduced. The significance of such shifts would be reduced if the coverage of pensions schemes were extended from single occupational groups to broad sectors of the population, but could still be substantial.

42. The randomness of variability of pay-as-you-go can be reduced by retaining at least a substantial actuarial element, subject to pay-as-you-go correction when assumptions are falsified. There are several ways in which this could be done.

43. One would be to recalculate the adequacy of past (as well as current) contributions at intervals of several years and to impose a surcharge or allow a credit on contributions to recover or repay, over a short period of years, any estimated deficiency or surplus insofar as it reflected different assumptions on inflation or the real rate of return. This would amount to the use of a notional fund, with contributions rather than benefits being the variable element. It would require further study but might result in rather large swings in contribution rates because the changes would have to pick up past errors and make provision for the future. The changes in accounting procedures required might also be costly.

44. Another approach, which we have examined in more detail, would be for the Government (or employer, as appropriate) to finance pensions increase up to, say the same extent as average practice in the private sector, and to levy from employees a percentage of salary sufficient to finance the remaining emerging cost of inflation-proofing. This would fit well with Course IV discussed in paragraphs 51-52 below, and much of the argument there

is also applicable here; the two combined perhaps provide the most convincing way of reconciling changes in benefits with pre-Election statements.

45. The attractions of the course outlined in paragraph 44 would include:

- (a) Since it would be based on private sector practice, it could be represented as making for greater fairness between public and private sectors; and it would respond automatically to changes in private sector practice;
- (b) It would yield significant savings; and since the pay as you go contributions would be assessed separately, and revised at intervals, it is possible that they would be less likely to be offset by subsequent pay increases.
- (c) Since the system would, in principle, be based on objective evidence about actual payments, it would reduce the scope for argument about valuation.
- (d) It might give the Government more options for dealing with schemes in groups 2 and 3. In the case of the teachers' schemes, for example, the Government could meet the cost of pensions increase corresponding to private sector practice, leaving any additional cost of inflation-proofing to be the subject of negotiations between employers and employees. (This could, of course, result in different levels of protection against inflation in different public services).

46. On the other hand -

- (e) It could lead to serious financial problems if the ratio between pensioners and active members changed significantly: the teachers' scheme is a case in point.
- (f) It could be expensive to administer, since pension contributions would vary from one period to another.
- (g) It would have to work in arrears, to allow for inevitable delays in collecting information about private sector practice (this is developed in more detail in paragraph 52 below).
- (h) It could be regarded as raising problems of equity between different generations of scheme members. For example, if the rate of inflation fell, and real returns improved, full inflation-proofing might become normal in both public and private sectors. People who, in employment, had paid large pay-as-you-go contributions on account of pensions increase for their previous colleagues might find in retirement that they enjoyed no preferential benefits.

G. POSSIBLE CHANGES - BENEFITS

47. It is not realistic to suppose that no arrangements for increasing pensions after award need be made. Even in times of relatively low inflation, hardship (and consequential

political pressures) would quickly grow; there have been measures to increase public service pensions since just after the First World War; and post-award pensions increase is commonplace in the private sector. The question is whether to modify the existing system.

Course III Purely discretionary increases

48. Pensions increase in the private sector is frequently provided on a partly or wholly discretionary basis. In principle, such an approach would go a long way towards meeting the criticisms set out in paragraph 7 above. Whether it did so in practice, and in particular whether it reduced the cost of pension increase, would depend on the size of the discretionary awards.

49. However, it would very much alter the nature of a pension from being a contractual obligation for services rendered to a discretionary payment subject to the political process. It would seem inequitable that the government, by allowing inflation, should be able to reduce its obligations, and a discretionary system of this kind would be likely to be deeply unsatisfactory to employees. There would be acute and conflicting pressures in the press, in Parliament, and from pensioners. Private sector schemes are not similarly exposed.

50. Experience before 1971, when pensions increase was on a discretionary basis, shows that pressures arise for special (and anomalous) treatment for "hard cases", such as small pensions or older pensioners. Annex D gives a brief account of what happened before 1971: there is no reason to suppose that the subject would prove any easier to handle if increases were once again made fully discretionary.

Course IV Increases based on private sector practice

51. An alternative would be to base pensions increases on average private sector practice. This would be widely regarded as fairer than the present system; and the cost of pension increase would be substantially reduced, since post-award increases in the private sector have in recent years averaged about 50-55 per cent of inflation and divergences could well continue in future; but, correspondingly, the civil service's "deduction" from pay would need to be lower than at present. Self-evidently, the system would be closer to private sector practice, and would adapt itself automatically to changes in that practice.

