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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

INFLATION-PROOFED OCCUPATIONAL PENSIONS

Note by the Chancellor of the Exchequer

E Committee on 23 January invited me to arrange consideration of wider implications of the proposal I had put forward in my note E(80)4. I have done this and attach at Annex 2 a paper by officials (Treasury in consultation with the CPRS, Civil Service Department and Government Actuary). I believe, however, that colleagues will find it helpful to consider options more widely. I also attach, therefore, at Annex 1, a specific proposal I have developed for the more fundamental approach of breaking - for a limited period and to a limited extent - the index link as it applies to "official pensions" under present legislation.

2. My deep concern over present arrangements arises from two considerations: of equity and of cost. To the extent that inflation-proofed pensions are more generous than typical private sector provisions for retirement there is a gross cost, and one which will rise rapidly in future years as the numbers of surviving pensioners increase; if the related contributions or deductions from salary of employees are inadequate, then there is also a net cost, which means that the private sector population is effectively subsidising public sector pensioners. Seen from outside, the division between privileged public sector pensioners enjoying full protection of the value of their pensions and those in the private sector who on average certainly fall well below this level of protection is a target of bitter criticism and resentment. In a period of severe inflation the difference appears, and I believe is, inequitable. This inequity becomes increasingly difficult to defend at a time when we shall be ceasing the automatic indexation of other benefits.

3. Not least for this reason, my preference in tackling this problem is to break the index link where we can. I recognise all the difficulties, which are reviewed in paragraphs 4 - 5 of my paper attached at Annex 1. With those difficulties in mind, I have developed a deliberately limited proposal, to break the index link for a temporary period (2 years, during which we could try to work out a more satisfactory long-term arrangement), to a limited extent (abating the index increase by only 5 percentage points) and at least in the first year of limited application (to the element of pension above £1,000 a year, to which in the nature of things the bulk of public criticism is directed).

4. I invite colleagues to consider whether we could not carry a limited proposal of this kind in the face of the many difficulties which would inevitably arise, and particularly at the present time when the working population at large will, under the pressure of our policies to reduce inflation, be expected to suffer a reduction in the real value of earnings.

5. I am advised that it is unlikely that the Government Actuary would, on the basis of a limited proposal of this kind, see any necessity to recalculate the assessment he makes and which is used as the basis for deduction of salary for the non-industrial Civil Service (and more recently some others).

6. The adoption of this limited proposal would not overturn the important arguments for re-assessing contributions or deductions from salary. I recognise, however, that it could be tactically wrong to seek the two changes simultaneously. Indeed, it could well be preferable as a basis for getting a sensible re-assessment of contributions to defer it until after the change in benefits had been introduced and when it would be possible to take stock calmly of the new pattern.

7. On the other hand, if my proposal to break the index link is not adopted, I would urge again the desirability of seeking an

early re-assessment of the relative value of inflation-proofing on the lines proposed in my previous note E(80)4, whose validity does not seem to me to be upset by the fresh consideration of implications in the note by officials at Annex 2 to this paper.

Conclusions

8. 1. I invite the Committee to agree to the proposals in paragraph 10 of my paper at Annex 1.

2. If (1) is not acceptable, I invite the Committee to agree as an alternative to the proposal to seek an authoritative outside valuation as a basis for revising contributions and deductions from salary, on the lines proposed in my paper E(80)4.

H.M.Treasury
18 February 1980

ANNEX 1

BREAKING THE INDEX LINK

My covering note sets out the case for taking some action in this area, and the relationship between on the one hand breaking the index link for public service pensions, and on the other reviewing the deduction from salaries. This paper accordingly examines in more detail the case for breaking the link, and how this might be done.

