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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

INFLATION-PROOFED OCCUPATIONAL PENSIONS

Note by the Chancellor of the Exchequer

At Cabinet on 15 January I was asked, in conjunction with the Secretary of State for Employment and the Minister of State for the Civil Service Department, to spell out in more detail the proposal in my minute of 10 January to the Prime Minister and the considerations underlying it.

2. I think we are all troubled by the inequity of inflation-proofing of occupational pensions being almost entirely confined to the public sector, but almost universal within the public sector. During the last few years of severe inflation, the value of inflation-proofing has been enormously enhanced, and there is deep public resentment over it. In terms of current employees, there are some 5½ million public sector employees enjoying the prospect of inflation-proofed pensions (of whom 3½ million qualify under the general legislation for official pensions, including civil servants, local government officers, Armed Forces, teachers, nurses and many others); these compare with some 6 - 7 million employees in private pension schemes, most of whose current pensioners have seen the value of their pensions significantly eroded, and many others who are outside pension schemes and rely on income from their own savings and annuities whose value has suffered even more.

3. The present arrangements are both inequitable and costly, and I believe that we must make some change. The most effective way of tackling the inequity would be to abandon inflation-proofing of

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public sector pensions and substitute some treatment of those pensions analogous to the treatment offered by private sector pension schemes. But there are two major problems in the way of this solution:-

(a) The Government has a degree of commitment to maintaining inflation-proofed pensions. There is a strong and explicit commitment, recently confirmed, in respect of the State pension scheme, but the commitment was given also, before the Election, in respect of official occupational pensions.

(b) The task of replacing the present arrangements by some new system would be bound to take a good deal of time: legislation would be needed, and it would be necessary to work out and specify the principles (if not the precise details) of future provision to cover official pensions, and seek parallel action, where it lay within the capacity of Government, to affect public sector inflation-proofed pensions outside the category of official pensions (including difficult cases, such as miners).

4. I do not reject the possibility of action of this kind at some future stage. It might for example be possible to take an initial step quickly by introducing a temporary, say 2-year, suspension of existing legislative provisions and the substitution of some appropriate temporary alternative, pending the working out of a fresh long-term system. This would however itself require amending legislation and would involve the same problems of consistent application as 3(b) above.

5. It seems to me, however, that it is worth trying, in the interests of speedy effect, an alternative approach which does not need legislation and does not run counter to any political commitment: an attempt to impose on the prospective beneficiaries of inflation-proofed pensions a charge which would be publicly regarded as more adequate than the present untidy mix of contributions and salary abatements.

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6. The present arrangements for employee contributions in the public sector towards inflation-proofed pensions are very varied in form and in amount - far beyond what could be justified by the relatively minor differences in the benefit arrangements. There are different levels of formal contributions as explicit deductions of a proportion of gross salary; and there are various abatements of salary in lieu of contributions, both explicit and implicit. Different groups of employees are governed by different legislative or negotiated conditions. The system cries out for a substantial overhaul, but this would be worth undertaking only if the overhaul could be made to embody satisfactory acknowledgment of the value of inflation-proofing.

7. The non-industrial Civil Service provides a good test case, not because it is a particularly favoured group, but because, on the contrary, some attempt has been made in relation to this group to evaluate the cost of inflation-proofing and charge for it in the form of abatement of salary. In relation to some public sector employees contributions and salary abatements do not go even this far (although it is interesting that the Clegg Commission has been extending the practice). But even in relation to the Civil Service, there has been widespread criticism that the present charge is inadequate. Two of the main grounds would be of general application, and it is on these that I concentrate:-

(a) In his evaluation of the cost of inflation-proofing for the Civil Service, the Government Actuary is obliged to make assumptions about the long-term future development of prices, earnings and return on investments. Critical to his arithmetic is the assumption about the long-term future real rate of return on investment. The figure he chooses for this has been widely criticised: it would have been valid - even modest - in relation to some past periods, but is considerably higher than the experience of the recent years of severe inflation. An alternative and lower assumption could have a significant though not dramatic effect on the proposal for salary abatement resulting from his overall calculations.

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(b) Even if the cost of inflation-proofing were in some sense correctly established, this would still fall short of the value of inflation-proofing to recipients, because the degree of security embodied in guaranteed inflation-proofing is felt by the individual to be of greater value than some statistical average which may in the event give a welcome bonus but carries the much more important risk of shortfall. However, an actuarial assessment cannot allow for what is essentially a subjective value of security. But it is this sense of security which inflation-proofing confers, and which is the envy - in recent years of severe inflation - of those who do not enjoy it.