52. The extent and basis of pensions increases currently given by private sector schemes vary widely; and evidence about them could be collected only in arrears. It would be possible to reduce some of the resulting difficulties by collecting information over, say, the previous 5 years, and increasing public service pensions by the appropriate proportion of the current inflation rate; but the evidence would still be in arrears and open to dispute. A more

substantial objection to this approach, however, is that the model for the public services would be an inadequately funded and performing private sector pensions industry (see paragraph 18); this objection could be partly met if there were provision for topping up financed by additional contributions (see paragraph 44).

Course V Pensions increase paid from surpluses

53. Increases could be paid from the surpluses emerging in actual or notional funds. This would be demonstrably "what could be afforded". The attraction of this course is its apparent similarity to private sector practice. However, there are substantial technical drawbacks:

- (a) Only the local government scheme is actually funded; and, even there, the pension funds do not bear the cost of pensions increase (which is paid by the rate fund on a pay-as-you-go basis). The NHS and teachers schemes are notionally funded; but they are deemed to be invested solely in fixed interest securities, which is inappropriate to a fund offering index-linked benefits; and the funds do not bear the cost of pensions increase. No other major public service scheme is funded. If actual rather than notional funding were adopted, massive funds would be involved; investment policies would raise political questions and the monetary consequences would need attention. It would be necessary to devise or revise funding bases for all public service schemes; and this process, which would raise numerous contentious issues (including the appropriate valuation assumptions for the establishment of the fund, and the level of contributions), would largely determine what could be paid by way of pensions increase for some years. It would offer critics an easy target from all directions.
- (b) Pensions increase in many private sector schemes is at least partly financed by employers, through ex gratia contributions or maintaining contribution levels which could be reduced if no more than the contractual benefits were paid. It would be difficult to exclude the possibility of such ex gratia contributions in the public services; but, once it was admitted, it would take the system back towards either purely discretionary increases or increases matching average private sector practice.

Funding would also theoretically permit a more individual approach, approximating to the treatment of the self-employed. This would, however, imply a "money purchase" rather than "final salary" basis and create discrepancies with the usual type of private occupational schemes. It would be very complex; and, in so far as such an approach would call basic benefits in question, rather than pensions increases, it falls outside our terms of reference.

Course VI A cut-off point

54. Although the Scott Report said that the Committee had assumed that in the last resort there would be a limit to the rate of pensions increase, this seems essentially to reflect the technical point that to allow for hyper-inflation would distort the valuation process: a very high cut-off point is adequate to meet this argument.

55. In order to have practical significance in current circumstances, a different type of cut-off would have to be chosen. There are various possibilities. Examples might be:-

- (a) a fixed percentage figure, such as 10 per cent;
- (b) a fixed proportion of the rate of inflation; since this would guarantee the erosion of pension benefits, the uncovered proportion would need to be limited - possibly to no more than, say, 20 per cent of the rate of inflation in a given year;
- (c) full inflation-proofing up to, say, 10 per cent, with one half or two thirds protection thereafter.

56. All such approaches would tend to reduce the cost of pensions increase. They would however, be inflexible. And it is not obvious that they would be fairer than the present system, as between public and private sectors: there is no evidence that the private sector applies a cut-off of this nature. There is also a dilemma. If the cut-off operates so as to make significant savings, it is certain to generate heavy pressure for discretionary increases. Furthermore, if there were substantial changes in general economic circumstances, it might be necessary to change the system itself, in which case this would not be a stable solution. A cut-off therefore serves the limited purpose of saving money, in an unpredictable but inflexible way, when inflation is high. It would seem arbitrary and unjust to employees, who would not know the limit of real income they might lose, while the question of equity vis a vis the private sector would be a matter of chance.

Course VII Power to increase pensions by less than inflation

57. A different approach would be to maintain the link with inflation but to take power (which would be exercised only infrequently and would presumably be subject to some form of Parliamentary procedure) to make increases less than the rate of inflation in any particular year within some pre-determined limit. This limit could be defined in various ways: for example, up to 5 percentage points, or up to one-third of the annual rate of inflation. Pensioners would then have an assurance of protection against inflation, except in circumstances where Ministers were prepared to defend an explicit decision to give less. The same objections would apply as to other discretionary systems; but to a lesser degree because of the extent to which the discretion would be circumscribed.

58. Such an approach would increase the flexibility of the system, and tend to reduce its cost. Whether it would increase fairness between public and private sectors would depend on how it was administered. Moreover, if there were a period of restraint on pensions increase, followed by some years of full inflation-proofing, differences would build up between new and old pensions - there would be pressure for special treatment of older pensioners, as there was before 1971, and this could quickly lead to complexity.

