

Copies to - Mr Wilson
Mr Walters
Mr Hoskyns
Mr Verker.

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Prime Minister.



Content with the Chancellor's paper and in
particular with paragraphs 12 + 13?
If so, agree that he may consider it, if
possible in conjunction with Lord Soames, in time
for Cabinet on 15 January?
Ready to write to Sir Bernard Scott on the
lines of X/ below. If so, we will let you have a
letter.

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

AMH

6.1.81.

PRIME MINISTER

*Delighted to
share them warmly.
But not to comment
on the report itself
no*

SCOTT INQUIRY INTO VALUE OF PENSIONS

Your Private Secretary's letter of 22 December suggested that I should prepare a paper on this for E Committee or Cabinet. You may feel on reflection that it will be best to go straight to Cabinet. I understand from the Secretariat that 15 January has been noted as a possible date. I would like to give colleagues a full week to study the paper and the Report of the Inquiry.

.....

2. I enclose a draft and am copying it with this letter to the Home Secretary, Lord President of the Council and Secretary of State for Employment, who are the only other Ministers who have so far had copies of the Report. I think it would be very helpful, providing our ideas coincide sufficiently, if the paper could be presented jointly by myself and the Lord President. I look forward to hearing whether he thinks this would be possible, and to receiving any comments you and others may like to offer at this stage.

X

3. It would in my view be appropriate for you warmly to thank Sir Bernard Scott and his colleagues for the expedition and care with which they have fulfilled a very difficult remit. Granted the technical and other difficulties of the subject, they have produced a well-balanced and sensible report.

G.H.

(G.H.)

5 January 1981

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DRAFT CABINET PAPER

INFLATION-PROOFED PENSIONS

Memorandum by the Chancellor of the Exchequer

.... Attached is a confidential copy of the Report of the Scott Inquiry into the value of pensions. It should be published as soon as convenient, which might be during the last few days of January. The appropriate form would be a Command Paper. For reasons given below, I think the Government should not offer definitive comment at the time of publication, but should give an indication of its general reactions and intentions.

Main Conclusions of the Report

2. The Report deplores the inequality in pensions treatment between the public sector and the private sector, but it does not condemn the inflation-proofing of public sector pensions. On the contrary, it asserts that the protection of retirement living standards is "a highly desirable social objective", although an expensive one, needing to be paid for, and perhaps even then temporarily unsustainable in occasional circumstances of extreme inflation or other economic difficulty. In my judgement the Report gives too little emphasis to these very real difficulties.

3. The Report notes that present disparities would be much eased if inflation were overcome. Meanwhile it points towards action in the following directions:-

(a) Strengthening of private sector occupational pension schemes: it is clearly implied that both employee and employer contributions to private schemes need to be increased, and it is noted that "employee contributions" by civil servants, although not levied in that form, are currently at twice the general level of such contributions by private sector employees.

(b) Government issue of index-linked bonds: these would provide an encouraging instrument for investment by private pension funds and by private employees who are not members of pension funds; they could also help to establish means of valuing inflation protection. (The Report refers to discussion of such bonds in the Wilson Committee Report and does not itself go beyond recommending Government consideration of the idea.)

(c) Reappraisal of public sector "employee contributions": taking the Civil Service as leading example (although repeatedly insisting on the application of the principle throughout the public sector), the Report is unable to place a precise value on inflation-proofing, notes that such a value could in any case change from time to time, and offers a range of valuations.

(d) The Report endorses in their context the methods of valuation used by the Government Actuary, subject

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to the different approach to "economic assumptions" embodies in the Committee's own range of valuations. It refutes some of the extreme criticisms and valuations which have been suggested. For the Civil Service, the Committee's own range would point to something between no increase and a 5-6 per cent increase in "employee contributions". There is material in the Report which could in present circumstances point to the top end of the range.

In addition there are some minor recommendations on particular aspects of the arrangements for determining and showing Civil Service equivalents of employee contributions. The Report offers no help on the separate subject of the value of job security.

Public Reaction

4. The Report is awaited with lively interest. It will be a disappointment to those hoping for a simple and clear-cut solution. Those who oppose any form of index-linking of pensions will be especially disappointed, but I would expect widespread support for the proposition that retirement living standards should be protected, and the Report's reminder that better provision is made for this in France and West Germany may attract interest. On the other hand I am myself anxious that the Report does insufficient to warn about the long-term costs and consequences of any system for index-linking of pay

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and pensions, for example the general dangers of allowing automatic, built-in indexation because of its effect on attitudes to inflation and on expectations.

5. Among those with particular responsibility and involvement:-

(a) Private sector pension fund operators and employers may not only be disappointed at the Report's acceptance of inflation-proofing, but seriously troubled by the clear suggestion that present inequalities should in part be redressed by improvements in private sector arrangements. On the other hand they may strongly welcome (and therefore urge on Government) the idea of Government issues of index-linked bonds. Some may also find helpful the reference to need for stronger contribution levels, including employee contributions.

