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20 October 1982

Michael Scholar Esq.
Private Secretary
10 Downing Street
LONDON
SW1

Prime Minister

This looks
satisfactory to me.

Ms 21/10

Dear Michael,

DEBATE ON THE SCOTT REPORT

In my letter of 15 October, I promised to send you a copy of the draft of the opening speech which Mr Hayhoe will be making in Friday's debate on the Scott Report. This I now enclose.

You will see that the draft remains silent on a possible connection between action on contributions and the future of index linking, as the Prime Minister requested. However, it seems likely that questions on this point will be raised and we are considering how best to deal with them without giving any commitment one way or the other.

I am copying this letter as before.

Yours sincerely,
Margaret O'Hara

MISS M O'MARA
Private Secretary

PENSIONS - DEBATE ON 22 OCTOBER - OPENING SPEECH

I welcome this opportunity to discuss the whole question of indexed linked pensions in the public sector in the light of the valuable report by the Committee under the chairmanship of Sir Bernard Scott which was published last year.

2. Since we last debated this subject in February, the rate of inflation has continued to show a welcome fall. At that time the annual rate was 12 per cent. Last week it was announced that the September index had actually fallen for the first time in 12 years, and the annual rate of increase of the Retail Price Index is down to 7.3 per cent, the lowest for 10 years. We fully expect the rate to decline further over the next few months.

3. More stable money reduces the disparity in pensions which has caused such public concern in recent years. With pensions, as in so many fields, we see the tremendous benefits of getting inflation under control.

4. Members will have noticed the Written Answer which I gave on Tuesday which compared movements in the Retail Price Index, national average earnings, and gross domestic product since 1970. As can be seen from the table, only occasionally have public sector pensioners increased their income by a higher percentage than those in work. But of course it is also true that during the last decade public service pensioners with index linking have generally fared better than other occupational pensioners. The House will remember that index-linking was established by the Pensions (Increase) Act 1971. When the Bill was debated in May of that year, it was universally welcomed. The disparities that rapid inflation was to cause were not then foreseen. However, it is worth recalling that before 1971 public sector pensions had been updated on an ad hoc basis - often after much public campaigning by those concerned. By and large, over time these irregular increases kept pensions in line with movements in prices. The significance of the 1971 Act was that it provided a regular system of uprating in place of the ad hoc and somewhat unsatisfactory arrangements which had existed beforehand.

Sometimes when I listen to the present pensions debates it sounds as though some commentators believe that the choice is between index-linking and doing nothing. Of course this is wholly unrealistic. The actual choice is between index-linking and some other updating arrangements. Pensions are earned over periods of up to 40 years, and then can be in payment for many years of a person's retirement. Even with low inflation, therefore, some method of uprating is necessary and this is recognised in the private sector as well as in the public sector.

5. Members will also have seen the other long Written Answer which I gave on Tuesday which describes the main pension schemes in the public sector whose benefits are index-linked and gives a great deal of information about the numbers involved, the costs, and the methods of financing. It is estimated that there are nearly $2\frac{1}{2}$ million pensioners and $5\frac{1}{2}$ million members of pension schemes whose benefits are index-linked. That is roughly a quarter of the working population. As the table shows, the average civil service pension at the moment is £32.40, and the average in the public services sector taken as a whole is £36.20 a week. Increases in line with those for the State Retirement pension are due in November, which will bring the Civil Service average to £35.80. I suppose it is inevitable that press comment concentrates upon the increase going to Admirals, Judges, Permanent Secretaries and the like, but there are of course not many of these. Moreover, there is evidence that the public want to see the retirement incomes of members of the armed forces, policemen, doctors, nurses, teachers and others ^{so far as possible} protected against price increases, and to judge from my own postbag, much of the earlier uninformed and sometimes misleading criticism has abated as the facts have become more widely known.

6. So far I have been talking only of the public sector. The situation in the private sector is quite different and perhaps even more complicated. The Scott Report itself gives some interesting information about the great variety of schemes, and this can be supplemented by the surveys which have been published since,

notably by the National Association of Pension Funds. On the whole, although it is very difficult to generalise in this area, it seems clear that during recent years private sector schemes have made discretionary upratings to their benefits which are well below the rates of inflation. On the other hand, the effective rate of employee contribution is usually lower in the private occupational schemes. Nevertheless, I recognise the continuing public concern that private sector schemes are generally less good than those in the public sector.

7. At the moment there are almost no schemes available in the private sector which can offer formal index-linking. However the Chancellor of the Exchequer announced in the 1981 Budget that the Bank of England would be issuing indexed gilt-edged stock as part of our policy of diversified funding, and indexed gilts give fund managers an important new financial instrument. Initially, purchase of the stock was restricted to pension funds and certain other institutions, but in the 1982 Budget the Chancellor announced the removal of this restriction, and the Government has issued $\pounds 3\frac{1}{2}$ billion of indexed stock so far.

8. Indexed gilts are not intended to provide the basis for indexed pensions throughout the economy, although individual pension funds may wish to use them in devising indexed schemes. Rather, indexed gilts make it possible for pension funds, as well as for insurance companies and individual savers, to diversify their portfolios so as to reduce their vulnerability to the risks of inflation.

9. The existence of indexed gilts traded freely on the stock market also helps us to see the price which the market is prepared to pay for indexed assets, and this is useful in setting a value on indexed pension schemes in the public sector.

10. In this connection it is worth drawing attention to the work of the Government Actuary's Department. The response of the market

has tended to confirm his department's assessments of the value of inflation-proofing of occupational pensions, a conclusion earlier supported by the Scott Committee itself, and I am glad to have this opportunity to thank the Government Actuary and his department for the work they do.