Course VIII Smaller increases for larger pensions

59. It would be possible to provide full inflation-proofing up to a certain level (eg the basic State retirement pension), with smaller increases above that. The prime aim of such a measure would be presentational. There is no evidence that the private sector generally provides better protection on small pensions; for some top hat schemes the reverse may be the case. Unless the taper began at a very low level, there would be little effect on cost.

60. This option would discriminate against those not only with high earnings, but also with long service or who had saved through the purchase of added years; it could be argued to be a form of income redistribution more appropriate to the tax system than to a pension scheme. Moreover, there are many people receiving more than one public service pension from different sources, as a result of two or more periods of service with different employers (or even with one employer); there would be no way of aggregating such pensions for the purpose of tapered increases. If it were thought necessary to give special treatment to male pensioners aged between 60 and 65 (who would not be receiving the State retirement pension), further complexity would result.

61. This approach would accordingly do little to meet the criticisms set out in paragraph 7 above. However, if the presentational advantages were thought to outweigh the substantial administrative cost, it could be combined with other options discussed in this section.

Course IX An alternative index

62. One of the objections levelled against inflation-proofing on the basis of prices is that it leads to an increased proportion of national resources going to pensioners if real earnings decline. It also leads to what are widely regarded as anomalies between pensioners retiring at different dates.

63. There is therefore attraction in linking pensions increases, instead, to an index of earnings. This would contribute to fairness as between pensioners and others, though it

would not necessarily reduce the gap between public and private pensioners. There are several possibilities.

(a) Parity

This concept is applied to public service pensioners in most European countries; it links pensions increases to increases in the earnings of the pensioner's former employment. It might be impracticable to do this precisely, because of changes in grade structure etc; but equivalent mechanisms could be constructed. This course would automatically solve the theoretical problem of indexed pensions being capable of overtaking current salaries. It would prevent pensioners increasing their share of national income in a recession. There are two main objections. First is simply cost: it would almost certainly be more expensive than the existing system because, in spite of some years recently when real earnings have not risen, the expectation must surely remain that in most years earnings will rise faster than prices. Secondly, it could produce substantial differences of treatment between the pensions of different public services in a way that would be hard to defend: it might, for instance, be decided to increase the relative pay of the police in order to improve recruitment; there is no obvious reason why the pensions of those who had already retired should be correspondingly increased.

(b) Link with a general earnings index

A link with earnings, either nationally, or in the public services as a whole, would avoid the second of the objections mentioned above. But the question of cost would remain - it is surely plausible to expect real earnings to rise over time, in which case it will be more expensive to index in relation to earnings rather than (as now) prices.

(c) Lower of earnings or prices

By contrast, a link with whichever was the lower of earnings or prices in any particular year could be expected to reduce costs, particularly if the link was with public service (rather than national average) earnings.

64. Of the options considered in the preceding paragraph, the last is the only one likely to be cheaper than the present arrangements. It does, however, suffer from important drawbacks. It would leave a substantial difference between public and private sector practice. It would, nevertheless, be a clear worsening of existing pension terms. If the criterion oscillated between earnings and prices depending on which was lower in any particular period, there would be little logic in the result; but if the time period were extended, so that one took whichever gave the lowest cumulative result, this would be likely to be the price basis and the Government would have gained nothing for the loss of good will from the change, which would have exacerbated the difficulty of increasing contributions if Ministers were to consider such a course appropriate.

H. FINANCIAL IMPLICATIONS

65. At this stage, only a broad indication is possible of the likely financial effects of the various courses discussed in paragraphs 36-64 above. Any assessment of costs is subject to many imponderables, notably future movements of pay and prices. And it is important to identify savings net of additional expenditure that may as a result be incurred elsewhere: a reduction in pension benefits, for example, might necessitate an increase in pay either gross or through reduced employee contributions. The thrust of this report is that the balance between contributions and benefits in public sector schemes could be altered in the Government's favour by raising contributions or reducing benefits (or a combination of the two): ultimately it ought not to make a financial difference which route was followed, though there might be a difference in practice reflecting how far each approach could be pursued in the particular circumstances. However, it is in the nature of pension schemes - especially those based on funding, notional funding or (as in the case of the Civil Service) having employee contributions calculated as if funded - that the financial consequences of ultimately self-balancing changes occur first on the contributions side. The pattern in practice will reflect the extent to which changes on both sides are related to each other; but, on the basis of the courses discussed in this report, the scale of contribution changes would initially be likely to be bigger than that of benefit changes, as shown below.