Present Position

2. Under the Social Security Pensions Act 1975 price protection of public service pensions is linked to, and dictated by, the price protection provisions for the earnings-related additional component of the new pension scheme (which will not be affected by the present proposals on short-term benefits). Thus, public service pensions are now increased each year in November on the basis of the price forecast used to determine the uprating of the retirement pension. The November 1979 increase was 16 per cent* and, on the basis of present Public Expenditure Survey assumptions, the November 1980 uprating would be 14 per cent. The current annual cost of public service pensions is about £2.3 billion, of which just under £300 million is the cost of the 1979 uprating.

Statutory Amendment

3. If we were so to decide, a measure taking power to uprate the pensions of the 1.4 million former public service employees and dependants by less than full price indexation would be technically feasible. The necessary legislation to amend the 1971 and 1975 Pensions Acts could be included in the next Social Security Bill, and announced with the social security package when the Public Expenditure White Paper is published in mid-March. This would allow us to break the link for public service pensions in the next uprating from November.

Merits

4. I recognise that there are considerable difficulties and even dangers in what we are proposing. For instance there is the question of the pledges we gave generally in this matter before the Election. There is the problem of potential anomalies, in that while we can get at public service pensioners (as listed in the annex)

*For an 11 month period, equivalent to 17½ per cent for a full year.

by this means, to get at the public sector including all the nationalised industries and other fringe bodies would require separate and complicated legislation; hence a sense of unfairness might be generated by the arbitrary way in which some people would be affected and not others depending on their employer. There will certainly be problems associated with schemes which are, or are deemed to be, contributory where people may claim they have "paid for" a right to index-linking which they must be allowed to retain. And more generally, of course, there is the question whether by breaking index-linking we shall be deemed to be affecting conditions of service of current employees, running into union opposition and a risk of industrial action.

5. We shall need to consider these difficulties. On pledges, I think that the present economic situation is such that a measure of de-indexing - possibly temporary - would be seen as justifiable; in fact there will never be a better time to grasp this nettle. On anomalies, it would be possible to distinguish between the public services as such and the wider public sector, though there would inevitably be some untidiness at the margin (e.g. the water industry, governed by the local authority rules). I am not convinced that the contributory argument would be a strong one, given that most of the contributions date from before 1971, and that we are in any case in some doubt as to whether the contributions are adequate. And overall the effect of our action would be lessened if, as I propose, we do not apply it to all public service pensions, but only to part of the pensions above a given figure. This would leave the majority of pensioners unaffected.

6. Against these difficulties we should be seen to have taken action in an area of public concern, and at a time of economic difficulty to have spread the burden of misery. We should, too, make a useful addition to our public expenditure savings.

<u>Detailed Proposals</u>

7. If my colleagues agree that we should seek an amendment in the next Social Security Bill, I propose that, like the amendment on short-term benefits, it should provide for less than full price protection by Order requiring an affirmative resolution. It should also allow for a different degree of de-indexation for different levels of pension.

I suggest that we should limit this statutory power by laying down a maximum degree of de-indexation (5 percentage points), and making it expire after two years. During these two years we should arrange to look at the whole question of public sector pensions and decide on a permanent scheme. Public service pensions, for existing pensioners, would of course remain at whatever lower real value was reached at the end of the two years, unless and until a Government found it possible to raise their value again.

8. Nationalised industries present a special problem. Unless we delay for separate and wider legislation (which would mean intervening in the internal affairs of each industry to overturn negotiated agreements), the amendment I propose would initially have the patchy effect on nationalised industries shown in the annex - for example the Post Office and British Rail would be affected, the National Coal Board not. But those affected could decide to alter the rules of their schemes, to break the link with public service pensions. Then whether they could continue to pay fully indexed pensions would depend on whether they could afford it. In a few schemes (e.g. British Rail, National Freight Corporation) the Government is providing financial support to cover some of the cost of indexation. We shall need to decide, before making any announcement on the public services side, whether the Government will continue to support full indexation of these schemes, or whether the changes proposed for the public services should also be carried through to these schemes by the withholding of financial support. In the short-term we shall need to make sure that the amendment would allow us to exclude all the nationalised industries; but this is another reason to examine the problem as a whole over the next two years.