(b) Public sector unions and employees may well show mixed reactions: relief that the basic entitlement is not challenged; worry over the high end of the suggested range of contributions; and determination to fight for as low an increase in contributions as possible. They are likely to point to the fact that the Report itself found that Civil Servants are already contributing twice as much as most private sector employees. (This is partly because private sector employee contributions are unrealistically low, and partly because of the greater benefits in the public sector schemes).

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Government Position

6. In the light of the Report, the central question for the Government is whether or not to allow inflation-proofing of public sector pensions to continue. This depends, I believe, on whether we can develop the ideas in the Report sufficiently to reduce the present inequalities of treatment and the sense of injustice arising from them, which are at the heart of public interest and disquiet. We need to consider the practical steps this would involve and their implications.

7. First, there would have to be increases - in some cases substantial - in "employee contributions" pretty well throughout the public sector. Unless we were able to negotiate or impose adjustments towards the top of the range suggested in the Report, I would see no hope of satisfying responsible public opinion. Because of the variety and complexity among different public sector employees in starting-points, methods of determining pay, etc., the process would take some time and need careful preparation and calculation in advance. Nonetheless I consider it important that we should seek to make adjustments as soon as practicably possible, preferably in the current pay round for groups which have not yet settled. In any case, the prospect might be used to support modest pay settlements this year. It should certainly be possible to bring in most groups at the point of their 1981-82 pay settlements.

8. I cannot at present assess the financial impact, but I see no reason why it should be harmful and it would be more likely to be helpful. An adjustment of 1 per cent over public sector employees as a whole would involve an abatement of pay or extra income from contributions in the order of £500 million per year. Some would have to be funded. There would be other, though smaller, offsets if - as might well happen - the assumptions behind the adjustment also necessitated a strengthening of existing public sector pension funds. The amounts prospectively payable as pensions would, of course, not be affected by these changes.

9. Secondly, there is the question of index-linked bonds. This is an idea we have been examining, but have not so far accepted, in the context of Government financing generally. To embark on it on a large scale - and the scale implicit in the recommendations of the Report could be very large indeed - would involve changes in the patterns of financial flows and markets in our economy with advantages and disadvantages, now and in the future, which are difficult to evaluate. This is not a matter which can be settled simply as a supplementary move on pensions, important though it may be in that context. If we were to adopt the idea, there would be much to work out on methods and conditions, and some consultation with the pensions fund industry and others could be desirable. My present view is that we need not rule out adoption of the idea in some form, but we should say that it needs more study before

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we give it any warmer reception. It may be of interest to see how much considered support of the idea the Report provokes, and from what quarters.

10. Finally, there is the key question of public political reaction and what the Government can do about it. We cannot expect any solution to reconcile or persuade the extreme schools of thought on this contentious subject. Our best hope is to lower the temperature of the debate and persuade a sufficient body of responsible opinion that the direction we choose is a tolerable one. The Report offers some help in improving public understanding, which is badly needed. Both Government and Parliament may be able to further this.

Recommended Line

11. I think it would be a mistake to reject the Report outright and go for a withdrawal of the various guarantees and near-guarantees of inflation-proofing of public sector pensions (not just for civil servants, but for others such as the armed forces, the miners, the nurses). The Report gives ground for introducing a cut-off point, a rather high one, if we wish. This could be presentationally helpful but does not solve the main problems. If the principle of inflation-proofing is to be retained the Report probably offers as strong a case for persuading public opinion in its favour as can be made. But acceptance of that case could well be conditional

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as a minimum on our determination and ability to achieve and demonstrate significant changes in public sector "employee contributions".

12. In outline I propose that our initial comments on the Report would take the following form:

- welcome the careful and measured analysis and judgement in the Report;
- acknowledge the theoretical desirability of protection of retirement living standards for all, underlining the cost, uncertainty and difficulty;
- endorse the sense of injustice over inequalities of treatment between public and private sectors;
- reassert determination to get inflation down and keep it down, stressing this as the most important contribution Government can make;
- indicate positive interest in the approach recommended, but without complete commitment, noting that much would depend on practicability, on reaction of private pensions industry and on general public reaction;
- invite public comment; possibly suggest study by a Committee of Parliament (?Treasury and Civil Service Committee);
- indicate that, in relation to public sector arrangements if inflation-proofing continues, the Government would judge that present circumstances justified changes in "contributions" at the top of the range suggested in the Report.

Meanwhile, it would be appropriate to set in hand urgently studies within Government of the handling of increased

"contributions" and the idea of index-linked bonds.

Conclusion

13. I invite my colleagues to agree:

(a) That authority be given for the Report to be printed as a Command Paper with the aim of presentation to Parliament towards the end of January.

(b) That the initial line to be taken by Government, and reflected in a statement in Parliament at the time of publication, should be as set out in paragraph 12 above.

(c) That arrangements be made for studies within Government of the practical process of adjusting "contributions" and of the idea of index-linked bonds.