2329

CONFIDENTIAL

10 DOWNING STREET

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FILE TITLE:	SERIES
PENSIONS	TREASURY
	PART: 11

PART BEGINS:	PART ENDS:	CAB ONE:
1ST MARCH 2001	7 JUNE 2001	

LABOUR ADMINISTRATION

PREM 49/2329

Part closed

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PART

CLOSED

DATE CLOSED	7 JUNE 2001

Series : **TREASURY**

File Title : **Pensions**

Part : **11**

Date	From	To	Subject	Class	Secret
06/03/2001	LP	EST	PMB: Pension Annuities	U	0
09/03/2001	PU	PM	Pensions, Annuities and Lifetime Savings: Need for a coherent appro	C	0
09/03/2001	MS/DTI	CST	British Coal Pension Schemes	U	0
13/03/2001	HMT	PPS	Early Draw-down of Pensions	U	0
14/03/2001	PPS	PM	Pensions, Annuities and Lifetime Savings: Need for a coherent appro	C	0
14/03/2001	MOD	DSS	Armed Forces Pension and Compensation Reviews: PQ for Written	U	0
04/04/2001	MS/DETR	CST	Travel concessions - age of entitlement for older people	C	0
27/04/2001	PPS	HMT	Pensions policy	C	0
05/05/2001	PU	PM	PFI, UNISON and the manifesto	C	0
05/05/2001	SS/DoH	CH/EX	NHS staff and hospital PFI deals	C	0
08/05/2001	CST	SS/DSS	Inherited Serps	R	0
10/05/2001	MOD	FA/APS	Pensions for Life for Attributable Widows - Gardner Campaign to Ext	R	0

87140

RESTRICTED - POLICY

MINISTRY OF DEFENCE
WHITEHALL LONDON SW1A 2HB

Telephone 020 7218 2111/2/3

SECRETARY OF STATE

MO 4/6K

10 May 2001

PENSIONS FOR LIFE FOR ATTRIBUTABLE WIDOWS - GARDNER CAMPAIGN TO EXTEND PENSION CONCESSION

You asked for further advice on the issue raised by Mrs Gardner in her letter to the Prime Minister of 27 February, and for a draft press brief. This note and the annexes covers the points raised in that meeting. I apologise for the delay in coming back to you, while Defence Ministers have considered the issue afresh.

The Gardner Campaign

Mrs Gardner represents those widows who had previously been in receipt of an Armed Forces Pension Scheme attributable widows pension and who lost this on remarriage, before the War Widows Association concession was introduced in October 2000. That change introduced AFPS widows pensions for life, but was not applied retrospectively to widows who had already remarried – information on the background to this change is at Annex A. The Gardner group is campaigning to have their pensions restored. (It might be helpful to clarify the categories of widows to which the October 2000 concession and the Gardner campaign relate. In the past, women whose husbands were killed in the line of duty received attributable benefits only from the DSS War Pensions Agency. In 1973, the MOD introduced attributable pensions for such widows, as part of the Armed Forces Pension Scheme (AFPS). They were not introduced retrospectively. The widows under consideration here are therefore only those in receipt of a post-1973 AFPS attributable widows pension. Generally, these widows are substantially better off than their pre-1973 counter-parts. In the context of the AFPS the term widows includes widowers.)

The policy considerations on reinstatement for those widows who remarried before October 2001 are:

Anna Wechsberg
10 Downing Street

MINISTRY OF DEFENCE
WHITEHALL LONDON SW1A 2HB

Telephone 020 7218 2111/2/3

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SECRETARY OF STATE

MO 4/6K

10 May 2001

Dear Anna,

PENSIONS FOR LIFE FOR ATTRIBUTABLE WIDOWS - GARDNER CAMPAIGN TO EXTEND PENSION CONCESSION

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The policy considerations on reinstatement for those widows who remarried before October 2001 are:

Anna Wechsberg
10 Downing Street

Against

- Cost. The GAD estimate the cost of restoring pensions to the Gardner group of widows would be about £22-26m. This is based on an assumption that there are about 100 widows within the group.

- A further undermining of the public sector pension schemes' policy on retrospection. The October 2000 change was an exception accepted by the Government because of the unique nature of the group involved and because there was a real risk that the Child Support and Pensions Bill might be defeated in the House of Lords. The change was agreed at a joint session of the Home and Social Affairs and Legislative Programme Committees with the Defence Secretary present. Treasury agreement would be needed to extending that concession further.

- Those who remarried before October 2000 would have done so in the full knowledge of the financial consequences

- There are other arguably more deserving groups on which to target any additional resources, for example pre-1973 widows receive only a DSS war widows pension (which still ceases on remarriage).

- Support for this campaign comes from a small, informal group with no backing from the larger pressure groups. There has been limited press interest. We have no reason to think that Mrs Gardner's supporters in Parliament could muster sufficient support to hold threaten future legislation, as happened last year.

For

- Attributable widows have been regarded as a unique group and all should be treated equally. It is inequitable that two attributable widows whose first spouses died in the same incident could be treated differently depending on the date of their remarriage

- Those who remarried in the past believe they are being unfairly treated - some claim they are being discriminated against. The current position could be seen as rewarding those who decided not to remarry and did not declare cohabitation.

- Exceptions to the Government's long held policy on retrospection in introducing changes to public sector pensions schemes were made in both the 1995 and 2000 concessions.

- There is a risk of adverse publicity, including the possibility that widows might evade the regulations by divorcing their spouse and then remarrying.

- The extra costs of this concession might be seen as small compared to the overall costs of the AFPS, and are less than the costs of the October 2000 concession.

Vulnerability of Current Policy to Legal Challenge

Mrs Gardner, and a number of other widows in her position, have instructed solicitors to act on their behalf. They have asked us for the pension scheme documents and for the name of the correct party against whom proceedings should be served in the event of a legal challenge on the basis of "unfairness and discrimination". There has not been any detailed indication of the basis on which a legal challenge might be brought, nor any definite indication that proceedings will be served.

We have sought further advice from MOD Legal Advisers. Legal Adviser's staff have concluded that there is slight risk that Mrs Gardner's group could succeed in bringing a claim within the scope of Article 1 of the First Protocol of the European Convention on Human Rights (ECHR) or Article 14 ECHR or both. Should she succeed in bringing a claim, our arguments in defence of the policy may not be sufficient to defeat the challenge. A more detailed explanation of the legal advice is at Annex B. To clarify the extent of the legal risk, the Defence Secretary has asked the Department to seek the opinion of expert Counsel as soon as possible – action on that is in hand.

Correspondence with Dr Cunningham

You also asked what correspondence the Department has had with Dr Cunningham (Mrs Gardner's MP). Last year, Mrs Gardner asked to meet Dr Cunningham to discuss the issue and Dr Cunningham wrote to Dr Moonie requesting information on the issue; Dr Moonie replied in September 2000. Dr Cunningham wrote again in March this year asking the Minister to meet a small delegation of widows to discuss the issue. Dr Moonie and Mr Spellar had met a delegation of widows from the RAF Widows Association and the Naval Bereaved Families Association in February, where this issue was raised. Mrs Gardner's group was not represented at this meeting, and Dr Moonie decided that a meeting with Mrs Gardner's group would not be appropriate. He wrote to Dr Cunningham turning down the request.

Way Ahead

The Defence Secretary's view remains that it is unlikely that the Government would want to concede to Mrs Gardner without a significant increase in support for her campaign in Parliament, from the recognised Veterans and Widows groups, and in the media. There would be increased pressure to concede if Counsel advised that a legal challenge would be likely to succeed.

In the meantime, the Defence Secretary's advice is that we should maintain our current position. But whilst the position on the likelihood of legal challenge is unclear, the Prime Minister may not wish to commit himself to a particular line. On that basis, and given his recent appointment as Veterans Minister, I suggest that Dr Moonie should reply on this occasion. I attach a draft of the terms in

which he would reply, together with a draft defensive press brief on which we could draw if the issue begins to gain prominence.

I am copying this letter to Lindsay Bell in the Domestic Affairs Secretariat and David Deaton at the Treasury.

Yours ever,

David

(D P WILLIAMS)
Private Secretary

ANNEX A

Background to the October 2000 Concession

It has long been the policy in public sector pension schemes that improvements are not made retrospectively. This means that the pension benefits a member and his/her dependants receive are governed by the rules of the scheme in place at the time the member served. Improvements are generally applied in respect of future service only: they are not usually given to existing pensioners or their dependants. The main reason for this is cost. It would be prohibitively expensive to apply pension improvements to existing pensioners and their dependants.

There have been exceptions to this policy. In particular, in 1995, the War Widows Association (WWA) successfully campaigned for widows' pensions to be restored automatically should subsequent marriages/relationships end. Until then, all Armed Forces widows pensions, like those for widows across the public sector stopped on remarriage (or cohabitation). The pension could only be restored when the second marriage/cohabitation ended **if** the widow could prove that she was left in a worse financial position than before the second relationship had started. The change agreed in 1995 made this restoration automatic rather than subject to a financial test. It was applied retrospectively, so that those whose second relationship had already ended before 1995, but whose pension had not been restored because they failed the financial test, had their pensions automatically restored at this time.

The War Widows Association also campaigned for the pension of AFPS attributable widows to continue if they remarried or began to co-habit in the future. Baroness Strange, President of the WWA raised an amendment to effect this change to the AFPS, in the Welfare Reform Bill in 1999. This was subsequently withdrawn, but a similar amendment to the Child Support and Pensions Bill was raised a few months later. During the passage of this Bill, the Baroness and some of the young widows from the WWA and their children met the Prime Minister at Downing Street. The amendment received a great deal of support in the House of Lords, many emotive speeches were made and the Government was defeated in the House of Lords. There was a risk that a major Government Bill might fall because of this amendment. At very least, it was likely that the amendment would absorb valuable Parliamentary time leading up to the summer recess in 2000.

Until then, successive Governments had resisted this change because such a concession might have a knock on effect across the public sector, in areas like the police and fire services. It might also set another precedent for other retrospective improvements to the AFPS and other public sector pensions schemes. Relevant pensions issues included:

- in the AFPS, amelioration of the effect of the so-called "pension troughs" created by the pay restraint policies of the 1970s;

- across the public sector, retrospective provision of half rate pensions to all widows; and backdating of the introduction of pensions for widows of post - retirement marriages.

A broad estimate by the Government Actuary's Department (GAD) is that the total cost of such changes could exceed £10 billion. The actual cost of the October 2000 concession, by contrast, was estimated to be about £40m (one-off capital charge), plus £2-3m a year thereafter.