9. We should be pressed to say what use we proposed to make of this power, as soon as the amendment was introduced. I think we should have to reach decisions and announce these straight away for November 1980 (later years would depend on economic and other circumstances at the time). For November 1980 I would suggest we aim for coverage of as many classes of public service pensioners as we could reach through the Statute or by our own action, though not, as explained, the nationalised industries. On the question of a threshold, I suggest that the first £1,000 a year of the pension should remain fully price protected, but that amounts above £1,000 a year should be uprated by

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5 percentage points less than that required to give full price protection. This would mean that pensioners over State retirement age would have full indexation of their retirement pensions and up to £1,000 a year of their public service pensions, but those below State retirement age - mainly men between 60 and 65 - would have full indexation on up to £1,000 of income only. £1,000 is clearly something of an arbitrary figure, and we could choose a different level if we wanted. But it would catch an estimated one-third of public service pensioners (to put this another way, the two-thirds on lower pensions would be unaffected) and it would yield a useful amount (upwards of £50 million) as public expenditure savings. A higher threshold than £1,000 per year would be possible, but we should catch increasingly fewer pensioners, and of course the public expenditure savings would be less.

Conclusion

10. I therefore propose:

(a) That we should include an amendment in the next Social Security Bill so as to take a general power to de-index public service pensions (with the 1975 Act coverage) subject to the limitations in paragraph 7 above, but leaving out the nationalised industries; and announce this along with the other social security measures.

(b) That we should use the 2-year duration of this amendment to carry out a thorough examination of the whole question of public sector pensions.

(c) That de-indexation in November 1980 of public service pensions (including Armed Forces) should be at the rate of 5 percentage points in respect of that part of each pension above £1,000 a year, the first £1,000 remaining fully price protected.

ANNEX

BASIS OF PENSION INCREASE FOR MAIN PUBLIC SECTOR SCHEMES

ORGANISATION (Numbers of Pensions)	BASIS OF PENSION INCREASE ARRANGEMENTS
PUBLIC SERVICES	
Civil Service (371,000)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Local Government (323,000)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Armed Forces (266,000)	By Royal Warrant or Order in Council. Would not be directly affected by Statutory change.
National Health Service (189,000)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Teachers (175,000)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Police and Fire (99,000)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Judges (n/a)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
Members of Parliament and Ministers (n/a)	Schedule 2 of 1971 Act. Would be affected by Statutory change.
NATIONALISED INDUSTRIES etc.	
British Gas Corporation (n/a)	The Scheme Rules do not require pensions increase. But pensions have in practice been reviewed annually and increased in line with official pensions. Would not be affected by Statutory change.
Electricity Council (n/a)	As above.
Post Office (177,000)	The Scheme Rules allow staff an option on retirement to have PI awarded as if they were subject to the 1971 Act. (The alternative is a higher initial pension without a guarantee of inflation-proofing.) Most staff have taken the former option. Would be affected by Statutory change.
National Coal Board (254,000)	There is an obligation under Scheme Rules to inflation-proof pensions (subject to the agreement of the Actuary) but not on the basis of the 1971 Act. Would not be affected by Statutory change.
Atomic Energy Authority (10,000)	The Scheme Rules state that pensions shall be treated for PI as if they were official pensions. Would be affected by Statutory change.
British Steel Corporation (78,000)	There is an obligation under Scheme Rules to inflation-proof pensions but not on the basis of the 1971 Act. Would not be affected by a Statutory change.
British Rail (120,000)	Scheme Rules make increases under the 1971 Act obligatory for salaried staff retiring after 1 September 1976. The same PI normally awarded to other pensioners. Would be affected by Statutory change.

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ANNEX 2

INDEX-LINKED PUBLIC SERVICE PENSIONS

INCREASING "CONTRIBUTIONS"

In the paper circulated as E(80)4, the Chancellor of the Exchequer proposed the setting up of an authoritative outside body to re-assess the relative value of index-linking of public service pensions and the use then of the new assessment as a basis for increasing "contributions" by employees, as widely as possible.