Effect of increasing contributions

66. Subject to such qualifications, there are potential large savings (running to several hundred £ million a year) to be obtained through higher contributions, mainly outside the Civil Service:

- (a) In principle, the financial effect of making Civil Service pensions contributory, with men paying 8½ per cent, (paragraph 27) would be neutral in the long run: net pay would be slightly reduced, offset after a time by slightly increased pensions. There would however be a net saving in the short term: about £40-50 million in year 1, declining to some £20 million by year 5. The effect of making armed forces pensions contributory would be similar, except that the figures would be smaller
- (b) A further increase in contributions of 2 per cent for the Civil Service (Course I, paragraphs 36-40) would raise about £90 million in a full year, provided, in the absence of pay comparability, it were not offset by a corresponding pay increase. If all public service employees' contributions were increased to 10 per cent, the gross saving (in contribution income) would be around £700 million a year. But it is unrealistic to suppose that no offsetting pay increases would be conceded. The net savings are therefore likely to be substantially less than the gross ones, particularly where pay negotiations are outside the Government's direct control.

- (c) If there were a partial switch to pay-as-you-go contributions (Course II, paragraph 44) serving public servants would bear just under half the inflation-proofing bill. For the Civil Service, this would amount to some 2½ per cent of pay. But civil servants already pay around this amount for the extent to which they have better inflation-proofing than their analogues; this is fortuitous, but implies that there would be no net saving for the Civil Service. Adopting a similar procedure for the other public services would broadly have the effect of raising their employee contributions to the level currently paid by the Civil Service: first year saving around £300-400 million gross, again offset by any pay increases that might be conceded.

The figures in (a) and (b) are additive; (c) is alternative to (b).

Effect of cutting inflation-proofing

67. The initial savings from reducing benefits would be lower than those from increasing contributions; for the Civil Service only they are shown in the following table on various short-term assumptions about inflation and pensions increases. On the assumption that Civil Service pay continued to take account of comparative pension benefits, the table also shows the increase in pay which would follow such a worsening of pension arrangements; this is subject to the following qualifications:

- (a) it is based on the assumptions used by the Government Actuary in 1980 - more conservative assumption would point to lower paid increases;
- (b) if Civil Service pay ceased to take explicit account of comparative pension benefits, the pay increases shown here might not occur; but they would no doubt be sought by unions in negotiation.

CIVIL SERVICE SUPERANNUATION: 1981-82 TO 1983-84
£ million 1980 survey prices

	10% inflation			7% inflation		
	1981-82	1982-83	1983-84	1981-82	1982-83	1983-84
A. 80% indexation (saving) [Offsetting pay increase (1%)]	-	-3	-14	-	-2	-10
	-	+38	+38	-	+38	+38
B. Half indexation (saving) [Offsetting pay increase (2%)]	-	-9	-35	-	-6	-25
	-	+72	+72	-	+72	+72
C. Nil indexation (saving) [Offsetting pay increase (5%)]	-	-18	-70	-	-12	-50
	-	+188	+187	-	+188	+187

68. Thus, the short-term effect of abandoning index-linking, while continuing to take account of pensions in pay determination, would, subject to the qualifications above, be an immediate increase in net expenditure. This would, however, be transitional: in the longer-term - after 5 years or so at 10 per cent inflation, longer at lower rates - the net effects would be relatively small.

69. The above table may be related to the options discussed earlier. Course IV (increases based on private sector practice) might broadly equate to half indexation (line B) until the relative performance of private sector pensions improved. Course VI (a cut-off point) and VII (power to increase pensions by less than inflation) would be likely to be nearer line A (80 per cent indexation). The figures apply only to the Civil Service. The gross savings on pensions for the whole public service would be about four times the savings shown. It is not possible at this stage to say how far this would be offset by pay increases: there would not be an automatic link, as hitherto in the case of the Civil Service; and, as contributions outside the Civil Service are low already, there would be less scope for their erosion.

J PROPOSED FUTURE WORK

70. Even the necessarily summary account in this report indicates the complexity of the subject and the wide variety of possible courses of action. Before main decisions can be taken, it will be necessary to investigate selected courses in greater depth in the light of the detailed arrangements for different schemes, the legislative implications, the effects of negotiating arrangements, and likely financial effects. It is highly desirable - in fact, indispensable if Ministers look for early decisions - to narrow down the range of courses for detailed consideration.

71. For the reasons in paragraph 28 we envisage that Ministers will wish us to examine further at least one course involving changes in contributions and one involving changes in benefits. We suggest the following "short list".

Course I (straight increase in contributions)

Course II (a partial switch to "pay as you go" contributions)

Course II could be coupled with Course IV (increases in pensions based on private sector practice) and could be made a variant of the same approach. Both Course I and Course II offer the possibility of substantial savings; and action on contributions is the most natural way of following up the Scott Report.

