10

PRIME MINISTER

MS

SOCIAL SECURITY REVIEWS

Monday's Meeting

The paper for this meeting is still being worked on and should be available between 6.00 and 7.00 p.m. on Monday evening. It will attempt to answer the questions set out in my record of the last meeting (Flag A). The Policy Unit note is at Flag B.

This meeting is taking place on a Bank Holiday because:

(i) Mr. Fowler is extremely anxious to announce the outcome of the reviews before the Whitsun Recess. With each delay the Government's task of presentation gets more difficult, as you yourself experienced at Questions.

(ii) With three days to go before the Cabinet is supposed to take decisions, the policy on SERPS is far from clear.

How did Government get in this position when it has been looking at the issue of pensions for 18 months? The answer is that the solution now being looked at differs radically from anything previously considered. The idea of a compulsory replacement emerged as a firm proposition only in February and its implications began to be spelt out only ten days ago. The idea of the phased end to SERPS emerged only three days ago. The details of these proposals are important, both for working out the costs to the PSBR, and the impact on the economy.

Despite a great deal of hard work in the past few days, the paper is likely to leave many loose ends. You will need to assess at the meeting whether the proposal before Ministers is sufficiently clear and commends sufficient support for it to be written up and presented to Cabinet on Thursday. If you are in doubt, you may wish to consider whether to stop and draw breath, in order to allow adequate time for an extremely complex and important proposal to be fully worked out. Failure to discuss on Thursday and hence failure to meet the 22 May deadline for announcing would be embarrassing, but there are risks too in presenting a half-baked proposal.

Keeping the Best of SERPS

SERPS is too expensive and freezes the public/private sector split, so major changes are needed. But SERPS has some advantages which are consistent with Government objectives.

(i) It provides a fair deal for early leavers;

(ii) It provides complete transferability which together with (i) is helpful to job mobility;

(iii) It does not impose excessive administrative burdens on small firms. The contributions are collected with the basic contribution; there is only one set of enforcement officers; the employer does not have to worry about the previous pension history of someone he takes on nor provide information to subsequent employers; and he does not have to negotiate terms with an insurance company.

The replacement compulsory scheme could be worse in all these respects unless care is taken to build in features which maintain the best aspects of SERPS.

AT

3 May 1985

CEA

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SECRET

ECONOMIC IMPLICATIONS OF INCREASING PENSION FUND INCOME

Note by the Chief Economic Adviser

The phased abolition of SERPS and the introduction of compulsory private pension arrangements have three components from an analytical point of view. It is helpful to separate them although in practice they are interdependent:

i. the implied lower scale of compulsory pension provision;

ii. the switch from PAYG to a fully funded scheme;

iii. the privatisation of the scheme.

Reduction in Compulsory Pension Provision

2. The proposed scheme involves a lower scale of compulsory pension provision. The proposed minimum compulsory contribution rate of 4 per cent to private schemes is less than the 8 per cent contribution rate for a new entrant that is estimated to be required if SERPS is to be fully funded. Hence there will be some reductions in future pension income if private contributions are at the minimum level.

3. The argument for reducing the scale of compulsory pension provision under the present unfunded SERPS arrangements is that there are expected to be very high NI contribution rates when SERPS matures. These will have adverse supply side effects because of their impact on incentives and enterprise. If SERPS were replaced by funded schemes there would have to be an increase in contribution rates immediately.

Switch from PAYG to a fully-funded Scheme.

4. The most important macro-economic aspect of the proposal is the change from PAYG to full funding. Such a shift would be important whether the fund is in the

private or public sector. The switch to full funding requires an increase in contributions in the period until SERPS would have matured. A fully funded public sector scheme would mean a lower PSBR; a fully-funded private sector scheme means increased contributions to private pension funds. In either case contributions by companies will increase and the take-home pay of employees will be reduced. This is the inevitable consequence of funding.

5. The effect of the move from PAYG to full-funding is to increase the amount of saving and investment which the economy as a whole undertakes, at the expense of consumption. The result will be a build-up of assets which will provide later generations with the income from which to finance pensions, so easing the burden on future workers. The additional investment is likely to be both domestic and overseas. Interest rates and the exchange rate are likely to be lower and the balance of payments on current account will be improved, and this will be matched by investment abroad.

6. The macro-economic effects of the switch to funding in the private sector are very similar to those of a switch to funding in the public sector. It makes little difference whether contributions are paid by employers and employees to the National Insurance Fund, and the Government uses the surplus on the Fund to reduce gilts sales; or they are paid to private pension funds which invest them in domestic and overseas financial markets. Either way the general level of interest rates and the exchange rate will be reduced although the structure of yields will differ.

7. The switch from PAYG to funding is likely to involve a transitional period of a few years during which output may be adversely affected. Essentially this arises because there tends to be a lag between the initial reduction in consumption that follows an increase in contributions and the subsequent rise in investment and net exports induced by the lower interest rates and exchange rate. But employment costs would be higher and take-home pay lower. This reduction in output is unlikely to be as much as a ½ per cent at its peak.

