Doc 3

ACT

Contracting Out

Any change to ACT would have an impact on the costs of contracting out rebates in future if it caused changes in the overall rates which pension funds earn from investing rebates in future and these changes were reflected in the assumptions made by the Government Actuary in the rates he recommends.

Removing the ACT recovery reduces by 20% the income pension funds receive from dividends, unless other changes affect dividends. The rate of return on equity investments will also depend upon any effect this change has on equity prices. In view of the different tax position of different types of investor, it is impossible to predict the market response with any precision. As a result, the effect of any change in ACT on pension fund actual rates of investment return is uncertain.

In setting the assumptions for contracted out rebates, which are intended to reflect the "cost of providing benefits of an actuarial value equivalent to" SERPS, the Government Actuary will *inter alia* have regard to the assumptions made by other actuaries in funding pension schemes. The extent to which any change in actual rates of return is reflected in the assumptions made by actuaries in funding pension schemes is also impossible to predict at this stage. It is possible that any changes made to such assumptions will not be precisely the same as implied by the immediate market changes to equity rates of return, as actuaries take a long term view and would normally include some level of prudence in deciding on such assumptions.

Given these uncertainties, it is impossible to estimate the likely financial effect of changes to the levels of the rebates for contracting out. If ACT recovery were to be removed entirely and market prices were to fall by 20%, the gross yield on equities would be unchanged and rebates and the costs of rebates in future would be unchanged. Such an extreme assumption for the effect of the change may be unreasonable as not all potential equity investors are affected by any ACT change.

If as a result of the ACT and consequential changes, the Government Actuary reduced the assumed rate of return from 2.25% to 2% in excess of earnings increases , and there were no changes in the numbers of contracted out occupational scheme members and personal pensions, the extra costs of rebates would be about £350 million in 1997-8 terms.

Example individual

"To illustrate this, a person who is about to retire and take a pension from an anticipated fund valued today at £100,000, could find his or her expectations of a pension of around £10,000 reducing to £8,000 if market prices fell by 20%."

This assumes that all the fund is invested in UK equities, which might be argued as inadvisable so close to retirement.

The figures also assume that no tax-free lump sum would be taken.

WITHHELD S40(2)

Government Actuary's Department
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