

Ref.A083/2603

PRIME MINISTER

Public Sector Pensions

C(83) 30

BACKGROUND

This memorandum by the Chancellor of the Exchequer proposes increases in public service pension contributions as the solution to the problem of index-linking.

2. The Cabinet last discussed public sector pensions on 3 June 1982 on the basis of a paper (C(82) 14) by the then Chancellor of the Exchequer (CC(82) 31st Conclusions, Minute 4). In essence, the basic structure of public service pension schemes would be left largely unchanged. Most public servants would pay a basic contribution of 6 per cent of salary, plus a "special charge" related to the year-by-year cost of index-linking; this "special charge" was expected to be about $2\frac{1}{4}$ per cent, and would vary in line with the cost of index-linking. Public servants with an especially early retirement age (mainly policemen, firemen, and members of the Armed Forces) and therefore faster than normal accrual of pension benefits would pay a rather higher basic contribution, and a higher "special charge", to reflect in part the significantly higher cost of their benefits. Particularly in view of the difficulty of legislating in the 1982-83 Session, it was decided not to proceed further at the time.

3. The present Chancellor's proposals, in C(83) 30, though also involving an increase in employee contributions to around 8 per cent in normal accrual schemes, are significantly different. In particular:

- a. He proposes extensive changes in the financing arrangements of public service pension schemes "to bring out more clearly the total costs of the benefits provided and how they are split between employer and employee".



b. Employees' pension contributions would not be split into two tiers and would be assessed on classical actuarial lines rather than, in part, by reference to the year-by-year cost of pensions increase as previously proposed.

He proposes that officials should be instructed to prepare a detailed programme of action on this basis.

4. As the Chancellor of the Exchequer points out, it would be consistent with the proposals in C(83) 30 to make the Principal Civil Service Pension Scheme contributory; there is separate correspondence on this aspect. It can, however, be left for separate consideration in the light of the Cabinet's decisions on the general questions raised in C(83) 30.

5. The proposals apply only to the public services. The Chancellor says that it will be necessary to consider 'how to make the nationalised industries follow the public services' lead', but gives no further details.

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6. A brief description of the financing of the main public service pension schemes is attached at Annex A.

MAIN ISSUES

7. The main issues before the Cabinet are as follows:

(i) Should the aim be to levy employee pension contributions, in the generality of public service schemes with normal rates of accrual of benefit, at a significantly higher rate than now?

(ii) If so, is the approach underlying C(83) 30 is the best one?

Higher contributions

8. To ask public servants for higher pension contributions is fully in accordance with the general tenor of discussions in Cabinet before the General Election, and has ample warrant in the Election Manifesto. But it is possible that some Ministers may have reservations.

(a) Allowing for differences in the timing and bases of the figures in Appendix I to the note by officials attached to C(83) 30, the present pattern of contributions seems fairly consistent. The majority of services are paying, in formal contributions, about 30 per cent of the cost of their pensions. The exceptions are other ranks in the Armed Forces, and MPs (both rather special cases), and the Civil Service. I understand that, on average, employees in the private sector pay contributions of some 4.3 per cent out of a total cost of some 15.3 per cent - around 28 per cent of the total cost. These figures do not provide a convincing justification for a substantial increase in employee contributions. In particular, staff interests can be expected to argue that the increases in contributions by the Armed Forces, police and firemen have brought them into line with the general pattern and do not constitute a reason for increases in contributions paid by other public servants.

(b) In those cases where the Government is seeking an increased employee contribution to bring it to a realistic level (ie from 6 per cent to 8 per cent in many cases). The objective will be to secure savings for the taxpayer. But these groups will no doubt press for their pay to be increased to offset the increased contribution, arguing that their existing pay must be assumed to take account of their pensions, benefits and contributions. To the extent that these claims are not resisted the savings will be lost.

Method

9. On the method to be adopted for securing increased contributions, the Cabinet may wish to consider whether the Chancellor's new proposals are preferable to those discussed by the Cabinet last year. They avoid the concept of a new "special charge" for index linking. They involve however recasting the finances of most public service schemes which may require lengthy negotiations with the staff and employers affected; and complicated legislation.