Course VI (a cut off point)

Although this has significant drawbacks - not least, the difficulty of choosing the cut off point - it has been widely canvassed as a possible course of action.

Course VII (power to increase pensions by less than inflation)

This would significantly increase the flexibility open to Ministers; it carries substantial drawbacks, but perhaps less than those of Course VI.

72. The following are not on our "short list".

Course III (purely discretionary increases)

In our view, the difficulties and anomalies produced by a purely discretionary system (going beyond Course VII), eg as operated before 1971, are strong arguments against reviving this approach.

Course V (pensions increase paid from surpluses)

In practice, this would have little advantage compared with Course IV, and suffers from serious technical difficulties.

Course VIII (smaller increases for larger pensions)

Such attractions as it may have seem limited to presentational ones: by itself it could not contribute substantially to lower costs, greater fairness or more adaptability. It could, however, be combined with other courses involving changes in benefits if Ministers saw advantages justifying the administrative and other objections.

Course IX (an alternative index)

Simply changing the index to which pensions increase was related might be regarded as an inadequate recognition of public concern; most of the options would be at least as expensive as the present system.

73. The discussion in this report and the selection recommended above incorporate a number of important assumptions; it would be helpful if Ministers could indicate that they regard these assumptions as acceptable or, if necessary, how they should be amended:-

- (i) We have assumed that not only courses involving changes in contribution arrangements but also those involving changes in benefits are open for consideration. This implies:
- that Ministers do not regard past statements as precluding changes in benefits;
 - that they would be prepared to promote the primary legislation required to make changes in the inflation-proofing of public service (and possibly public sector) pensions.
- (ii) We assume that Ministers would start from the presumption that any changes should in principle affect at least all the public services alike, and not only the Civil Service. (The position of the wider public sector will also need to be

considered in greater depth). This implies that Ministers do not rule out such possibilities as:

- changing the terms of public service pension schemes over the heads of employers and employees; or
 - altering the terms of Exchequer support for certain public sector pension schemes; or
 - taking all practicable steps to influence pay negotiations to secure a genuine increase in contributions from public service employees.
- (iv) We have assumed that it will be necessary to justify the eventual decisions in an objective way.

74. Finally, account needs to be taken of the fact that public servants have taken particular courses (eg accepting or remaining in their jobs) or entered into financial transactions such as the purchase of added years, with the Government's approval or encouragement, on the basis that index-linking would continue. In the public services, entitlement to pensions increase rests solely on an Act of Parliament, which can always be amended or repealed by another Act (as has happened recently with the State pension scheme); this falls short of a guarantee, and the existence of one has been denied by Government spokesmen. Nevertheless, it would appear to many as a breach of faith if inflation-proofing were not continued at least in respect of pensions already in payment or earned by service up to the date of change. If such arguments were accepted, it would greatly reduce any savings to be achieved by altering benefits (as opposed to contributions). For the purpose of presenting this report, the financial calculations assume that any changes would be applied to all categories of people who might be affected.

Annexes attached:

- Recommendations of the Scott Report.
- Details of Main Public Sector Pension Schemes.
- Private Sector Pension Schemes.
- Pensions (Increase) Legislation before 1971.

5th June 1981

ANNEX A

RECOMMENDATIONS OF THE SCOTT REPORT

(Paragraph numbers refer to the Scott Report. They are drawn from the section of "summary and conclusions" (paragraphs 6-45; the recommendations are developed at more length in the relevant chapters of the report).

1. The general principles set out in the report (ie regarding the valuation of pension benefits) are applicable both in the non-industrial civil service and in other parts of the public sector where pay is determined by reference to comparability exercises. In parts of the public sector where pay is not so determined, negotiators should draw on the findings of the report to assess whether proper account is being taken of pension terms (paragraph 11.)
2. Public sector analogues should be excluded (for both pay and pensions) from the comparisons used in civil service pay research (paragraph 18).
3. Calculations of the value of index-linking in the public sector should take account of the fact that the prime disadvantage of private sector employees is the lack of certainty about future inflation (paragraph 24).
4. The approach to valuation put forward by Professor Brealey and Doctor Hodges (which takes explicit account of uncertainty) should receive serious consideration (paragraph 27).
5. The Government should look seriously at the case for issuing indexed bonds to cover pension liabilities: this would reduce the difficulty of arriving at agreed assumptions about the future (paragraph 28).

6. The Government Actuary should discuss the assumptions used to value pensions in comparability exercises with economic and commercial opinion as well as with professional actuarial opinion (paragraph 32).