8. My proposal is that we should attempt to obtain values for the two important elements of inflation-proofing which I have just described, and apply them as widely as possible in the public sector. Potentially, a considerable amount of public expenditure is at stake. An abatement of salary of 1 per cent, applied to the non-industrial Civil Service alone, would amount to some £30 million per year, and full extension through the public sector would multiply this by 10.

9. The non-industrial Civil Service is a convenient starting-point. The unions and the Government are bound, by the terms of the Pay Agreement, to accept the Government Actuary's calculation of the abatement of salary appropriate to compensate for differences between the pensions benefits of the Civil Service and those of outside employees with whom the Civil Service is compared in the pay research process. Thus, if the Government Actuary thought it right to accept any alternative assumption for his calculations, the results would apply automatically. A judgment on an appropriate adjustment for the second factor in paragraph 7 above - the security of full inflation-proofing - would be more difficult to enforce. It would have to be argued, among other factors, with the unions in the final stages of negotiation, and it would be subject to all the risks of Arbitration. These must be serious in the absence of any absolute guarantee of future inflation-proofing, which we clearly could not give. On the other hand the chances of sustaining an adjustment of salary on these grounds would of course

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be greatly increased if there had been a clear Government statement to the effect that all public sector negotiations would be expected to take a similar adjustment into account, and the adjustment itself derived from an impressive and publicly acceptable authority.

10. As I indicated in my minute to the Prime Minister of 10 January, the position of the Government Actuary in relation to the Civil Service system, and the negotiating realities, mean that we could not secure adjustments of the kind I am suggesting simply by unilateral assertion. We need an authoritative outside judgment. To obtain such a judgment we would need to seek a well-balanced group of people of general experience, rather than specific technical expertise. We should avoid a large group in the interests of speed. Three or at most four should suffice. A possible balanced trio might be:-

Alex Jarratt (Chairman of Reed International), and
R.E. Holland (Chief General Manager of Pearl Assurance), and
David Lea (Assistant General Secretary of the TUC) or
Leif Mills (National Union of Bank Employees and has been an able member of the Pay Research Unit Board).

11. If colleagues ^{agree} with the proposal, I hope that it will be possible to establish a group of this kind and to obtain its report quickly. The task is not one which should require extensive collection and study of data or taking of evidence. What is required in essence is a judgment based on experience. But the group might well be under pressure to listen to some evidence from public sector union representatives, and it might be prudent for them to do so, if only in order to avoid subsequent accusations of having refused even to listen.

12. It would be ideal if the results from the group were available in time to be taken properly into account in the 1980 pay negotiations for the non-industrial Civil Service, and extended to other negotiations and awards taking place around the same time. It will clearly now be very difficult to achieve this time-table, and is perhaps already too late. Nevertheless, the earlier the results are available, the sooner they can begin to be applied to subsequent negotiations.

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13. This note has hitherto concentrated only on inflation-proofed pensions. A closely parallel question arises over job security, which we have previously discussed in relation to the work of the Clegg Commission. It seems to me that it would be appropriate, if a group of people were established to pronounce on inflation-proofed pensions, to ask the same group to pronounce at a later stage on the value - again a matter of subjective judgment - of job security.

14. I attach draft terms of reference.

15. The Secretary of State for Employment and the Minister of State for the Civil Service Department are both in broad agreement with my proposal and with the draft terms of reference.

(G.H.)

H.M. Treasury
22 January 1980

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DRAFT TERMS OF REFERENCE

Having regard to the need to ensure that full account is taken in all areas of the public sector, whether by contributions or salary abatement, of differences in the degree of inflation-proofing of occupational pensions, and of relative job security, compared with the private sector:

- a. to review the assumptions and methods used by the Government Actuary in his assessment of the value of differences in inflation-proofing;
- b. to consider the relative degree of security in the full inflation-proofing enjoyed by public sector employees compared with those in the private sector, and the additional value to be placed upon it; and to recommend the appropriate adjustment to be made, by way of contributions or salary abatement; and
- c. to consider how to assess the relative job security enjoyed by employees in the private and public sectors and suggest how this should be quantified in pay negotiations.

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