Nationalised Industries

10. In previous discussions, the Cabinet has shown a preference for extending decisions in this field to the nationalised industries; but, given the lack of Ministerial control over the terms of nationalised industry pension schemes, it has proved impossible to devise any reliable way of doing this. It may be that the language of paragraph 6 of C(83) 30 will prove too sanguine, and that exhortation is the most that will be feasible.

Further work

11. If the Cabinet broadly approves the proposals in C(83) 30, further work by officials will be needed, as the Chancellor says. I suggest that this work should be overseen by the Ministerial Sub-Committee on Public Sector Pay (E(PSP)), reporting its conclusions to you as appropriate. This work could include the position of the nationalised industries.

Announcements

12. The Chancellor suggests that the Government's intention to proceed in the way he proposes should be announced to Parliament when it returns. Given the desirability of maintaining a coherent line across the public services, there is much to be said for a single announcement. But unless an announcement is full, it is likely to generate a good deal of disquiet among staff. It would probably be appropriate to ask officials, as an early part of their work, to advise on its form and content.

HANDLING

13. You will wish to ask the Chancellor of the Exchequer to introduce his memorandum. The Foreign and Commonwealth Secretary, the Home Secretary and the Secretaries of State for Education and Science, Northern Ireland, Defence, Scotland, Environment and Social Services will have views on the implications for the services for which they are responsible. The Secretary of State for Employment can advise on the likely implications for pay negotiations. Ministers with sponsoring responsibilities for the nationalised industries may wish to comment on the prospects for making the industries follow the lead of the public services.



CONCLUSIONS

14 You will wish the Cabinet to reach conclusions on the proposals in C(83) 30, ie:

- i. whether the financing arrangements of public service schemes should be reformed to bring out more clearly their costs and the split between employer and employee;
- ii. whether all public service schemes should be reviewed, in association with the Treasury, to settle and introduce appropriate realistic contribution rates;
- iii. whether 8 per cent should be the realistic contribution rate for normal accrual schemes;
- ii. whether officials should be asked to prepare a detailed programme of action;
- v. whether there should be a public announcement when Parliament returns.

RTA

ROBERT ARMSTRONG

14 September 1983

Financing of Public Service Pension Schemes

There are three main methods of financing public service pension schemes.

'Pay as you go' (PAYG)

2. The Civil Service, Armed Forces, Police and Fire schemes are all financed by this method. The employer receives all employee contributions and other forms of income (for example, transfer values from other schemes) and takes them into his general finances; he defrays all benefits and other outgoings, including pensions increase, as they arise, from his general finances. There is no employer's contribution, as that phrase is usually understood in the private sector: the employer simply meets the difference between income and outgoings.

Notional funds

3. The teachers' and National Health Service pension schemes are notionally funded. Contributions from employers and employees (assessed on actuarial principles) and other forms of income are deemed to be invested in a fund, against which basic benefits and most other outgoings are deemed to be charged. But the fund does not exist: it is essentially an accounting device, which was originally intended to serve as a check on the adequacy of employers' and employees' contributions and the equity of the division between them. The actual financial transactions are essentially on a PAYG basis.

4. Pensions increase is not charged to the notional funds: it is paid by the Exchequer. Thus the taxpayer pays the full cost of pensions increase for teachers, whether they are employed by local education authorities or by the private sector. If employees' pension contributions were adjusted to take explicit account of pensions increase, it would be logical to integrate the financing of basic benefits and pensions increase. The employers would no doubt insist that any resulting changes should not shift any part of the cost of pensions increase from the Exchequer to them. Arrangements to achieve such a result might well be complicated.

Real funds

5. The schemes for local authority white collar and manual workers are genuinely funded: local authorities or groups of local authorities maintain real funds, like most private sector employers, into which employers' and employees' contributions are paid. The contribution income and the return on the funds' investments are used to pay basic benefits and most other outgoings.

6. Again, pensions increase is not charged to the fund: it is financed by PAYG charges by employers on the rates. If employees' contributions were adjusted to take explicit account of pensions increase, it would be logical to integrate the financing of basic benefits and pensions increase. This would appear to require substantial recasting of the existing system.