2. This note discusses some possible implications and repercussions of this process.

3. There would be two significant elements in the proposed valuation: the first, focussing on the important economic actuarial assumption of the long-term future real rate of return on investment, would be concerned with the estimated cost of index-linking and would involve the public endorsement by Government of an assumption which is relevant to the entire pensions industry and could be considered relevant more widely in the economy; the second, relating to the special subjective value of a guarantee of index-linking over and above other systems would by definition not affect the rationale of those other systems, but would have implications for the degree of commitment of Government to index-linking for the future.

The "Economic" Actuarial Assumptions

4. In the case of the non-industrial Civil Service (and other public service groups with non-funded schemes in which the same kind of adjustment could be made), the effect of taking a more pessimistic assumption of the real rate of return on investment in the long-term future would be translated into an increase in the employee "contribution"; (levied by way of reduction of salary awarded).

5. Elsewhere, however, the result would normally be to increase employers' costs rather than to reduce employees' take-home pay. This is because virtually all pension schemes, including those in the public sector, have fixed employee contributions which are usually renegotiated only if the benefits of the scheme are improved. Renegotiation on grounds that the actuarial assumptions have been changed is rare and difficult. In practice, the only method of recoupment open to the employer would be to pray in aid, during

annual pay negotiations, the extra cost of pensions as a reason for a lower pay settlement. In the case of funded schemes (ie virtually all schemes outside the public service) even where it is possible to enforce a salary reduction in respect of service from now on, the backlog in respect of the revised cost of pensions derived from past service would inevitably fall on the employer.

6. The Government Actuary has estimated that, if the assumption of real rate of return were reduced by one percentage point and this were carried through in full to the valuation of all pension funds, the increase in annual contributions might be as much as £1½ billion (£1 billion in the private sector, £½ billion in the public sector).

7. There is, however, considerable doubt about what would happen in practice. The Government Actuary believes that his present assumption - real rate of return on investment of 3 per cent - is comfortably within the range of varying assumptions taken by other actuaries. The authoritative judgment of an outside body, endorsed by the Government (and the Government would wish to attach maximum authority to the judgment, even if confined to a specific purpose) might be expected to carry some weight generally. But actuaries would not be bound by this judgment; indeed they would quite properly resist any narrowing of their professional freedom to advise in the best interests of their clients. The case of contracting-out provides something of a precedent. The terms adopted by the then Government imply a stronger actuarial basis (ie lower investment yields net of inflation) than the basis currently adopted by the Government Actuary. Actuaries have not followed the contracting-out basis in general, although it may have had some influence. However, the result of a new judgment now could be to create a climate of opinion in which managements, especially in the public sector, would ask themselves whether their pension funds were strong enough, and in which actuaries would want to consider whether to use stronger bases. In the public sector this could in turn make it difficult to resist claims for increased Government finance for such industries as British Rail and the National Freight Corporation; it could lead to the setting off of profits in other industries against pension contributions; in many cases the change would tend to lead to higher prices.

8. The matter is essentially one of degree. Already some nationalised industries have pension funds valued on a weaker basis than the Government Actuary 3 per cent figure and the inconsistency has not imposed particular strain. As a broad overall judgment, it might be expected that revision of the Government Actuary assumption by, say, up to 1 per cent might have very little, and certainly very little rapid, effect in practice elsewhere. A larger discrepancy would pose questions much more sharply and be likely to lead to much more widespread effects.

9. It seems doubtful whether an authoritative change in the assumption currently used by the Government Actuary would have significant effects outside the pensions industry. There could, however, be a political dimension in any radical reduction giving, for example, what would appear to be a projection of a zero long-term real rate of return on investment. This would seem to imply zero or negligible future economic growth or persistent high levels of inflation or some pessimistic combination of low growth and high inflation for an indefinite period. It is perhaps implausible, however, that any authoritative body would reach a conclusion as pessimistic as would be implied by zero real return on investment. The bulk of the attack on the current Government Actuary figure has come from economists or lay critics. The latter in particular have no doubt been heavily influenced by the very unfavourable experience of much of the past decade. Many economists are tending to predict a lower rate of real economic growth in the future than they were inclined to predict some 20 years ago, but most economists would tend even now to accept the probability of a positive real rate of return on investment as the long-term pattern, and in any case do not normally forecast as far ahead as the whole period which actuarial assumptions have to cover.