11. Perhaps I should also refer to the long term prospects of all our pension arrangements both state and private. Pensions are, after all, a form of transfer of income between generations. And we must recognise the danger of imposing upon the working population, now or at some future date, through contributions and taxes, a commitment to provide more for the retired population than can be afforded. The Chancellor of the Exchequer drew attention to this point in an important speech to the National Association of Pension Funds in May of last year in Birmingham. The demographic arithmetic is there for all to see and without a renewal of growth in the economy it just will not be possible to protect the incomes of a growing retired population without affecting the incomes of those in work. Obviously this is not the central issue of our debate today but I thought it right to draw attention to this more general problem which should never be ignored when we look at pension matters.

12. I should like now to turn to the narrower question of pensions in the Civil Service for which the Government has a direct responsibility. Since our last Debate, we have had the report of the Committee under the Chairmanship of Sir John Megaw which inquired into Civil Service pay. The report was published in July. Although primarily about methods of determining pay, the Megaw Report devotes a chapter to non-pay benefits including especially pensions. The Scott Report remarked that the methods by which the pay of civil servants was adjusted, under pay research, were complex and obscured the reality of what civil servants contribute for their pension arrangements Scott suggested that it would be an advantage if in future the pension element of the pay comparison were better publicised. The Megaw Report goes further and recommends that:

"provided this can be introduced at no additional cost to public funds, the basis by which civil servants contribute to their pensions should be one whereby a direct contribution is made from the pay actually received to cover the whole of the employee's share of pension costs. Both the employee's and the employer's share should be publicly declared".

13. Much of the earlier misapprehension about "civil servants not paying for their pensions" has abated as a result of the Scott and Megaw reports. These made it very clear that civil servants have been making a sizeable effective contribution estimated by Scott at some 8 per cent. Nevertheless, misunderstandings are almost bound to continue. The Government is therefore attracted by the proposal to make the Civil Service pension scheme contributory. To do so would make it much easier to see the link with pay and to compare the position of civil servants with that of other groups. There would, of course, be no question of uncovenanted benefits or windfall gains going to civil servants as a result of a change to a contributory scheme.

14. I should particularly welcome the views of the House on this suggestion. The idea has been put forward and considered from time to time, and in the past the argument that the existing system is simpler and more efficient has carried the day. But I must confess that I have long seen attraction in a contributory scheme which would avoid the sort of misunderstanding and misrepresentation which has dogged the present arrangements.

15. Elsewhere in the public services, the armed forces and the police are now making a more appropriate contribution towards their pensions which are more favourable than those of most of other groups because of the relatively early retirement age which is required because of the physically demanding nature of their work. The armed forces and policemen now pay an 11 per cent pension contribution. And the pension contribution of firemen is under consideration.

16. Much of the public concern about public sector pensions is focussed upon the costs of index-linking and there is very understandable resentment at any additional burdens placed upon taxpayers as a result. Few would dissent from the proposition that public service pension schemes should be based upon fair contributions from those concerned and that in this context we include the cost of pensions increases not just of the basic pension. It is also well worth noting that action on contributions produces more money more speedily, than action to cut back the level of benefits. The sums involved are substantial. For example this year's 4 per cent increase in the contribution rates of the police will save the Exchequer some £47 million in a full year. Over the public services as a whole it is worth noting that a 1 per cent increase in pension contributions would amount to around £200m whereas a 1 per cent reduction in the amount of pension increase would amount to £30m.

17. Another important section of the Megaw Report relating to Civil Service pensions recommended that the advantages enjoyed by civil servants in terms of better pension rights on changing jobs should be taken into account in pay negotiations. Discussions between the Government and the CCSU are taking place and I do not wish to comment upon the merits or substance of this recommendation but it does illustrate one of the other main disparities between the public and private sector, namely their treatment of early leavers. It is comparatively easy for an employee to change his job within the public sector since the schemes are similar, and he can either take his pension rights with him or have them preserved until retirement age. In much of the private sector on the other hand, as the Occupational Pensions Board has shown, people who change jobs can be put at a severe disadvantage as far as their accrued pension rights are concerned and this can be a disincentive towards changing jobs at all. The Government believe that the managers of pension funds should review their current practice which is often both unfair and a constraint on mobility and therefore on economic performance.

18. In recent years many suggestions have been put forward for replacing the present system of index-linking - for example returning to a system of discretionary upratings, including an element of discretion to cut back the increase if the index goes up by more than a certain figure, reducing the increases for those with the biggest pensions, and so on. They all have advantages and disadvantages and I am sure many will be referred to during the course of today's debate. However the arguments ebb and flow and whatever the economic justification for one course or another, let no one underestimate the very severe legislative and institutional difficulties in making changes which apply to all index-linked schemes. All told, there are about 130 schemes and the legislative and contractual bases on which they are built differ considerably. In the case of the Civil Service, the pensions increases are provided directly by statute under the terms of the Pensions (Increase) Act 1971, to which I referred earlier, and the Social Security Act 1975. Some of the other schemes in the public sector at present use a notional fund, while others operate solely on a pay as you go basis. In the case of most nationalised industries, there are fully funded pension funds financed by employer and employee contributions which cover the costs of the benefits. It is an immensely complex subject. I do not propose to announce firm Government conclusions today. We are making progress in getting contributions right, and I am glad that the debate provides an opportunity for Hon Members to express their views on the complex and important issues involved.

Keen Pet, Fuglathin Proofed
Densuins, Pt 4