Against this background, and with the MOD's internal review of the AFPS likely to recommend that widows pensions for life should be introduced, the Cabinet Secretariat convened a joint meeting of the Home and Social Affairs and Legislative Programme Committees in July 2000 at which the Child Support Bill amendment was discussed. Despite reservations on the part of the Chief Secretary, the Committees decided that the change sought by the WWA should be made. They considered, and the Home Secretary (responsible for police and fire pension schemes) agreed, that this group of AFPS attributable widows could be ring-fenced. The change was to be applied retrospectively, in the sense that existing widows would benefit if they were to remarry in the future. But the Committees also agreed that those who had married previously should be excluded from this change as they had made their decision to remarry in the full knowledge of the financial consequences.

The Defence and Social Security Secretaries made a joint announcement that the AFPS would be changed from Autumn 2000, and the Baroness Strange withdrew her amendment to the Child Support and Pensions Bill.

ANNEX B

GARDNER CAMPAIGN - LEGAL ADVICE

Article 1 of the First Protocol states that "every person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law."

The ECHR has taken the view in previous cases that entitlement to a pension can be a "possession" for the purpose of Article 1 to the First Protocol of ECHR. What we do not know is whether the Court would also rule that ceasing the pension on remarriage or living together as man and wife would amount to a deprivation of a possession. The right to a pension is not an unconditional right, but an interest granted on the condition that the widow stays unmarried and does not live with a man as his wife. There is therefore scope to argue that to cease paying pension on remarriage or cohabitation does not amount to a deprivation of a person's possession. If the court accepts this argument, there would be no breach of Article 1 of the First Protocol.

If, however, the court did not accept this view, we would have to rely on the defence that the deprivation is in the public interest and satisfies the requirement of proportionality. In support of such a defence, we would argue that the cost of including the widows who were already married or living together as man and wife as at 31 October 2000 (£22m-£26m) , was too expensive. However, Legal Adviser has warned that the costs are small as compared to the overall costs of the AFPS, and as compared to the costs of extending the benefits to the attributable widows who were not married or cohabiting as at 31 October 2000. We would therefore have difficulty in convincing a court on cost grounds. Our second line of argument is that extending the benefits to the widows who were already married or cohabiting would breach the public policy principle that we do not generally improve the benefits of pensioners. We have been advised, however, that this argument is unlikely to be persuasive, as we have already made two exceptions to this principle in relation to widows pensions, in 1995 and in October 2000.
Our third argument is that we were justified in refusing to make a third exception to the above principle in relation to the already-married widows, because, at the time they chose to remarry or cohabit, they would have been aware that they would lose their pensions under the rules of the AFPS. Our legal advisers, however, take the view that this would not be a persuasive argument for the purposes of ECHR.

To conclude, there is a risk that a court would accept that ceasing the pension constitutes deprivation of a possession for the purposes of Article 1 to the First Protocol. We do not think the risk is great. However, should a court do so, we might have difficulty in convincing it that such deprivation was in the public interest and satisfied the test of proportionality.

Mrs Gardner could also bring a claim based on discrimination under Article 14 ECHR . This guarantees the freedom to enjoy Convention rights (including that described in Article 1 of the First Protocol,) without discrimination on "any ground, such as sex, race.... or other status". By excluding those who have already married from the benefits we are conferring, it might be argued that we are discriminating on grounds of "other status". There is no case law at the moment that would indicate that such an argument would be successful. However, there is a slight risk that a future court would accept such an argument

If the court did accept that excluding the widows who were married at October 2000 constituted discrimination under Article 14, the discrimination would not violate Article 14 if we could show that it had an objective and reasonable justification. In other words we would have to show that the policy had a legitimate aim, and that the effect on the individual was not disproportionate. Again, our Legal Advisers are concerned that our arguments in this context are unlikely to be strong enough to convince the Court

Legal Advisers will now instruct Counsel with particular expertise in ECHR litigation to advise on the merits of Mrs Gardner's case. In the light of this advice, MOD will review its position.

NEWSBRIEF

REINSTATEMENT OF ARMED FORCES PENSIONS TO WIDOWS WHO REMARRIED/COHABITED BEFORE 31 OCTOBER 2000

Background

1. Until recently, all widows receiving a pension under the Armed Forces Pension Scheme had their pension stopped if they remarried or started to cohabit (ie living together as man and wife). The Scheme was changed on 31 October 2000 to permit widows in receipt of an Armed Forces attributable pension who, in future, remarry or start to cohabit to retain their pension.

2. A group of widows, led by Mrs Polly Gardner, is now campaigning to have attributable pensions restored to widows who had already remarried or started to cohabit before implementation of the new regulations. We continue to resist such a concession for the reasons included in the defensive lines below.

Defensive Lines.

Q What is an attributable widows' pension?

A If the Serviceman's death is due to service in the Armed Forces, or is aggravated by such service, an attributable widow's pension may be paid. Pensions can be paid to a widow for a death which occurred either whilst her husband was serving or after he left service when the cause of death is identified as directly related to the illness/injury for which he received an attributable pension.

Q What was the basis for last year's decision to permit widows in receipt of an Armed Forces attributable pension to retain their pension on remarriage of cohabitation?

A The Government listened to representations made by the War Widows Association of Great Britain who campaigned for the reinstatement of attributable widows pensions to widows who, in the future, remarried or started to cohabit. The Government agreed that their case was exceptional as:

- Armed Forces attributable widows were a unique group of widows whose husbands had died in the service of their country,

- these particular widows were generally younger than other groups of widows, and often they had young children to support,

- the numbers affected were greater in the Armed Forces than in other areas of public service.

Q Why is the MOD resisting the request to reinstate pensions for widows who had already remarried before 31 October 2000?

- Pension policy in the public sector has traditionally included a provision to withdraw widows' pensions on remarriage or cohabitation. This also applies in some private sector schemes.

- It is the long standing policy of successive governments that improvements to public sector pension schemes should be made from a current date and for future service only. Hence pensioners, deferred pensioners and dependants should receive only those benefits which the member earned when he/she was an active member of the scheme.

- The Government decided last year that the widows who had not already remarried constituted a unique group and should be ring-fenced. On this basis, an exceptional change was made to the policy for Armed Forces attributable widows who might wish to remarry or cohabit in the future.

- These widows, who decided to remarry or cohabit before 31 October 2000, did so in the full knowledge of how the rules of the pension scheme would affect them.

[Not for release: the Home and Social Affairs and Legislative Programme Committees meeting in joint session considered the matter of widows who had already remarried, but agreed only to restore pensions to those who remarried or started to cohabit after the implementation date (31 October 2000)]

Q What is the reasoning behind this policy of non-retrospection?

A The reasons for not making retrospective improvements to pension schemes are based on the fundamental principle that pensioners should receive only those benefits which the member earned when he/she was an active member of the scheme.

<u>If pressed</u>

If scheme improvements were applied to those who had already retired, the cost of improvements would rise significantly and there would thus be very little scope to provide improvements for current and future members. Pensions are an important part of the overall remuneration package for Armed Forces personnel which has a direct effect on the ability of the Services to recruit and retain individuals.

Q But this is a small group and the costs would not be great?

A The costs would be a one-off payment in the region of £22-26M. But there are implications across the public sector; to agree to retrospective improvements for one group of individuals would raise expectations of other groups which might believe they had an equal, if not more, justifiable claim for improvements. There are a number of groups of individuals with former service in the Armed Forces, and across the public sector, who are seeking retrospective improvements to their pensions.

Q How much would it cost to make all the improvements across public sector schemes retrospective?

A A very rough estimate is that the cost could exceed £10 billion. But this would also set a precedent for future improvements to schemes to continue to be applied to pensioners; in so doing, either the longer term costs would be much higher or very few improvements could be afforded.

Q But surely you have made a retrospective improvement when agreeing last October that widows could have their pensions restored on remarriage or cohabitation?

A The October 2000 concession was very exceptional. It does not mean that the Government has changed the underlying principle in public sector pension policy of not introducing pension scheme improvements retrospectively.

Q So if you have agreed to reinstate pensions for these widows, surely under the European Convention on Human Rights, you are discriminating against those who have already remarried?

A We do not believe there is any unfair discrimination here.

Q Has the decision to permit attributable widows in the AFPS to retain their pension led to any increase in pressure to change the rules for widows under the DSS War Pension Scheme.

A There has been no organised pressure on this point. Representatives of war widows have drawn a distinction between attributable pensions payable under an employer's occupational pension scheme and those provided by the State under the War Pensions Scheme.

DRAFT REPLY FROM US of S TO MRS POLLY GARDNER

Thank you for your letter of 27 February 2001 to the Prime Minister about Armed Forces widows' pension benefits. The Prime Minister has asked me to reply in view of my responsibility for Veterans Affairs.

As you are aware, last year, the Government announced changes to the Armed Forces Pension Scheme (AFPS) - which came into effect on 31 October 2000 - to allow the widows and widowers of ex-Service personnel to retain their Armed Forces attributable pension if, in the future, they decided to remarry or cohabit. The change did not, however, apply to those who had remarried (or cohabited) before this date, nor to those in receipt of a non-attributable forces family pension or a DSS War Widows' Pension – both of which continue to cease on remarriage or cohabitation.

The Government considered the position very carefully and decided that the change should not apply to those who had already remarried before the new regulations came into force. Because of the cost of making changes to public sector pension schemes, successive Governments have held to the principle that they should not be retrospective. They have therefore made changes for the future only, on the principle that individuals and their dependants receive benefits according to the terms and conditions of Service when they served. This particular change was exceptional, but it was felt those who had chosen to remarry in the past had done so in the full knowledge of how this would affect their pension entitlement.

I am sorry that this will come as a disappointing reply. I can assure you that the Prime Minister understands your position but, in the circumstances, I am afraid that a meeting with the Prime Minister is not considered appropriate.

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Treasury Chambers, Parliament Street, London, SW1P 3AG

Rt Hon Alistair Darling MP
Secretary of State for Social Security
Richmond House
79 Whitehall
LONDON SW1A 2NS

8 May 2001

Dear Alistair,

INHERITED SERPS

Now that the dust has settled following your announcement late last year of our solution to the inherited SERPS problem, I thought that we ought to tie off the remaining loose ends.

2. The main one is the cost of compensating (through your existing redress arrangements) people who can show they were misled by incorrect or incomplete DSS advice but who are not covered, or not fully covered, by the arrangements you announced. We did of course agree that these people would have to be compensated, subject to the high burden of proof that normally applies under your redress arrangements. But we left open how this would be funded.

3. We also left open how we would deal with the £4.7 million left unspent out of your 2000-01 agreed claim on the DEL reserve to meet the

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cost to DSS of gearing up for the compensation scheme that was the original solution to inherited SERPS.

4. I appreciate that we do not know whether that £4.7 million will be sufficient, too little or too much to meet the cost of claims under the existing DSS redress arrangements, and of processing them. But it looks to be in the right ball park. And I would suggest that the easiest and most sensible way forward would be for us to agree that the remaining £4.7m from the original Reserve claim can be carried forward to meet the cost of claims for inherited SERPS under the existing redress arrangements and to meet associated costs such as publicity strategy and adjustments to the IT systems. In the event that the costs undershoot the £4.7m provision, the unspent resource will of course be surrendered.