10. It may well be, therefore, that the change at issue under this heading would not have dramatic effects on the attitudes and financing arrangements of those in the pensions industry generally; and it may also be doubted whether under this heading substantial additional deductions from the salaries of public service employees could be secured.

The Subjective Valuation of the Guarantee

11. The proposition here is one which clearly distinguishes those in the public sector enjoying a guarantee of inflation-proofing, and those in the private sector who, generally speaking, do not. The valuation proposed is not one of the cost of the scheme, but relates instead to the subjective value to the prospective beneficiary of the protection he enjoys against risk. Whatever figure might be put on this value should have no effect on the rest of the pensions industry and would simply result in an extra "contribution" from public service employees in relation to a revised valuation of the benefit they were enjoying.

12. The introduction of this concept would, however, implicitly endorse and strengthen the guarantee of index-linking. In theory, it is not impossible that a case could be argued for some extra "contribution" from public service employees even if the present index-linking were abandoned in favour of some lesser degree of inflation-proofing, <u>provided</u> that the new arrangement established some limit to the prospective risk of loss of value and could properly continue to be judged to give a more favourable prospect of safe benefit than the general run of private pension schemes. In practice, however, any detraction from the present index-linking would be seen as a precedent which would greatly weaken the assurance for which the additional charge was being proposed.

General Comment

13. The main advantage of proceeding with the proposals to seek revised valuations is that the results could in principle be applied - at risk of some protest from unions but with the advantage of publicly acceptable authority - to a wide range of public service pay levels, with consequent rapid benefit to public expenditure. There would be considerable difficulties:

- we cannot in advance rely on simple and welcome results of the proposed review;

- unions might be expected to argue against the principle of any charge in excess of actuarial costs, as being wrong practice for a "good employer";

- extension of the arrangement widely in the public sector would be difficult because of the fixed nature of existing employee contributions in many public sector pension schemes, and the difficulty of negotiating comparable adjustments through the side-route of salary deductions in pay negotiations;

- the difficulty of extending the arrangements throughout the public sector could provoke charges of discrimination from the employees with official pensions who would be the main groups affected by the change;

- even in the public services it may not always be easy to ensure a proper deduction because of the nature of the pay arrangements in particular areas or the absence of a firm enough 'right' pay level from which to make it.

- from the point of view of private sector critics of index-linking, even a substantial extra "contribution" would not be seen as satisfactory: such critics are likely to be content with nothing less than the breaking of the present index-linking arrangements;

- a significant change in the Government Actuary's assumptions would very likely lead to more onerous support arrangements for British Rail and National Freight pension funds, and might lead to other offsetting costs within the public sector through increased employers' contributions to schemes. Wider difficulties in the private sector are possible but less likely.

14. If it were decided to break the present full index-linking, the case for seeking a revaluation and increased "contributions" would be severely diminished. To the doubts about the net advantage to be gained from changing the rate of return assumption would be added the apparent inconsistency of increasing contributions at a time when benefits were being explicitly reduced, the hostility among unions which that would undoubtedly create, and the possibility that an outside body would judge in the changed circumstances that the guarantee of inflation-proofing no longer had significant value. But a case could still be made if there were statutory limitations on the break in index-linking (eg in duration and amount, as proposed in

the paper by the Chancellor of the Exchequer at Annex 1), so that there would remain a favourable commitment to an important degree of index-linking in the medium-term.

15. On the other hand, if it were decided to maintain full index-linking, there would be an important potential advantage to be gained from revising assessments of contributions.