7. The pension element in civil service pay research should be better publicised (paragraph 38).

8. The feeling of injustice in the private sector regarding inflation-proof pensions must be recognised (paragraph 42).

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing?	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
<u>Public services</u>									
Civil Service	732	391	787	1 $\frac{1}{2}$ % (men)	-	about 6 $\frac{1}{2}$ % (1980-81)	1971 Act	unfunded	All benefits
Armed forces	317	281	544	-	-	AFPRB (unquantified)	Follow 1971 Act	unfunded	All benefits
Local government	1077	359	686	5% (manual) 6% (other)	8 $\frac{1}{2}$ % (average)	2.8% in 1979 manuals settlement	1971 Act	funded for basic benefits	60% of PI and employer contributions
Teachers	693	187	670	6%	8.4%	about 1 $\frac{1}{2}$ % in 1979	1971 Act	notionally funded for basic benefits	All PI, 60% of employer contributions
NHS	822	208	480	5% (manual) 6% (Other)	7 $\frac{3}{4}$ %	some groups, various arrangements	1971 Act	notionally funded for basic benefits	PI and employer contributions
Police	139	78	192	7% (men) 5% (women)	-	None	1971 Act	unfunded	Grant element of benefits
Fire	40	25.5	44	6 $\frac{3}{4}$ %	-	None	1971 Act	unfunded	60% of benefits
Overseas	6	47	80	-	-	-	1971 Act	mainly unfunded	All PI
Judiciary	1	0.5	4	3-4%	-	None	1971 Act	unfunded	All benefits

	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
Parliamentary	0.65	0.3	0.8	6%	16%	None	1971 Act	Fully funded	Employer contribution
Total public service (approx)	3830	1580	3500						
<u>Nationalised industries etc</u>									
British Airports Authority	7.5	1.2	2.9	6-7%	11 ³ / ₄ -12 ¹ / ₂ %	None	Yes-follow RPI	Fully funded	Nil
British Airways	47	15	46	7 ³ / ₄ %/8 ³ / ₄ % (men) 5 ³ / ₄ %/7% (women)	12.65% - 25.5%	None	Follow 1971 Act	Fully funded	Nil
British Railways Board	217	64	40 (1979)	9 ³ / ₄ %	14%	None	Follow 1971 Act	Fully funded	Some, for historical reasons
British Steel	128	101	127	8% (staff) 5 ¹ / ₂ % (manual)	16%	None	Follow 1971 Act	Fully funded	Nil
Civil Aviation Authority	7.4	1.6	8.7	7 ³ / ₄ %	25%	Linked to Civil pay	Follow 1971 Act	Fully funded	Nil
Cable and Wireless	9.1	1.2	4.3	6.5% (men) 5% (women)	17-22.5%	None	Yes, discretionary	Fully funded	Nil
Forestry Commission	8	4.7	7.1	1 ³ / ₄ % (men)	-	As for Civil Service	1971 Act	unfunded	All benefits

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	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
National Bus Co	36	5	6	2½% (manual) 7½% (staff)	7½% 22½%	None	Broadly follow 1971 Act	Fully funded	Nil
National Freight Company	34	10	14	7½%	11½%	None	Follow 1971 Act	Fully funded	Some, under Transport Act 1960
Post Office	400	180	571	6%	9%	None	Follow 1971 Act	Fully funded	£45 million a year under 1969 Act
UKAEA etc	35	7.5	18	1½-7½%	10-12½%	Non-industrials linked to Civil Service	Follow 1971 Act	Fully notionally funded	Employer contribu- tions (except in BNFL and TRC)
Electricity supply	143	66	133	6%	12%	None	Follow 1971 Act in practice	Fully funded	Nil
NCB: miners	240		130	5½%	5½%	None	RPI since 1975, subject to Actuary's advice	Fully funded	About £50 million in 1980-81
NCB: staff	59	50	85	4½-5½%	10-12%	None	About 92% since 1971	Fully funded	Nil
British Gas	93	39	65	6%	15.2% (manual) 29.1% (staff)	None	Follow 1971 Act	Fully funded	Nil
London Transport	50	14	21	5% (manual) 6% (staff)	13½% (manual) 18.9% (staff)	None	1971 Act	Fully funded	Nil
Water Industry	5.6	11	27.5	5% (manual) 6% (staff)	11%	None	1971 Act	Funded for basic pensions	Nil