5. In other words, this should finally draw the line under funding for inherited SERPS. I recognise, though, that you may have a concern round what would happen if you were – entirely unexpectedly – hit for a large number of claims, for big amounts. And in those circumstances I would be prepared to consider the position, though of course without any commitment at this stage to a further claim on the DEL reserve.

6. I very much hope that you will be content with this proposal. A brief note in confirmation would be helpful.

020 7270 5456

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7. A copy of this letter goes to the Prime Minister and to Gordon Brown.

Best wishes,

Andrew

ANDREW SMITH

0171 210 5410

file

Richmond House 79 Whitehall London SW1A 2NS Telephone 0171 210 3000
From the Secretary of State for Health

Rt Hon Gordon Brown MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

5 ~~March~~ May 2001

Dear Gordon,

I spoke to Andrew Smith earlier today about how we can make progress on the radical proposals I have put forward to solve the problem caused by NHS staff having to transfer to private sector employers as part of hospital PFI deals.

As you know, we have suggested how this problem can be overcome once and for all, principally through sub-contracting the 'soft FM' services back to the NHS as a preferred option, or alternatively through secondment of NHS staff. Andrew, Shriti, advisers and officials here have discussed the preferred sub-contracting option in detail but I understand you have concerns about it. I also now understand from Andrew that other options are under consideration presumably with a view to their inclusion in the Manifesto.

Whatever options are under consideration must be workable politically, provide for smooth industrial relations and be deliverable in the NHS. I have neither been consulted nor informed about any new options. Since I would have responsibility for delivering any option, it needs to have my agreement. Given the time constraints we need to identify a potential solution quickly. My officials will need to examine all the options. I suggest we then meet to discuss any new proposals alongside the proposals I have already made to avoid low paid NHS staff being penalised by the PFI process.

I look forward to hearing from you. I am copying this letter to the Prime Minister.

Yours sincerely,

Alan Milburn

ALAN MILBURN

RESTRICTED - POLICY

From: Robert Hill

Date: 05 May 2001
cc: Jonathan Powell
David Miliband
Sally Morgan

PRIME MINISTER

FAXED

PFI, UNISON AND THE MANIFESTO

There is nasty situation boiling up regarding what is said about PFI in the health section of the Manifesto. At the root of the problem is a breakdown in communication between Gordon and Alan.

Background
Alan and Gordon know that you have indicated to Dave Prentice that you want a solution to the problem of what happens to NHS staff when a PFI hospital building contract is signed. Alan, Andrew Smith and Shriti were working on this problem. Two options had been suggested:

- Requiring the PFI consortium to sub contract the soft Facilities Management (FM) services – i.e cleaning catering, portering etc – back to the NHS trust provided they met the cost and quality standards required by the consortium and the contract.

- Seconding the NHS staff to the PFI contractor – i.e. they would remain on NHS wages, conditions of service and pension but would come under private sector management.

The problem with both these solutions was that they might effect the allocation of risk and thus the value for money equation. All NHS PFI schemes operate on the margin in terms of passing the VFM test, so even a small adjustment could render them non-viable.

For the past month Shriti has been seeing whether the first option could be made to work. Yesterday she phoned me to say that there were two insurmountable technical problems - I was not convinced by her reasoning but said the key thing was to put Alan in the picture. (On Thursday both Alan and David Miliband had asked Andrew for a meeting on this but Andrew made himself unavailable. Subsequently it has become clear, from what Andrew told Alan in a conversation this morning, that Gordon has taken direct charge of the issue).

Shriti also told me, however, that it might be possible to get the second option – secondment – to work but that there was not enough time to resolve all the issues prior to the election.

However, Gordon has been having conversations with Dave Prentice. As far as I can gather he spoke with him on Thursday and Friday night. Notwithstanding what Shriti told me he has offered Dave the secondment route and even some specific words to go into the Manifesto:

"Staff would remain employees of the NHS with NHS pay and conditions of service under the management of the PFI contractor."

He has been urging Dave to agree to this and that if he does not then the offer will be withdrawn. We know all this because Dave has been talking to Nita and Bob Abberley has been talking to Alan. Dave has not said 'Yes' –not least because he wants to know that he is getting a deal with all sections of the Government!

Alan is not opposed to the principle of Gordon's solution but wants to see the detailed proposition that underpins it. He wants to be sure that before he signs up to any solution that it is technically feasible and deliverable (for example, he wants to know from his officials that the PFI consortia will accept and live with this change and the VFM equation will not be compromised) given that the whole of our £7 billion hospital building programme is at stake. The importance of this is underlined by the fact that Andrew Turnbull (unbeknown to Gordon) has phoned Jeremy expressing his concern that what is being contemplated could have repercussions for PFI in other areas.

Alan thinks that Gordon is excluding him so that Gordon can brief (the unions, the papers or both) that he was the one who cracked the problem. Alan has now written to Gordon (letter being sent to you via the Garden Rooms) demanding to be involved in what is going on.

All this is shaping up for an almighty row after the political cabinet on Monday.

The way forward

First, Gordon needs to share with Alan his thinking and the working papers that underpin his proposed solution. It would be extremely risky – not to say foolhardy - to offer something that could jeopardise the hospital building programme.

Second, we should aim to keep the wording in the Manifesto general rather than specific (David already has some wording that does the business) and have the detailed understanding with UNISON set out in an exchange of letters.

Third, we need to be clear before we conclude a deal what we are getting back from UNISON in return. Their form on this is not good – we need assurances that they will disown any local branch taking strike action against PFI schemes and they understand that even though staff may remain NHS employees there will often be job reductions and restructuring as part of PFI schemes coming into effect. We do not want to be faced with a whole new set of demands on this front.

Postscript
It may be useful if you have a word with me before you talk to Gordon on this. In any event you need to protect Shriti and Dave Prentice – Gordon may not be aware (though he may suspect) that they are in contact with either us or Alan.

Robert

0171 210 5410

Richmond House 79 Whitehall London SW1A 2NS Telephone 0171 210 3000
From the Secretary of State for Health

Rt Hon Gordon Brown MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

5 March 2001

Dear Gordon,

I spoke to Andrew Smith earlier today about how we can make progress on the radical proposals I have put forward to solve the problem caused by NHS staff having to transfer to private sector employers as part of hospital PFI deals.

As you know, we have suggested how this problem can be overcome once and for all, principally through sub-contracting the 'soft FM' services back to the NHS as a preferred option, or alternatively through secondment of NHS staff. Andrew, Shriti, advisers and officials here have discussed the preferred sub-contracting option in detail but I understand you have concerns about it. I also now understand from Andrew that other options are under consideration presumably with a view to their inclusion in the Manifesto.

Whatever options are under consideration must be workable politically, provide for smooth industrial relations and be deliverable in the NHS. I have neither been consulted nor informed about any new options. Since I would have responsibility for delivering any option, it needs to have my agreement. Given the time constraints we need to identify a potential solution quickly. My officials will need to examine all the options. I suggest we then meet to discuss any new proposals alongside the proposals I have already made to avoid low paid NHS staff being penalised by the PFI process.

I look forward to hearing from you. I am copying this letter to the Prime Minister.

Yours sincerely,

Alan Milburn

ALAN MILBURN

CONFIDENTIAL - PERSONAL

Electronic copy in DCO Inbox

FILE

10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

27 April 2001

Dear Tom,

PENSIONS POLICY

I attach a paper prepared by Derek Scott in the Policy Unit which raises a number of questions about the current tax and regulatory regime for pensions and savings more generally.

The Prime Minister has asked Derek and Carey Oppenheim to discuss the paper with Treasury, Revenue and DSS experts. As you know, he is very keen to look again at the current rules on annuities. In addition, he would like to see further advice on:

- whether the concept of a fixed retirement age still makes sense and whether we should be doing more to allow/encourage people to take a part-pension while still working part-time for the same or a different employer;

- whether the current level of "compulsion" is appropriate and whether we need to return to the issue of the self-employed;

- whether there is scope for a major deregulation and simplification of the Inland Revenue rules on pensions;

- whether the current tax treatment of equity release arrangements is inhibiting such schemes.

The Prime Minister intends to hold a meeting with the Chancellor of the Exchequer and the Secretary of State for Social Security on these issues in the summer. It would therefore be useful to have an agreed note by officials by end-June.

VLS

I am copying this letter to Ed Balls (HM Treasury) and Neil Couling (Department of Social Security).

Yours, Jeremy

JEREMY HEYWOOD

Tom Scholar Esq
HMT

Lifetime savings, pensions and annuities: bringing them up to date

1. All governments express a desire to "encourage savings" and various tax incentives have been introduced to further this objective, often in a rather piecemeal fashion rather than from "first principles". But one objective is well understood and supported by generous tax relief: the need for individuals during their working lives to accumulate, in one way or another, a capital sum to provide an income when they cease work.

2. The tax regime is only one factor that affects the pattern of savings. The transparency or otherwise of savings vehicles and advice play their part, as do the myriad of administrative regulations affecting pensions and annuities.

3. There is need to ensure that public policy towards savings is coherent and that the framework for pensions an annuities is up to date with changing patterns of behaviour and longevity and that unnecessary administrative complications are removed.

4. The following sections set out some of the issues involved and a summary of the questions to be answered are set out below:

i) The main beneficiaries of current tax relief on savings are higher rate taxpayers and those with large capital gains. What are the policy objectives in "encouraging saving" and are the various forms of tax relief best designed to achieve this objective?

ii) How might incentives be designed to encourage individuals, including those on modest income, along the "savings spectrum"?

iii) What is the scope for introducing a flexible band for retirement age with a proportionately higher pension for those retiring later?

iv) Do institutional fund managers need to review the implications of greater longevity for "prudential" investment and if so what is the role of government in promoting this reassessment and in providing appropriate guidelines for fund managers?

v) In general people are unaware of the level of contributions needed to provide their anticipated income in retirement. When this becomes apparent government may faces charges of "miss-selling". Would it be desirable to introduce a greater degree of compulsion for employee contributions to pensions and how might the net impact of this on individuals be reduced or phased in?

vi) How do we ensure that the huge scope for increasing the transparency and reducing the complexity of regulations affecting pensions is delivered? At the very least why not allow full concurrency?

vii) How can additional sources of income be made available for pensioners from other sources of capital (particularly housing) by changes in tax and social security regulations?

viii) How can we ensure that the "open-market" option (or alternatives such as the "best quote" or annuities exchange) is made available to all?

ix) How can the rules on annuities be changed to provide greater flexibility for retirees while ensuring they do not become a burden on the state?

x) How could the "bargain" between the individual and the state over tax relief be amended to provide greater freedom for annuitants and greater equity between recipients of tax relief?

xi) What is the scope for introducing greater fairness by giving 40% relief to all taxpayers up to a certain amount with a tapered relief thereafter, again up to a total limit?