8. The transitional impact on output from a move to a private sector funded scheme could be offset by an equivalent increase in the PSBR. This would have the effect of offsetting the higher private sector savings by higher public sector borrowing and effectively undo the switch to funding. Taxes could be reduced on both employers and employees, thus "matching" the increased pension contributions. But, of course, there would be presentational difficulties in explaining a higher PSBR simply because of higher flows to pension funds.

9. Another possibility is that the private sector reduces its other savings and increases its borrowing to offset the effect of higher savings in the pension funds. This is most likely in the case of personal pensions but the scale of this is unlikely to be large, particularly in the short-term.

Privatisation of Pensions

10. In addition to the macro-economic effects of switching to fully funded pensions in the private sector, there are other relevant aspects of privatisation.

11. Financial Markets. The efficiency of financial markets may be affected by the greater proportion of all financial intermediation that is undertaken by pension funds after privatisation. The direction and extent of the effect depends on the efficiency of pension funds compared with other financial intermediaries. We have little evidence on which to base a judgement about this.

12. Individual Choice. Schemes in the private sector could - in certain circumstances - be more responsive to individual needs than public sector schemes. The development of personal pension schemes could increase choice and enable contributors to build up individual property rights. This would, of course, be at the expense of some increase in the risk borne by individuals; the risk spreading inherent in the state scheme and present in many occupational schemes would be impossible. These risks would be large if financial markets were volatile. In present conditions, however, most private pension provision is in the form of occupational schemes, where employees have only limited choice about contribution rates, benefit levels, or the investment of funds.

13. Mobility of Labour. If privatisation were to take the form of more occupational pension schemes, which are less portable than SERPS labour mobility would be reduced. Cross-subsidisation is inherent in occupational pension schemes. This reduces the risk borne by individuals but inevitably it limits the extent to which they can be transferred from one job to another. Early leavers suffer relative to those who remain with a single employer.

14. Administrative Burden. The administrative burden of operating a compulsory private scheme could be severe for small businesses not contracted out. Operating private schemes will be more complicated than SERPS.

Summary

15. The main points can be summarised as follows:

a. the argument for a reduction in the scale of compulsory pension provision is that, under the existing arrangements, there will be a major rise in contributions with consequential adverse supply side effects, and, under a funded scheme, there would have to be a significant increase in contributions when the funds were set up;

b. a switch from PAYG to a fully-funded scheme is likely to increase saving and investment and hence provide later generations with more income from which to finance pensions;

c. there will be a transitional period of a few years during which output will be marginally lower than otherwise; this could be offset in part by higher public sector borrowing but this could be presentationally difficult and would undo the move to funding future obligations;

d. the bulk of the effects stemming from privatisation are likely to be micro in nature. There may be some improvement in the efficiency of financial markets but we have no basis for believing it is likely to be large. They give more consumer choice but at the cost of increased individual risk. Labour mobility is likely to be damaged as private schemes do not deal as well as SERPS with those who change jobs. And the administrative costs of operating compulsory private pensions could be significant, ~~particular~~ly for small businesses not contracted out. ~~those employers with a higher proportion of those on low~~ pay.

H.M. TREASURY
3rd May, 1985.

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INSTITUTE OF DIRECTORS

File

SOCIAL SECURITY SPENDING AND THE FOWLER REVIEWS

ERRATUM

"Some copies of SOCIAL SECURITY SPENDING AND THE FOWLER REVIEWS (IOD MAY 1985) contained errors on page 18 of the paper. A substitute page is attached"

	£ million 1985-86
Immediate and short term	
Children and young people	3,318
Supplementary benefit	550
Personal social services	500
	4,368
Long term	
Child benefit/maternity allowance	(1,600)
Supplementary benefit	(4,700)
Non-contributory benefits	(1,250)
	(11,918)

Thus the initial economies discussed in this paper could yield some £4.5bn in the immediate future and the short-term. Long-term economies could add a further £7.5bn, without allowance for the massive economies eventually obtainable from the basic state retirement pension and other contributory benefits (paragraph 45, above)

57. Although we have proposed or would accept limited increases in government spending in a few areas, the main use of the funds released by these economies would be the reduction of taxes. If any significant proportion of the options explained in this discussion paper were implemented, massive tax reductions could follow.

E.R.

MR ADDISON

Meeting on Monday Evening to discuss Social Security Review

Andrew asked me to set up the above which I have done and the following will attend:-

Lord President
Chief Whip
Secretary of State for Health
Chancellor of the Exchequer
Secretary of State for Trade
Chief Secretary to the Treasury
Antony Newton, Min of State, DHSS
Barney Heyhoe ~~Peter Gregson~~ CHRIS BRIERLEY.
David Willetts
John Redwood.

I am afraid there will be one or two things for you to do tomorrow afternoon - Friday:-

1) This is only pencilled into the respective diaries and will need confirming (Andrew will explain why, I do not know!).

2) Explain arrangements for receiving papers having found out from Andrew what they are.

3) Andrew specifically asked that special arrangements were made for the people attending the meeting to come through the Cabinet Office and not the Front Door here.

C

1 April 1985