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	Scheme members 000	Pensioners (including dependants) 000	Expenditure 1980-81 £ million	Contribution rates		Pay adjustments in respect of pensions?	Full inflation Proofing	Financing arrangements	
				Employee	Employer			General	Direct Exchequer support
New Towns	3	0.2	1.6	6%	11.5%	None	Follow 1971 Act	Fully funded	Some for corporations operating revenue deficits
Crown Agents	1.7	1	3	14% (men)	35% (pre- 1980 entrants) 18% (others)	As for Civil Service	Follow 1971 Act for pre- 1980 entrants only; 5% limit for others	Fully funded	Nil
British Council	2	0.9	3.6	12% (men)	23%	As for Civil Service	Follow 1971 Act	Fully funded	Grant-in-aid
University Superannuation Scheme	58	38	52.5	6%	14%	None	Follow 1971 Act	Fully Funded	Grant-in-aid
BBC	21.5	7	21½	7%	20%	None	Follow 1971 Act in practice	Fully funded	Nil
IBA	1.4	0.1	0.6	6%	12%	None	80% of RPI practice	Funded for 3% pa post- retirement increases	Nil
Total nationalised industries etc (approx)	1600	580	1200						
Total public sector (approx)	5400	2200	4700						

PRIVATE SECTOR PENSION SCHEMES

Coverage

It is estimated by the Government Actuary's Department that in 1979 there were about 15.7 million employees in the private sector. In addition, the Inland Revenue estimate that about $\frac{1}{2}$ million people are receiving tax relief on contributions to retirement annuity schemes for the self-employed. About $11\frac{1}{2}$ million employees were employed by companies with pension schemes, and 6.2 million were members of the schemes. The remainder were excluded for a variety of reasons - they were too young or had insufficient service (about 35%), their particular jobs were not pensionable, they were part-time, or they had opted out. About 50% of men and about 25% of women belonged to schemes. By way of comparison, there were $7\frac{1}{2}$ million employees in the public sector, of whom 5.6 million belonged to pension schemes.

There were estimated to be over 608,000 employers, 16% of whom had pension schemes. Over 80% of those with 100 or more employees had schemes. Nearly all with 1000 or more had schemes.

The nature of the schemes

Virtually all schemes are funded. Some 35-40% of scheme members are thought to belong to schemes which are privately invested by Trustees, and a similar number have their contributions invested on their behalf by insurance companies. The remainder are covered by various mixtures of the two arrangements. Over 90% of scheme members have prospective benefits based on salary at or near retirement. In particular, probably at least three-quarters of those in insured schemes have final salary benefits; there has been a relatively recent trend by insurance companies away from money purchase schemes (which are more appropriate to the self-employed) and into final-salary schemes on behalf of employers.

Of those employees in final salary schemes, about three-quarters have benefits based on $\frac{1}{60}$ th of salary for each year of service, up to a maximum of 40 years. The great majority offer the option of commuting part of the pension to a lump sum. (Full commutation would give benefits broadly equivalent to the public sector norm of a $\frac{1}{80}$ ths pension and a $\frac{3}{80}$ ths lump sum).

Contributions

All Inland Revenue approved schemes must be financed, at least in part, by an employer contribution. For more than 98% of employees, their contribution is less than the employer contribution. 80% of scheme members pay less than 40% of the total contribution. On average, employers pay nearly 4 times as much as employees.

Pensions increases

No private sector scheme is known to guarantee that pensions will be increased in line with prices once they are in payment. Most schemes (covering 80% of scheme members) guarantee no increases at all, while the remainder guarantee small fixed annual increases, usually the lower of 3% or the rate of inflation.

In practice, however, a great many employers go beyond the strict contractual entitlement of the scheme, and give further increases, either out of surpluses in pension funds or by discretionary topping-up. In 1978 and 1979, about 30% of private sector pensioners received increases of two-thirds or more the inflation rate. A further 25% received increases of about half the inflation rate. The remaining 45% received either the strict contractual entitlement (no increase, or a small fixed increase), or had in the past received occasional increases, but on an irregular basis.

There are a significant number of large private sector concerns - generally speaking, those considered to follow the best employment practices - who have given very substantial protection in recent years. They represent about 5-10% of the private sector, and typically gave their pensioners 80-90% protection against inflation over the period 1975-80. None is however known to have given 100% protection, though (see paragraph 8(d) of the Report) the cost of inflation proofing a (Private) pension based on sixtieths is greater than doing so for a (Civil Service) pension based on eightieths.

Some insurance companies are now offering some guaranteed index-linked benefits, based on the recent issue of index linked stock. But as yet such schemes fall short of the type of basic benefit offered in the public sector.