The need to raise the level of savings

5. A large proportion of the population is without any savings, and there are many more with amounts that are inadequate to meet the various calls that occur during the working lifetime or to provide a satisfactory standard of living when work stops.

6. The ability or inclination of individuals to save changes over their lifetime and at various stages it is perfectly rationale for households to consume rather than save, for example when a couple first start a family.

7. Those on modest incomes will need to retain access to savings and for those on low incomes saving may be a luxury that, quite literally, they cannot afford.

8. Public policy has to pay due regard to all these issues. Saving is more appropriate at some times in the life cycle than others. Individuals and families will always need access to a proportion of their savings. All individuals need to be encouraged to build up a capital sum to provide income in retirement.

9. This means providing a framework with as much flexibility as possible while being consistent with a well defined overall objective. What is this?

10. All savings can be considered as part of a spectrum. At one end is the "rainy day" fund for emergencies that can be accessed easily; at the other a pension fund in which contributions are inviolate.

11. In between there are lots of other calls on savings, including life policies, houses, consumer durables and holidays as well as education and training, all of which may be held in savings vehicles with varying decrees of access.

12. A useful distinction can be made between "savings" and "investments", with the former held mainly in forms of cash and the latter in riskier higher yielding assets like stocks and bonds.

13. The presumption will be that "investments", particularly equities, will be held for lengthy periods of time since although over the medium term they can be expected to outperform other asset classes they can fluctuate in the short term.

14. There is thus some logic in trying to encourage longer- term holdings of riskier asset classes and this might mean that some investment vehicles imposing a penalty for access before maturity, but this is not essential as can be seen with maxi- ISAs (and the old-style PEPs).

15. The well off will be in a position to set money aside right along the spectrum of saving. Those on modest incomes will be more constrained, but in addition to making some provision for a pension many will aspire to some smattering of non-housing "investment" as well as "savings". Those on lower incomes will struggle to accumulate significant holdings of "saving" let alone a pool of "investment".

16. Policy should be designed to encourage individuals to increase their initial amounts of saving at appropriate times and to gradually move along the spectrum. The less well off will have to be nurtured along gradually through the "cash savings" channel if they are to accumulate even modest amounts on "investment capital".

Incentives to save

17. At least two issues need to be addressed. First, are tax incentives a suitable instrument for encouraging more saving? Secondly, if the answer is "yes", are the existing incentives well designed for the purpose?

18. There are a variety of factors that determine any decision to save or invest. Small tax breaks are unlikely to have much impact on these decision, large ones might. However, this can mean that decisions to save and invest are made purely for tax reasons and the design of investment vehicles is driven by the need to take advantage of particular tax regime. This may not the best way to allocate resources efficiently or safeguard the interests of savers and investors.

19. Any form of savings typically has three components- initial payments, income accrual and withdrawal – and each of these is a possible target for taxation.

20. Pensions offer the most generous tax breaks. Contributions obtain tax relief. There is no tax on fund income. Tax is paid on withdrawal, but 25% of the fund can be distributed as a tax- free lump sum.

21. Contributions to ISAs are made out of taxed income, but there is no tax on fund income or withdrawal. The contributions to other interest bearing accounts – that will include most small savers who have not opened a mini-ISA - are also made out of taxed income. There is no tax on withdrawal, but since all nominal interest income is taxed holders of these funds are effectively taxed twice.

22. Other forms of savings, for example, life assurance and shares are treated in a slightly different manner. Contributions are made from taxed income, there is some tax on fund income and no tax on withdrawal below capital gains limit.

23. Where does this leave "the incentive to save"?

24. There is no incentive to save for those not paying tax.

25. Those with small amounts of saving in interest bearing accounts (other than mini ISAs) are liable to tax (and are effectively taxed twice since contributions are paid out of taxed income and interest is also taxed).

26. Basic rate tax-payers avoid paying income tax on accrued interest for which they would have been liable in an account outside an ISA, but the real gainers are higher-rate taxpayers and those with capital gains above the current tax free-limit (£7500 a year). The most substantial tax break applies to pensions. This ensures that those on the highest income are the main beneficiaries.

27. Finally, with the exception of pensions – where access is not so much limited as prohibited - there is no tax incentive to encourage long-term holding of assets.

28. The present system of tax breaks might be modified in a number of ways.

29. The incentives might be redesigned to encourage savings along the savings continuum, for example a 20% relief might be supplemented by an extra 5% for every five years (say) a holding was retained. It could be made possible to transfer lump sums into a pension account. Relief might be restricted to the basic rate of tax or it might be possible to "cap" total annual relief to a monetary figure, to shift the bias away from higher rate taxpayers.

30. There are many options that can be considered, but they should start from a clear objective. The present set of reliefs lacks coherence, fairness and logic.

Pensions and annuities

a) Longevity & labour market participation

31. Pension policy has not kept pace with improvements in longevity or the need for greater flexibility as to what constitutes retirement. Retirement should be thought of as a "process" rather than an "event".

32. The current retirement concept was conceived many decades ago when those around sixty did not have expectations of living much longer. Age sixty-five was considered “too old” to keep working. Today, life expectancy and the ability and readiness to work are vastly different.

33. Industrial restructuring and pension fund surpluses in the 1980s led to forced early retirement and labour force participation among those between fifty and sixty five has fallen significantly. Many older people would like to continue in employment, but have early retirement forced on them. Such people may have much to contribute to the economy, yet are being paid not to do so.

34. One option would be to introduce a flexible band of retirement ages (eg 55-75) depending on health and financial status. The incentive to a longer working live would be encouraged if a proportionately higher pension could be paid to those retiring later.

35. Greater longevity alters the type of investment that might be considered “prudent”. People can spend more years drawing out a pension than they spent paying into it. For many people past current “retirement age” there is thus a case for keeping a larger proportion of funds in equities rather than purely bonds.

36. This raises questions about the appropriateness and the design of traditional annuities and the time they should be taken out (see annuities section below), but increased longevity also has implications for decisions for fund management prior to retirement.

37. For example, at the moment when retirees approach retirement, fund managers will shift funds out of equities into less risky bonds. However, this prudential practice might look less prudent if it is thought desirable for at least a proportion of the "the elderly" to remain to some degree invested in equities.

b) Inadequate saving & compulsion

38. Large numbers of people are simply not saving enough to provide themselves with the standard of living they probably anticipate. And this is accentuated if employers reduce their contributions in any shift from a DB to DC scheme. Today, if an individual had to fund a personal pension equivalent to the basic state pension he/she would need a capital sum of about (£55,000). More and more, people will have to build up capital for their old age. The average pension fund has assets of around £30,000.

39. Clearly it is important to raise the level of knowledge through financial education, but the case for greater compulsion needs to be addressed. This is likely to become an issue not only in the UK, but also in other countries where the funding of pensions is less well developed.

40. The politics of this are difficult. Compulsory contributions may be seen as another tax so that it would be necessary to offset by some reduction in the rate of tax. However, the political consequences of not doing anything may be large too. People think they are contributing enough, when they realise their pensions are inadequate they are liable to blame the government for "miss-selling".

c) Rules and regulations

41. There is a massive volume of Inland Revenue rules and limits controlling contributions paid in and benefits paid out of pension funds. Much of this is unnecessarily complicated and without rationale. One way of reducing this confusion would be to allow full concurrency, but there will be other ways to reduce unnecessary complexity.

42. For example, there is no particular reason to taper the proportion of income that can be set aside for a pension by age. The earlier individuals start making contributions to a pension the easier it is to build up a decent pension fund. However, contribution rates need not be tapered with age, though clearly there would have to be a maximum total that could be put away each year while gaining tax relief.

43. Many of the problems with pension regulations arise because new pension legislation and regulations are often "bolted on" to existing arrangements so that the cumulative effect is confusion and complication rather than simplicity.

44. One recent example serves to illustrate how unnecessary complications can be introduced. If an individual joins a firm with a one year vesting period before new entrants can enter the company pension scheme, the firm is not obliged to provide a stakeholder pension. If the vesting period is two years there is such an obligation. There is no logic in this.

45. Sometimes there appears to be insufficient consideration as to how changes in one area impinge on others. For example, for some sections of the population the introduction of pensioner credit has complicated the decision on the merits of taking out a stakeholder pension. This has made the task of IFAs more difficult and may make some providers wary of introducing the new product.

d) Additional sources of retirement income

46. There is too little regard to other potential sources of income in retirement and ensuring that the tax treatment is consistent.

47. If income needs are analysed through the normal lifecycle, there is an increasing need typically about ten years into retirement as the effects of inflation gradually bite into spending power of those on fixed incomes and any "nest egg" saved up to retirement has been used up.

48. Such people are then often in their seventies and too old to generate additional income, and caught in a trap they cannot escape. They may become increasingly dependent on the state.

49. Large numbers of such pensioners have substantial capital, but it is locked away in the value of their house. With an increasing proportion of retired people owning their own home, in most cases with little or no mortgage, it is difficult to see the economic argument why equity release schemes should not be encouraged to fill the gap.

50. One problem is the "negative tax trap". This has two aspects to it. First, anyone on income support loses such benefit pound for pound in respect of income from a "home loan plan". Even if the level of income support is relatively low, it is virtually impossible for an adviser to recommend such a plan, given the requirements to justify recommendations to satisfy the FSA. Thus a plan which might generate, say, an additional £40 per week, could not be recommended if the retired person concerned would lose even £10 per week in social security benefits. This is illogical and is compounded by the fact that the DSS classify income as money from any source, notwithstanding that the Inland Revenue deem some or all of the income (depending on the design of the plan) to simply be a return on capital and therefore non-taxable.

51. A second difficulty follows from this. For the vast majority of retired people, their home is their only property and as such is exempt from capital gains tax. However, as soon as it is used for an equity release arrangement, its value becomes liable to income tax in one way or another, notwithstanding that it continues to be their only place of residence.

52. To the extent that the value released would be spent on goods and services, which create additional employment and generate a secondary source of VAT and income tax, this would be beneficial from a macro-economic sense. However, as with the previous example, the income tax implications makes it difficult for an adviser to recommend such a scheme.

53. One possible solution would be for the government to make available exemptions from DSS claw-backs and income tax for certain approved equity release schemes, such approval might be along the lines of CAT-marking. It would clearly be necessary to consider the implications for the rented sector and those dependent on it.

e) Annuities

54. The law requires that people with a personal pension must use the accumulated capital fund (apart form 25% that can be withdrawn as a lump sum) to buy an annuity by the time they are 75. It would be very stupid to do away with the obligation entirely, but there is scope for important modification.

55. Annuities have had a bad press and some of this is justified, but some of the difficulties arise from the transition to an environment of low inflation and low interest rates. In the past people have not put enough aside for their retirement but this has been masked until recently by apparently high annuity rates created by high interest rates and a high inflation economy.