PENSIONS (INCREASE) LEGISLATION BEFORE 1971

The first Pensions (Increase) Acts (in 1920, 1924, 1944 and 1947) were in response to inflation during and after the 1914-18 and 1939-45 wars. They were specifically aimed at relieving potential poverty, and were subject to conditions as to the pensioner's means, and responsibility for dependants.

2. By the early 1950s, however, inflation had continued and there began a series of Acts which spanned about 20 years until the introduction of systematic arrangements under the 1971 Act. The 1952 Act provided flat-rate increases, irrespective of means, ranging from £4 to £26 a year, depending on the date of the pensioner's retirement and whether he was married or otherwise responsible for dependants. For the first time, increases were given to all pensions, no matter what their size. The 1954 Act applied to certain Civil Service pensions not covered by the 1952 Act, and awarded a 10% increase. The 1956 Act represented a further step towards current practice in that all means testing and distinctions between married and unmarried pensioners were abolished. It provided increases of 10% of basic (unincreased) pension or £100 a year, whichever was the less.

3. The Acts of 1959, 1962, 1965 and 1969 all followed a standard pattern. They carried forward the improved features of the 1956 Act, and also provided for percentage increases, irrespective of the size of the pension, so that the practice of flat-rate increases fell into disuse. They were also based on current pensions, so that successive increases were compounded. All were biased in favour of those who had been on pension the longest. This was partly in response to representations from the Public Service Pensioners' Council, and the reasons included the lower levels of pay on which such pensioners retired; the less generous pension increases up to the early 1950s; the age of the recipients; and the lack of entitlement to national insurance pension. Briefly, the provisions of these Acts were as follows:

1959 Act 12% increase for pension beginning before 1 April 1952, descending in equal 2% steps to a 2% increase for pensions beginning by 1 April 1957.

1962 Act 12% increase for pensions beginning up to 1 April 1956, descending in equal 2% steps to a 2% increase for pensions beginning by 1 April 1961.

1965 Act 16% increase for pensions beginning up to 1 April 1957, descending in equal 2% steps to a 2% increase for pensions beginning by April 1964.

1969 Act 18% increase for pensions beginning up to 1 July 1955 descending by a mixture of 1% and 2% steps to a 2% increase for pensions beginning by 1 July 1967.

The cumulative effect of these Acts on the purchasing power of pensions was erratic:

Pension beginning	Pensions increase by 1 April 1969	Increase in prices to 1 April 1969	Purchasing power as % of original pension
1 April 1952	72%**	51%**	114%**
1 April 1956	58%	51%	105%
1 August 1959	29%	40%	92%
1 January 1963	14%	27%	90%
1 January 1966	4%	14%	91%

* Figures computed from 1 April 1956 onwards

Many anomalies were created by this legislation. It became clear that giving the biggest increases to the oldest pensioners was no longer equitable, and by the time of the 1969 Act there was general agreement that a system which compensated for increases in the cost of living - the general aim of previous legislation - should be introduced. Both major parties committed themselves to this course, which was regarded at the time as entirely uncontroversial. The 1971 Act, as well as introducing regular reviews of pensions in the light of changes in the cost of living, restored all pensions whose purchasing power had declined to their value at the time of award.

CONSERVATIVE STATEMENTS ON INDEX-LINKED PENSIONS AT THE TIME OF THE ELECTION

Our Manifesto made no mention of index-linked public service pensions. However, a guidance note on the subject was issued by Conservative Central Office to all candidates. This suggested the following line to take:

"We are not proposing to change the index-linking provisions for public sector pensions.

There is, however, a real problem about the way contributions are assessed in the public as compared with the private sector..... We would ensure that the independent Pay Research Unit Board is fully satisfied that the deduction which is made from public sector wage settlements for index-linked pensions is realistic".

In the course of the campaign, a good many letters were received from members of the public about index-linked pensions. The following is typical of the line taken in reply:

"The Conservative Party is not proposing to change the index-linking arrangements for existing public service pensions..... We should want to ensure that deductions from public sector pay cover the cost of index-linked pensions at a proper and realistic level."

The Chancellor of the Exchequer was asked by a caller on Robin Day's Election Call on 22 April 1979 whether the Conservatives intended to take index-linking away from public service pensioners. The Chancellor replied:

"No, there's no intention to do that.....But of course it is important also to make sure that the cost of those benefits which existing public service pensioners are going to enjoy is properly shared."

A full transcript of this exchange was subsequently published in the journal of the Civil Services Pensioners' Alliance.

In August 1978, a detailed letter on armed forces pensions was sent to the Officers' Pension Society on behalf of the Prime Minister. On index-linking, the letter said:

"I can assure you that the Conservative Government will continue with the present arrangements."

This letter was subsequently reproduced in the Society's journal.