56. There have been some modifications to legislation in recent years, but by and large these have benefited those in high incomes and large capital sums. There are opportunities to act on a broader front.

57. There are some issues that can be addressed immediately, for example enforcing the "open-market" option to ensure that at the point of taking out an annuity individuals can make an informed choice. Alternative proposals to achieve the same aim include an annuities exchange or the enforcement of "best quote"

58. Other proposals might take a bit longer to implement, but there is some evidence that the guidelines on annuities from the Inland Revenue have not kept up with developments in the market and that these are stifling the development of new products.

59. Annuities are seen as part of the bargain that people who take out personal pensions make with the state. Individuals get substantial up-front tax relief on contributions that are significantly greater than other savings vehicles, in return for meeting various requirements later. One of these is to take out an annuity.

60. Most people accept that individuals should take out an annuity at some stage to provide a stream of guaranteed income to ensure that they do not become a burden on the state. However, once obligation has been met and a minimum income guaranteed (at whatever level is deemed appropriate) there is more room for argument.

61. There are at least two options for dealing with the capital sum that remained after the required "minimum" annuity had been purchased.

62. First, the capital sum passed to the individual could be taxed, perhaps at the 40% inheritance tax rate. Secondly, it could be retained as a "ring-fenced" fund that would attract income tax if income were drawn, or tax free if the fund was allowed to accumulate. On death the outstanding remaining sum would attract inheritance tax before being passed onto the final estate.

63. However, it might be worth re-examining the nature of the "bargain" over pensions between the individual and the state. It is at least arguable that if the bargain is one of up-front tax breaks in return for preventing individuals becoming a burden, then tax breaks should cease when sufficient capital has been accumulated. This could be set at a fairly generous level, but this approach might enable individuals to be given greater freedom with their capital on retirement.

64. At the very least it is worth examining the profile of tax breaks for pension contributions. The present arrangement brings much greater benefits to the better off. One option would be to give 40% relief to all taxpayers up to a certain amount, with an additional contribution gaining relief at 20% (or the basic rate). The details of this would have to be examined closely, but such a taper provides means of injecting greater fairness.

RESTRICTED - POLICY

THE RT HON LORD MACDONALD OF TRADESTON CBE
MINISTER FOR TRANSPORT

DEPARTMENT OF THE ENVIRONMENT
TRANSPORT AND THE REGIONS

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OUR REF: GM/7923/01

The Rt Hon Andrew Smith MP
Chief Secretary to the Treasury
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

- 4 APR 2001

Dear Andrew,

TRAVEL CONCESSIONS - AGE OF ENTITLEMENT FOR OLDER PEOPLE

Thank you for your further letter of 19 March in reply to mine of 12 March.

I note your comment that there is no intention to re-open the RSG settlement for 2002/03 and that it would be much better to avoid any action that may have financial consequences before 2004/05. If you recall, the arguments in favour of action sooner rather than later were set out at some length in my original letter of 8 February. The key reason for seeking a friendly settlement in the *Matthews* case, and committing to amending legislation, was to ward off the strong possibility of an adverse ruling from the Court, with even more serious financial consequences. My officials understand that DfEE and DSS, for example, continue to support this view; no doubt colleagues will confirm.

But even if that were not the case, the scope for delaying matters is severely limited. Matthews and his backers are already showing reluctance to settle without a stronger commitment to early legislation, although they appear willing to put negotiations on hold until after an Election. If, despite earlier collective agreement to press ahead, we were instead to wait for a ruling from the Human Rights Court, whether by default or by design, we would in practice be little better off in terms of timing. The Court could be expected to give a

ruling by the summer, and we would have to consider action under a remedial Order. Delaying a response, or deferring implementation, until 2004/05 would be a highly unusual step, in the circumstances, and would be bound to draw strong criticism and adverse publicity. Neither the Court of Human Rights nor the Law Officers are likely to regard financial constraints as a proper excuse for delay.

And there is now further pressure in the form of another case, *Spindlow v. Croydon Council and the DETR,* which seeks leave of the courts for judicial review on the grounds that Croydon's refusal to issue a travel concession pass to Mr Spindlow, a 60 year old Croydon resident, breaches the equal treatment Directive 79/7/EEC and the ECHR. This case is unlikely to come to court before the autumn, but in principle it raises the same points as *Matthews* and, if pursued to a hearing, would be likely to result in a declaration of incompatability. It will inevitably keep up the pressure for early action. And it could, of course, lead to a succession of damages claims by men in the Strasbourg Court, on the grounds that all domestic remedies had been exhausted.

Given the force of circumstances, it is extremely difficult to see how the financial impacts of equalising the age of entitlement to travel concessions can possibly be held off in the way you suggest. I therefore hope that, on reflection, you will at least be willing to acknowledge this as an unavoidable pressure to be taken into account as and when it arises.

I am copying to the Prime Minister, the Deputy Prime Minister, other members of HS and LP, and to Sir Richard Wilson.

Yours

Gus

GUS MACDONALD

MINISTRY OF DEFENCE
WHITEHALL LONDON SW1A 2HB

Telephone 020 7218 2111/2/3

SECRETARY OF STATE

MO 4/6C

14 March 2001

[Dear Dan]

ARMED FORCES PENSION AND COMPENSATION REVIEWS

As you will have seen, the Deputy Prime Minister has now minuted giving the Defence Secretary formal HS Committee clearance to proceed with a period of public consultation on the Armed Forces pension and compensation reviews. This letter is just to let you know that it is intended to announce the start of this consultation in a low key manner, through a written PQ answer, on Friday of this week. You have already seen the draft answer but I attach a further copy of it for your convenience.

I am copying this letter to Anna Wechsberg (No 10), Lewis Neal (Chief Secretary's Office) and Richard Abel (Cabinet Office).

Yours ever,

David

(D P WILLIAMS)
Private Secretary

Dan Couglin Esq
PS/Secretary of State for Social Security

DRAFT
PQ FOR WRITTEN ANSWER

Question: To ask the Secretary of State for Defence if he will make a statement about the review of the Armed Forces Pension Scheme and the Joint MOD/DSS Compensation Review.

Answer: I am pleased to announce that the emerging findings of these reviews are being published today for public consultation. I appreciate that both reviews are taking longer than originally intended, but they have raised complicated issues and I am determined that we should find the right package of benefits appropriate for our modern Armed Forces.

The review teams have carried out detailed analysis of the current arrangements and the options for modernisation. They have devised proposals in each area working closely with the Services personnel staff. The next stage in the review process is to seek the views of individual Service personnel, ex-Service and Widows organisations and the general public. This will include wide circulation of material describing the proposed changes, both in hard copy and on a range of web sites. We will also be going out to interested organisations to explain our proposals, answer any questions and seek views. Because of the complexity of the proposals I have allowed over four months for consultation. After this time we will publish a summary of the responses and consider how to take the package forward in the light of them.

Copies of the consultation documents will be placed in the libraries of both Houses and will also be available on the MOD and No 10 websites. The Joint Compensation Review consultation document will also be available on the DSS War Pensions Agency website.

F

From: Jeremy Heywood
Date: 14 March 2001

PRIME MINISTER

cc: Jonathan Powell
David Miliband
Derek Scott
Carey Oppenheim

PENSIONS, ANNUITIES AND LIFETIME SAVINGS: NEED FOR A COHERENT APPROACH

You asked for my comments on Derek's stimulating note.

I agree with many of Derek's ideas. In particular:

(i) we need to review from first principles whether the current rather haphazard patchwork of tax reliefs reflects a clear-headed assessment of the sorts of savings/investment the Government actually wants to encourage;

(ii) we should look again at whether the concept of a fixed retirement age makes sense. We have separately been working with HMT to encourage a more flexible approach – for example allowing people to take a part-pension while still working part-time for the same employer;

(iii) we need to revisit whether the current level of "compulsion" is adequate to lift future generations' pensions above the MIG and pensioner credit. As you will recall, we never really cracked this in 1998 (particularly in relation to the self-employed);

(iv) we need to push for a major rationalisation and simplification of the Inland Revenue rules on pensions;

(v) we should look again at whether the current tax treatment of equity release arrangements is inhibiting such schemes;

(vi) we need to review the rules on annuities. More and more people will be affected by these rules as those on deferred contribution schemes get to retirement age and beyond. There is a case for looking radically at the whole tax regime here. It seems excessive to me to give people both 40% tax relief up-front on pension contributions and a tax-free lump sum. Tightening up one or both of these reliefs could generate the resources necessary to permit a sensible liberalisation of the annuity rules;

I am less convinced by Derek's idea of trying to encourage everyone to save through and single "lifetime savings account". I do not see much gain from this to outweigh the loss of freedom and flexibility that it implies. I feel uncomfortable outflanking Derek in this area (!), but his "profusion of separate accounts" seems to me to be the competitive marketplace in action. Why should I have to get my ISA, my pension and my bank account in an integrated account through a single provider?

I am not too fussed about the wide range of products on offer. The key thing is to ensure that the hierarchy of tax reliefs etc reflect the Government's policy objectives. Simplifying greatly the current spectrum is:

(1) most generous treatment: pension lump sum

	(tax relief on entry; tax free on on exit)	venture capital trusts
(2)	neutral treatment: (taxed on entry; tax free on exit)	housing ISAs
(3)	least generous: (taxed on entry; taxed on exit)	ordinary shares and corporate bonds bank accounts

The immediate issue is whether you want to introduce an even more favoured savings vehicle than category (1) by introducing match funding on top of tax relief for savings put into a special baby account or into the proposed "ISA plus". Views differ on this:

- the Treasury argue that match funding can only be justified for immediately-accessible rainy day savings by the poorest groups (ISA plus);

- others here think that match funding is also justifiable to encourage the poorest parents to put aside money for their children's 18th birthday.

You are likely to have to resolve this with GB In the meantime should we set work in hand on the more detailed ideas in Derek's note?

JZ

JEREMY HEYWOOD

Yes & let us push the HMT again on annuities.

Treasury Chambers, Parliament Street, London, SW1P 3AG

Jeremy Heywood
10 Downing Street
London SW1A 2AS

13th March 2001

Dear Jeremy,

Early Draw-down of Pensions

Thank you for your letter of 14 February to Niki Cleal.

The Economic Secretary agrees with the Prime Minister that this is an important issue and one that has significant political mileage if it can be achieved without opening a tax (NICs) loophole.

Work by Inland Revenue officials has identified a serious difficulty not covered by the original report – details are given in the attached letter from the Economic Secretary to Margaret Hodge.

I am copying this letter to Tom Scholar, Ed Balls, Derek Pain and the Private Secretaries to Alistair Darling and Sir Richard Wilson.

Yours sincerely,

Richard Vaughan
Assistant Private Secretary

JH: I think this is good. What are y' comments?

From: Derek Scott
Date: 9 March 2001

PRIME MINISTER

cc: Jeremy Heywood
Carey Oppenheim
David Miliband
Jonathan Powell

Pensions, annuities and lifetime savings: need for a coherent approach

A previous note drew attention to some of the problems surrounding annuities. The government has taken certain initiative to "encourage saving" in general (ISAs) and for some specific purposes ("individual learning accounts"). Other proposals are floating about with the aim of at building up asset for the less well.

All very worthy stuff, but we need to be wary of a proliferation of "accounts" without seeing how they fit together. In my view we need to avoid being too prescriptive in how individuals should judge their own best interest. Above all we need to see individual proposals in the wider savings context.

All governments say they want to encourage saving, though the objectives are rarely set out. This may be one of the reasons why the incentives to save are such a mess. In effect we have a system where small savers are taxed twice (contributions are paid out of taxed income and earned interest is taxed) while the main beneficiaries of savings incentives are higher rate tax- payers and those with substantial capital gains.

One clear public policy objective is to encourage people to save for pensions. But much pension legislation and regulation has grown like Topsy, much of it is unnecessarily complicated and lacking in rationale.

Policy has not kept pace with increased longevity and changing nature of retirement and the needs of retirement income.

The attached note sets out some of the issues and I have attempted to set them out in a framework that illustrates the continuum of savings since policy needs to address this more logically. A summary chart is attached.

I am no expert in this field and put forward suggestions rather than answers, but we do need to get some answers early in the next parliament. This would probably need 3-6 months hard work that should be driven by clear political direction but include a small number of experts from within Whitehall and from outside. One of these should be Dr Ros Altman who has advised on the Myners Report and whose opinions I have sought in preparing this note.

Introduction: annuities in context

1. A recent note drew attention to the need to consider whether the current treatment of annuities needed to be altered to bring it in line with the future requirements of pensioners. It pointed out that most of the possible changes needed to be carefully thought through before any decision, but some might be implemented more quickly.

2. The budget made some tentative proposals for dealing with one of the most pressing and uncontroversial aspects of annuities, the enforcement of the "open market option", but nothing has been resolved and other issues remain to be addressed.

3. But it is no good examining annuities in isolation. They have to be seen in the context of the spectrum savings made by individuals and households at various stages in their working lifetime as well as the changing concepts of retirement and retirement incomes.

4. All governments express the desire to "encourage savings", and various tax incentives have evolved. In practice, these have tended to shift the pattern of savings rather than increasing the aggregate amount.

5. The tax regime is only one factor that affects the pattern of savings. The transparency or otherwise of savings vehicles and advice play their part, as do the myriad of regulations, particularly those surrounding pensions.

6. This needs a thorough going review. There are some potentially difficult political issues – for example the framework for tax breaks on pensions - that can only be handled as part of the whole – for example the desirability of giving people more choice over the use of capital on retirement.

The spectrum of savings: the need to save

7. There is more awareness of the need to save than twenty years ago. But a large proportion of the population is without any savings, and there are many more with amounts that are inadequate to meet the various calls that occur during the working lifetime or to provide a satisfactory standard of living when work stops.

8. The ability or inclination of individuals to save changes over their lifetime and at various stages it is perfectly rationale for households to consume rather than save. Those on modest incomes will need to retain access to savings and for those on low incomes saving may be a luxury that, quite literally, they cannot afford. Public policy has to pay due regard to all these issues. Policy should encourage people to save at appropriate times in their life – when a couple just start a family may not be the right time to save – and this means providing a framework with as much flexibility as possible.

9. Savings can be considered in a spectrum. At one end is the "rainy day" fund for emergencies that can be accessed easily; at the other a pension fund in which contributions are inviolate.

10. In between there are lots of other calls on savings, including life policies, houses, consumer durables, holidays as well as education and training, all of which may be held in savings vehicles with varying decrees of access.

11. A useful distinction can be made between "savings" and "investments". The former are held mainly in forms of cash and the latter in riskier higher yielding assets like stocks and bonds. The presumption will be that "investments", particularly equities, will be held for lengthy periods of time since although over the medium term they can be expected to outperform other asset classes they can fluctuate in the short term. Some investment vehicles may impose a penalty for access before maturity - and contributions to pension funds cannot be touched - but this is not invariable as can be seen in the case of ISAs.

Public policy towards saving

12. One clear public policy objective is to encourage all individuals to save in order to provide themselves with an income on retirement and there are minimum compulsory contributions for those in work. However, a wider degree of saving is also seen as a "good thing".

13. The well off will be in a position to set money aside right along the saving spectrum summarised in the previous section. Those on modest incomes will be more constrained, but in addition to pensions many will aspire to some smattering of non-housing "investment" as well as "savings". Those on lower incomes will struggle to accumulate significant holdings of "saving" let alone a pool of "investment".

14. A sensible policy objective is to encourage an increase in initial saving and the gradual movement along the spectrum paying due regard to the various constraints for those on modest incomes. The less well off will have to be nurtured along gradually through the "cash savings" channel if they are to accumulate even modest amounts on "investment capital".

Incentives to save

15. At least two issues need to be addressed. First, are tax incentives a suitable instrument for encouraging more saving? Secondly, if the answer is "yes", are the existing incentives well designed for the purpose?

16. There are a variety of factors that determine any decision to save or invest. Small tax breaks are unlikely to have much impact on these decision, large ones might. However, this can mean that decisions to save and invest are made purely for tax reasons and the design of investment vehicles is driven by the need to take advantage of particular tax regime. This may not the best way to allocate resources efficiently or safeguard the interests of savers and investors.

17. Any form of savings typically has three components- initial payments, income accrual and withdrawal – and each of these is a possible target for taxation.

18. Pensions offer the most generous tax breaks. Contributions obtain tax relief. There is no tax on fund income. Tax is paid on withdrawal, but 25% of the fund can be distributed as a tax- free lump sum.

19. Contributions to ISAs are made out of taxed income, but there is no tax on fund income or withdrawal. The contributions to other interest bearing accounts – that will include most small savers who have not opened a mini-ISA - are also made out of taxed income. There is no tax on withdrawal, but since all nominal interest income is taxed holders of these funds can be said to be taxed twice.

20. Other forms of savings, for example, life assurance and shares are treated in a slightly different manner. Contribution are made from taxed income, there is some tax on fund income and no tax on withdrawal below capital gains limit.

21. Where does this leave "the incentive to save"?

22. There is no incentive to save for those not paying tax. Those with small amounts of saving in interest bearing accounts are liable to tax. Basic rate tax-payers avoid paying income tax on accrued interest for which they would have been liable in an account outside an ISA, but the real gainers are higher-rate taxpayers and those with capital gains above the current tax free-limit (£7500 a year from April). The most substantial tax break applies to pensions. This ensures that those on the highest income are the main beneficiaries. Finally, with the exception of pensions – where access is not so much limited as prohibited - there is no tax incentive to encourage long-term holding of assets.

23. Any form of tax break will disproportionately benefit the better off, but in essence the current tax incentives for saving primarily benefit higher rate taxpayers and those with substantial amounts of capital gains.

24. The present system of tax breaks might be modified in a number of ways. They might be redesigned to encourage savings along the savings continuum, for example a 20% relief might be supplemented by an extra 5% for every five years (say) a holding was retained. It could be made possible to transfer lump sums into a pension account. Relief might be restricted to the basic rate of tax or it might be possible to "cap" total annual relief to a monetary figure, to shift the bias away from higher rate taxpayers.

25. There are many options that can be considered, but they should start from a coherent objective. The present set of reliefs lack coherence, fairness and logic. However, if reliefs are to be policed without huge increase in administration is that it very important that the providers continue act as the watchdogs for the Inland Revenue. One way to meet this is the single account for lifetime earnings.

Lifetime savings: a single account

26. A version of this account has been set up in New Zealand, but there are other models and a number of people are giving this attention in the UK.

27. The idea is to bring the continuum of savings identified in previous paragraphs into a single account. This helps simplify things for investors and providers also find the concept attractive, since the prevailing inertia of the public means that once "captured" individuals usually stay with a particular company. Providers are thus more ready to bear the costs of administering

relatively small amounts of money in the early stages of such an account in the hope of reaping greater benefits later.

28. It also provides a vehicle through which any monies from government could be channelled in a way that would avoid a profusion of separate accounts.

29. The account is set out in a stylised form in the attached chart. In simple terms this account can be divided into three components. First, "savings" (cash). Secondly, "investment" (mainly equities). Thirdly, "pensions" (equities and bonds).

30. At each stage, with the possible exception of pensions, it would be possible for individuals to take an option giving easy access. But at each stage incentives could be introduced to encourage longer-term holdings. And even in the case of pensions it would be possible to design a system that allowed certain specified emergency loans to be taken out.

31. For example, the "savings" account would have a straightforward cash account. This might incorporate the traditional current account, the pending "basic bank account", the mini-ISA, as well as odds and sods like the individual learning account, all within one administrative roof.

32. But the "savings" account is would also have a "notice" account. This would offer higher returns depending on the length of time the money was locked-in, thus increasing the gains from any tax breaks. In essence this would be a revival of the old Tessa.

33. The "investment" account would include the existing maxi-ISA, that allows instant exit, but there is no reason why additional incentives should not incorporated to encourage longer- term holding.

34. An appropriate incentive structure would have to be designed since as seen above the existing one provides no real encouragement to longer- term holdings or to movement along the savings/investment spectrum. For example, to encourage people from "saving" to "investment" an incentive might be 20% relief with an extra 5% for every five years. It would be possible to devise an "investment" account that would allow a certain proportion to be withdrawn every ten years tax free. The move from "investment" to "pension" could be helped by 40% relief for all up to a certain level, with 30% relief thereafter.

35. Whatever system is devised it should follow logically from an agreed public policy objective. The present system doesn't.

36. Other policy objectives can also be met within this framework.

37. For example, various proposals have been put forward to help those on low incomes to save. Some of these focus on specific objectives, such as education or training. Others are broader in scope, for instance, the so-called "baby bond". All such proposals need to be thought through carefully, but were they judged to be sensible, they could be channelled through the Lifetime Savings Account. This would be simpler and more transparent than setting up a range of different schemes or accounts.

38. The precise destination within the account would depend on the purpose for which funds were being allocated. For example, those that are designed to provide income support in some form or another would be paid into the instant access cash account. Other flows would more logically go into notice account or into the investment channel, for example if a decision were taken to introduce a version of the so-called “baby bond”.

Pensions and annuities

39. Pensions form part of the single account for lifetime earnings, but there are some specific issues affecting pensions and annuities that need to be addressed.

a) Longevity & labour market participation

40. Pension policy has not kept pace with improvements in longevity or the need for greater flexibility as to what constitutes retirement. Retirement should be thought of as a “process” rather than an “event”.

41. The current retirement concept was conceived many decades ago when those in their sixties did not have expectation of living much longer. Age sixty-five was considered “too old” to keep working. Today, life expectancy and the ability and readiness to work are vastly different.

42. Industrial restructuring and pension fund surpluses in the 1980s led to forced early retirement and labour force participation among those between fifty and sixty five has fallen significantly. Many older people would like to continue in employment, but have early retirement forced on them. Such people may have much to contribute to the economy, yet are being paid not to do so.

43. One option would be to introduce a flexible band of retirement ages (eg 55-75) depending on health and financial status. Retirement might relate to inability to work, not chronological age. The incentive to a longer working live would be encouraged if higher pension could be paid to those retiring later.

44. Greater longevity alters the type of investment that might be considered "prudent". People can spend more years drawing out a pension than they spent paying into it. For many people past current "retirement age" there is thus a case for keeping a larger proportion of funds in equities rather than purely bonds.

45. This raises questions about the appropriateness and the design of traditional annuities and the time they should be taken out (see annuities section below), but increased longevity also has implications for decisions for fund management prior to retirement. For example, at the moment when retirees approach retirement, fund managers will shift funds out of equities into less risky bonds. However, this prudential practice might look less prudent if it is thought desirable for at least a proportion of the "the elderly" to remain to some degree invested in equities.

b) Inadequate saving & compulsion

46. Large numbers of people are simply not saving enough to provide themselves with the standard of living they probably anticipate. Today, if an individual had to fund a personal pension equivalent to the basic state pension he/she would need a capital sum of about (£55,000). More and more, people will have to build up capital for their old age. The average pension fund has assets of around £30,000.

47. The issue of greater compulsion needs to be addressed. The politics of this are difficult. Compulsory contributions may be seen as another tax so that it would be necessary to offset by some reduction in the rate of tax. However, the political consequences of not doing anything may be large too. People think they are contributing enough, when they realise their pensions are inadequate they are liable to blame the government for "miss-selling".

c) Rules and regulations

48. There is a massive volume of Inland Revenue rules and limits controlling contributions paid in and benefits paid out of pensions. Much of this is unnecessarily complicated and without rationale.

49. For example, there is no particular reason to taper the proportion of income that can be set aside for a pension by age. The earlier individuals start making contributions to a pension the easier it is to build up a decent pension fund. However, there doesn't seem to be any particular reason to taper the contribution rates, though clearly there would have to be a maximum total that could be put away each year, at least as long a existing system of tax relief remains.

50. Many of the problems with pension regulations arise because new pension legislation and regulations are often "bolted on" to existing arrangements so that the cumulative effect is confusion and complication rather than simplicity. One recent example serves to illustrate how unnecessary complications can be introduced. If an individual joins a firm with a one year vesting period before new entrant can enter the company pension scheme, the firm is not obliged to provide a stakeholder pension. If the vesting period is two years there is such an obligation. There is no logic in this.

51. Those who are familiar with the field can identify huge scope for making pensions regulations simpler for the benefit of providers and users.

d) Additional sources of retirement income

52. There is too little regard to other potential sources of income in retirement and ensuring that the tax treatment is consistent.

53. If income needs are analysed through the normal lifecycle, there is an increasing need typically about ten years into retirement as the effects of inflation gradually bite into spending power of those on fixed incomes and any "nest egg" saved up to retirement has been used up. Such people are then often in their seventies and too old to generate additional income, and caught in a trap they cannot escape. They may become increasingly dependent on the state.

54. Large numbers of such pensioners have substantial capital, but it is locked away in the value of their house. With an increasing proportion of retired people owning their own home, in most cases with little or no mortgage, it is difficult to see the economic argument why equity release schemes should not be encouraged to fill the gap.

55. One problem is the "negative tax trap". This has two aspects to it. First, anyone on income support loses such benefit pound for pound in respect of income from a "home loan plan". Even if the level of income support is relatively low, it is virtually impossible for an adviser to recommend such a plan, given the requirements to justify recommendations to satisfy the FSA. Thus a plan which might generate, say, an additional £40 per week, could not be recommended if the retired person concerned would lose even £10 per week in social security benefits. The illogicality of this is compounded by the fact that the DSS classify income as money from any source, notwithstanding that the Inland Revenue deem some or all of the income (depending on the design of the plan) to simply be a return on capital and therefore non-taxable.

56. A second difficulty follows from this. For the vast majority of retired people, their home is their only property and as such is exempt from capital gains tax. However, as soon as it is used for an equity release arrangement, its value becomes liable to income tax in one way or another, notwithstanding that it continues to be their only place of residence. To the extent that the value released would be spent on goods and services, which create additional employment and generate a secondary source of VAT and income tax, this would be beneficial from a macro-economic sense. However, as with the previous example, the income tax make it difficult for an adviser to recommend such a scheme.

57. A further problem was created in the late-1980sby a number of unscrupulous schemes promoting certain mortgage/investment bond arrangements. These so-called home income plans involved high risks for the unsuspecting elderly who were caught badly when interest rates rose sharply and house prices fell in the early 1990s.

58. One possible solution would be for the government to make available exemptions from DSS claw-backs and income tax for certain approved equity release schemes, such approval might be along the lines of CAT-marking.

e) Annuities

59. The law requires that people with a personal pension must use the accumulated capital fund (apart form 25% that can be withdrawn as a lump sum) to buy an annuity by the time they are 75. It would be very stupid to do away with the obligation entirely, but there is scope for important modification.

60. Annuities have had a bad press and some of this is justified and there are some specific issues that can be addressed immediately, for example enforcing the "open-market" option, but some of the difficulties arise from the transition to an environment of low inflation and low interest rates. The historical problem has been that people have not put enough aside for their retirement but this has been masked until recently by apparently high annuity rates created by high interest rates and a high inflation economy. The real issue is to improve the totality of people's saving that can be utilised to support a better retirement.

61. Annuities are seen as part of the bargain that people who take out personal pensions make with the state. Individuals get substantial up-front tax relief on contributions that are significantly greater than other savings vehicles, in return for meeting various requirements later. One of these is to take out an annuity.

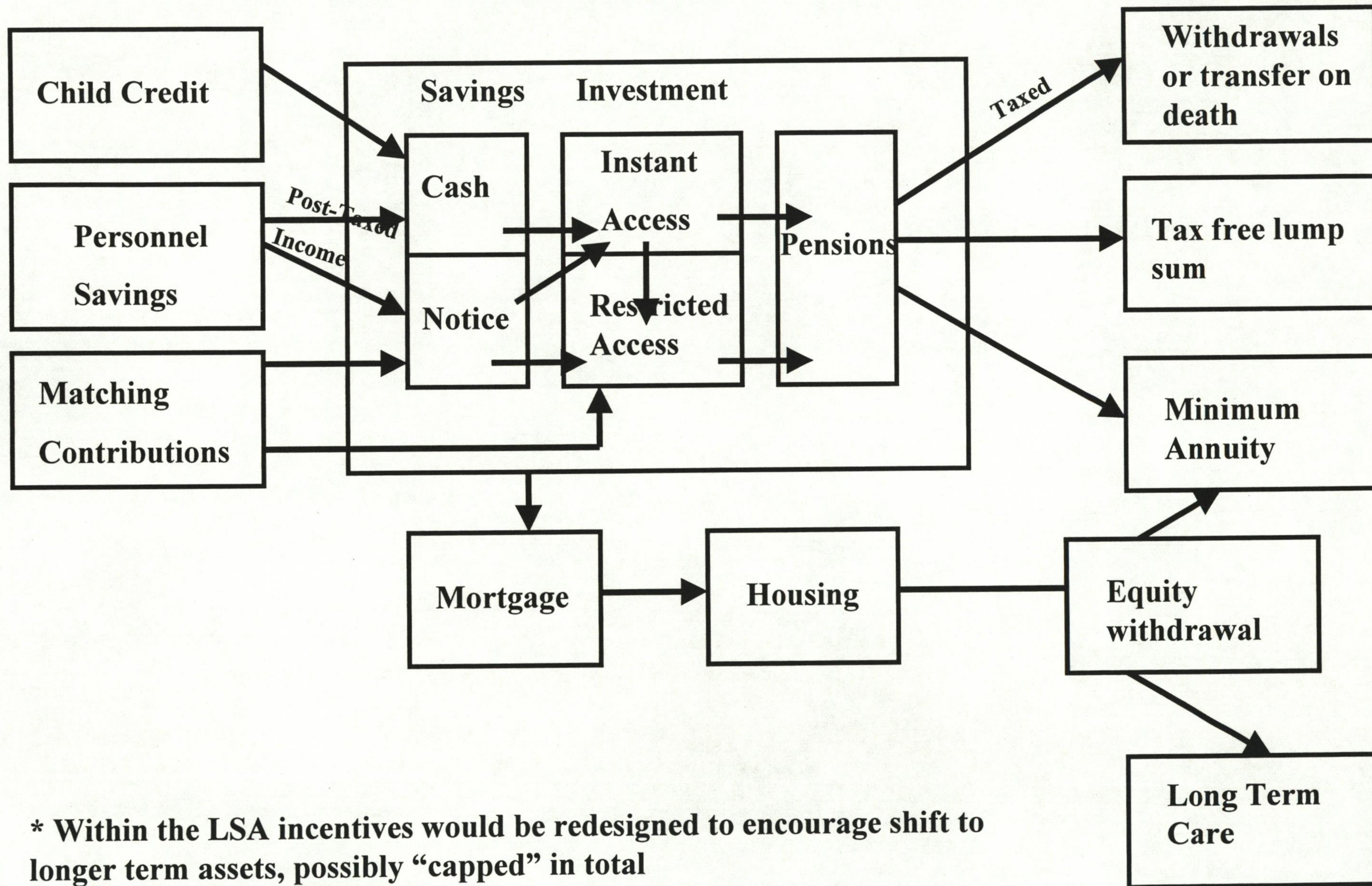
62. Most people accept that individuals should take out an annuity at some stage to provide a stream of guaranteed income to ensure that they do not become a burden on the state. However, once obligation has been met and a minimum income guaranteed (at whatever level is deemed appropriate) there is more room for argument.

63. There are at least two options for dealing with the capital sum that remained after the required "minimum" annuity had been purchased.

64. First, the capital sum passed to the individual could be taxed, perhaps at the 40% inheritance tax rate. Secondly, it could be retained as a "ring-fenced" fund that would attract income tax if income were drawn, or capital gains tax if the fund was allowed to accumulate. On death the outstanding remaining sum would attract inheritance tax before being passed onto the final estate.

65. However, it might be worth re-examining the nature of the "bargain" over pensions between the individual and the state. It is at least arguable that if the bargain is one of up-front tax breaks in return for preventing individuals becoming a burden, then tax breaks should cease when sufficient capital has been accumulated. This could be set at a fairly generous level, but this approach might enable individuals to be given greater freedom with their capital on retirement.

LIFETIME SAVINGS ACCOUNT*



*** Within the LSA incentives would be redesigned to encourage shift to longer term assets, possibly "capped" in total**

02072155645

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The Rt Hon Andrew Smith MP
Chief Secretary
HM Treasury
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9 March 2001

Dear Chief Secretary,

Summary

Both DTI and HMT are coming under increasing criticism regarding the financial benefit HMG derives from its relationship as Guarantor to the former British Coal pension schemes. Much of the adverse publicity has focussed on the plight of older former miners on particularly low pensions of under £10 per week and sometimes as little as 10p per week. Outlined below is a proposal whereby we might assist low pension cases by targeted lump sums payments of £1,000 each. The total cost would be £69 million. I would like to enable the Chancellor, if he wishes to do so, to announce this when I visit his constituency on Friday 16 March on coal matters.

As you know, since coal privatisation in 1994, DTI has acted as Guarantor to the two former British Coal pension schemes (the Mineworkers' Pension Scheme (MPS) and the British Coal Staff Superannuation Scheme (BCSSS)). Our guarantee provides that pension levels as at privatisation will always rise in line with inflation and that total pension (ie. basic pensions plus any subsequent bonuses) will never fall in cash terms. In exchange for the safeguard which our guarantee provides, we are entitled to a 50% share of any valuation surpluses.

The existing surplus sharing arrangement has, for some time, been attracting considerable criticism from sections of the Scheme memberships, from backbench mining MPs and from other organisations who represent mineworkers and their communities. The most vocal of these has been the Coalfield Communities Campaign (CCC) which, in December 1999, published a well-reasoned and researched document calling for the Government to reduce its percentage take from coal scheme surpluses and to deploy more of the sums it did receive towards the regeneration of former mining communities. The CCC re-launched its campaign at the beginning of this year and has been successful in securing the backing of many backbench colleagues.

02072155645

The arguments against the current arrangements hinge around their fundamental risk/reward balance. Each of the Schemes has been valued twice since privatisation revealing total surpluses of £1.4 billion in the BCSSS and £2.5 billion in the MPS. A further BCSSS valuation, the results of which are imminent, is likely to reveal an additional surplus in the region of £1 billion. To date, payments flowing to HMG as a result of these surpluses have totalled some £830 million. Even before factoring in any assumptions over surpluses beyond the current BCSSS valuation, we are set to receive income of around £380 million per annum in the coming years.

On the basis of these results, there is a widely held perception in mining communities that the cost of the guarantee is too high in relation to the risk to Government. That risk is, at present, difficult to quantify. Both Schemes have commissioned detailed asset/liability modelling studies, which will be completed later this year, and these will help us to evaluate the current level of Guarantor risk. My officials (and our advisers) are ensuring that the Guarantor's interests and concerns are factored into this work and they will keep HMT colleagues fully informed of its progress and outcome.

We have to date consistently resisted pressure to change the 50/50 split of surpluses. It was part of a deal struck at privatisation into which the Scheme Trustees entered with their eyes open. In the intervening period, investment returns have been exceptionally high and the equity markets in particular have been extremely buoyant. We continually emphasise that there can be no assurance that such performance will continue over the longer term whereas the safeguard provided by the guarantee will. Additionally, we stress the point that it is, to a large extent, the very existence of the guarantee which allows the Trustees to pursue an investment strategy capable of generating the surpluses we have seen over the last five years or so; without our underwriting, we suggest surpluses, had they emerged at all, would have been much smaller. The Trustees themselves recognise these arguments, but this did not prevent those in the MPS asking last year whether we would consider re-examining the division of surplus. We declined to do so.

Despite our defensive efforts, there is no indication that pressure will subside and, indeed, it is likely to rise if the asset/liability modelling concludes that the risk to the taxpayer - ie. beyond the Guarantor's reserves held in the fund - is slight. My officials have, therefore, been in discussion with the Scheme Trustees to explore the scope for targeted benefit improvement that might take the immediate sting out of the ongoing criticism. To date, these discussions have focussed on the MPS where a recent valuation has provided the scope for Trustees and Guarantor to consider cost sharing measures.

A particular problem in the MPS stems from its historical flat rate contribution structure. Prior to 1975, when the Scheme moved to a more favourable earnings related footing, contributions were very low as, consequently, were benefits. We are left with a situation where considerable numbers of the older and, often more infirm miners, receive very meagre pensions indeed. In many cases, these can be measured in pence per week, rather than pounds.

In conjunction with the Trustees, my officials have been exploring the scope to provide a targeted enhancement to those sections of the MPS membership on the lowest of weekly

pensions. We had established, with the help of analysis from the Government Actuary, that for a total cost of £66.8 million it would have been possible to enhance to £10 the basic weekly pension of all Scheme members with at least ten years' service. The Trustees would have been prepared to meet half the cost of such a measure if we had been willing to do the same in the context of a broader package where we had been asked to contribute to certain other benefit improvements which the Trustees wished to pursue. I had anticipated that, to carry the Trustees with us on low pensions, we would have had to have been prepared to contribute around £50 million to the total package.

Although initially attracted to this proposal, I have grown increasingly uncomfortable about the potential for criticism arising from benefit "clawback". The Scheme does not possess non-Scheme related income data for its members, but I think it is almost inevitable that it would emerge that very many of those with the lowest pensions are in receipt of means-tested State benefits. In such cases, the payment of increased pensions will simply lead to the withdrawal of, or reduction in, means-tested benefits with no net improvement to the incomes of the pensioners involved. At best, we could be accused of making an empty political gesture. At worst, we could be accused of using the resources of other MPS members to reduce payments from the State.

I have, therefore, considered a lump-sum cash alternative which, although not without its own difficulties, is more likely to deliver a tangible benefit for those we are seeking to assist. The drawback is that the Trustees themselves would not be in a position to contribute to cash payments. The Scheme Rules only provide for the possibility of cash lump sums in particular, limited circumstances and, although as Guarantor we have the power to amend the Scheme rules, we cannot do so in a manner which creates new liabilities for the Trustees.

I have established, however, that if we were prepared to convert to lump sums the total cost of our original weekly pension enhancement concept, then we could deliver a meaningful lump sum payment to 69,000 mining pensioners all of whom are in receipt of a weekly pension of less than £10. A willingness marginally to extend the cost to £69 million would allow us to announce a £1,000 cash payment to each qualifying pensioner. Such a payment would avoid benefit "clawback" although would be subject to means testing of savings. My officials have discussed this approach with officials in the Department of Social Security.

This arrangement would leave the Trustees with £50 million that they had otherwise set aside for low pensions within an agreed package of improved benefits. For reasons discussed above, none of this can be contributed to a lump sum solution. It would, however, be available to fund the other benefit improvement *we* would have considered as part of a total package. These include the correction of what appear to be anomalies in the current benefit structure, the improvement of the position of the widows of members who die in deferment and, perhaps most importantly, the extension to the entire membership of the option to take an actuarially reduced pension at the age of 50.

We would, of course, seek to present the entire package as one which was made possible through the joint contribution of Government and the Scheme members' funds.

In terms of our funding, it can be achieved with no direct impact upon our coal pension receipt forecasts, by utilising the Scheme's Investment Reserve rather than the established flows of valuation surplus monies.

The Investment Reserve was established in 1994 using British Coal's unused share of earlier surpluses. On its inception, it was valued at around £500 million. With investment returns over the years, it has grown to around £900 million at market value. The Reserve acts as the first line of defence against fund deficits but, to the extent that it is not required to support guaranteed pension payments, it is payable to HMG over the longer term.

At each valuation, the Scheme actuary is required to consider whether a release of funds to HMG from the Investment Reserve is appropriate and, if so, its size. In his most recent valuation report in September 2000, the actuary envisaged the possibility of a "modest" release but did not elaborate, in view of ongoing benefit improvement discussions between the Trustees and ourselves. On past experience, it is not unreasonable to assume, however, that "modest" in this context may mean in the region of £100 million. This would be more than sufficient to cover the cost of the package outlined above.

The Government Accounting treatment of the Investment Reserve balance is such that drawing the contribution to improved pensions from it will have a net neutral impact on the Department's budgets. The Investment Reserve is currently presented as a DTI asset with increases/decreases reflected as a movement through the Revaluation Reserve and Statement of Recognised Gains and Losses. Although deploying part of the Investment Reserve would have no immediate impact upon Government receipts, any additional disbursement would clearly require your agreement.

I believe that, in the current climate, the measures I have outlined above should go some way towards defusing the growing pressure surrounding coal pensions. On broad public policy grounds, my view is that the level of public expenditure involved, and the manner of its delivery, is justifiable if it is expressed as being in recognition of the large sums which the Government has received to date as a result of the guarantee arrangements. A precedent was set in this regard, albeit on a smaller scale, when the Treasury agreed to endow the Coalfield Regeneration Trust with £10 million in 1998. That payment was expressed in the same terms.

I do not imagine that this proposal will quell criticism altogether, but I think we do have sound reasons to maintain our position on the more fundamental elements of the guarantee arrangements pending the outcome of the asset/liability studies.

In the meantime, however, it would be very helpful to have your agreement in principle to the financial commitment of £69 million outlined above. I appreciate that notice is very short, but it would be ideal if I was to receive a favourable response in time to allow for an announcement on Friday 16 March when I have been invited to visit Gordon's constituency.

Given the nature of what I propose, I am copying this letter to Jeff Rooker.

I look forward to your response.

Yours sincerely,

pp Nicola Cunner

PETER HAIN
(Approved by the Minister and signed in his absence)

File

CS

C/PU

The Rt Hon Margaret Beckett MP

PRIVY COUNCIL OFFICE
2 CARLTON GARDENS LONDON SW1Y 5AA

6 MARCH 2001

Dear Melanie,

PRIVATE MEMBERS BILL: PENSION ANNUITIES

Thank you for your letter of 21st February regarding the handling of John Butterfill's Private Member's Bill

The Bill would amend the legislation that requires the holders of personal pensions to purchase an annuity by age 75. It would require holders to purchase an index-linked annuity equal to the Government's Minimum Income Guarantee, with any funds left over being treated as a tax-free lump sum.

You said that, although the existing legislation is not perfect, and the Government is looking at possibilities for reform, John Butterfill's Bill is not the answer. In particular, those with small pension finds would not be able to afford the index-linked annuities that his Bill would require. In addition, the tax proposals would be a major extension of the existing tax relief available, would cost some £5bn a year and would largely benefit the better off.

No colleague has commented, so you may take it you have agreement to proceed as you proposed. Arrangements will be made to block the Bill if it reaches Second Reading.

I am copying this letter to the Prime Minister, members of LP Committee, Sir Richard Wilson and First Parliamentary Counsel.

Regards

Margaret

MARGARET BECKETT

Melanie Johnson MP
Economic Secretary
HM Treasury