5th November, 1965

CABINET

EARNINGS-RELATED SHORT-TERM BENEFITS

Memorandum by the Minister of Pensions and National Insurance

In July I was invited by the Cabinet (C. (65) 43rd Conclusions, Minute 4) to open discussions with the Trades Union Congress (T. U. C.), the Confederation of British Industries (C. B. I.) and other interested bodies on my proposals for a scheme of earnings-related short-term benefits, as set out in memorandum C. (65) 112. These discussions have now been taken as far as possible within the limits of confidentiality and time available. They were conducted either directly with the organisations concerned or through the machinery of the Official Committee on Occupational Pensions (O. C. O. P.) which was used to consult a wide range of employers in the public sector, including the nationalised industries and local authority associations, with a particular interest in the proposed modification of the arrangements for contracting out of part of the State pension scheme. I now report the outcome of these consultations.

2. Appendix I to this memorandum summarises the observations made on the proposed scheme. While some features of it have been criticised, the general tenor of my discussions and of the comments received has confirmed me in the belief that the proposed scheme represents a realistic assessment of what we can reasonably hope to achieve by the autumn of next year as an interim measure in advance of the result of the general review of social security benefits. In the light of experience of the operation of the scheme refinements will no doubt be possible when claimants, employers and the staff of the Departments concerned have become used to the new techniques required and our resources are increased by the availability of automatic data processing equipment.

3. As regards the proposed change in the contracting-out arrangements the reaction of those consulted has, of course, varied. Some of the bodies concerned welcome it, a few dislike it; but the attitude of the majority can be summed up as one of reluctant acquiescence. In practically all quarters there is a recognition of the inevitability of such a change within the next few years and an acceptance of the reasoning which has led me to conclude that it should be made now. There is understandable concern particularly in the public sector with the implications of the new arrangements for some pension schemes and related conditions of service. The effect of any change in the national insurance scheme on conditions of employment is, however, a matter for normal employer/employee negotiations. In this connection it has been strongly urged upon me that concurrently with the proposed changes in...
national insurance arrangements the Government, as employer, ought to initiate negotiations with public sector employees on the long-term relationship between their occupational provision and the State scheme. It is clear that such negotiations will be necessary and they are bound to be both lengthy and controversial. The flat-rate abatement plan itself if generally accepted not only as a sensible way of bringing contracted-out employees into the scope of the graduated system of contributions which will finance the new earnings-related benefits but also as a means of removing an obstacle to the development of longer-term plans in the pension field.

4. While I must emphasize that flat-rate abatement is the only practicable method I have found both for dealing with our immediate benefit proposals and for making room for future developments, I do not put it forward as just a technical device. I see it as an essential first step towards our long-term plans for a dynamic earnings-related pension scheme and it also has immediate merits of its own. It would provide every worker with the cover of the graduated scheme for widowhood; it would relieve the lower-paid contracted-out worker of a quite unjust contribution burden; and it would secure a fairer contribution from the higher-paid contracted-out worker who is at present paying less than he ought. The proposed change is explained in more detail in Appendix II.

5. With the inclusion of earnings-related widow’s allowance which was recently agreed by Cabinet (C.C. (65) 55th Conclusions, Minute 3), the cost of my proposals would be about £59 million a year.

6. If we are to bring earnings-related short-term benefits into payment in the autumn of 1966 the Bill to give effect to these proposals must be presented immediately after the Christmas Recess and passed by the end of March. This is a very tight timetable and it is now urgent that we finalise our views. I therefore invite the Cabinet’s approval of an interim scheme of earnings-related short-term benefits, accompanied by changes in contributions and contracting-out arrangements, on the basis of the proposals set out in C.(65) 112.

M.H.


4th November, 1965
Summary of Comments made on the proposed scheme

A - Earnings-related short-term benefits

1. For convenience, the comments are listed and discussed by reference to the summary of the proposed scheme set out in paragraph 2 of C.(65) 112.

Scope of the scheme

2. The C.B.I. accepted my proposal for earnings-related unemployment benefit, which they recognised was desirable on economic grounds. They were opposed to extra social expenditure on sickness benefit, which would increase industrial costs and create a bad impression abroad. I pointed out that to make better provision for the unemployed than for the sick would produce socially undesirable results and grave administrative anomalies and would attract the strongest criticism. The C.B.I. seemed impressed by these considerations, and did not press their objections at the end of my meeting with them. (The T.U.C. are, of course, insistent that sickness benefit must be covered.)

Scale of benefit

3. The T.U.C. regard the proposed scale (one-third of average weekly earnings between £9 and £30) as inadequate for lower wage-earners, particularly those with family responsibilities. They pointed out that at the lower end of the scale the new benefits would be insufficient, in themselves, to remove the need for national assistance supplementation. I pointed out to the T.U.C. that the low-wage earner with family responsibilities is inadequately provided for whether he is at work or not. (It is estimated that there are far more people in work who are receiving a total income below the national assistance standard than there are affected by the 'wage-stop'.) This problem cannot be solved until we can do something for such families whether the head of the household is in work or not, e.g., by radical changes in provision for children through family allowances. The arguments are set out more fully in paragraphs 6 to 10 of C.(65) 112.

The benefit ceiling

4. The T.U.C. thought the dangers of over-compensation could be overlooked - or deliberately disregarded - in an interim scheme and urged me to reconsider the proposal to have a benefit ceiling at all. On the other hand, the C.B.I. (and the National Coal Board) argued very strongly that the proposed ceiling of 85 per cent of gross earnings was too high and would discourage people from seeking or returning to work. They objected in particular to the proposal (paragraph 20 of C.(65) 112) that, in injury
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benefit cases, the existing 55/- differential between the rates of injury benefit and sickness benefit should be paid on top of the benefit ceiling. I impressed upon the T.U.C. the importance in an earnings-related scheme of keeping the maximum rate of benefit below the level of take-home pay (subject to retaining the normal preference for those who are injured at work). The proposed benefit ceiling seems a reasonable compromise between the conflicting views of the two sides of industry.

Reference period for reckonable earnings

5. The proposal to use gross earnings in the previous tax year was strongly supported by the C.B.I. who assured us that employers would be very ready to cooperate in making the scheme work on this basis. (Such co-operation will be vital to the success of the scheme.) The T.U.C. accept that there is no better practical alternative for a scheme to start next year but they hope it will be possible eventually to adopt a more flexible reference period.

No allowance for interruption of earnings in the reference period

6. The T.U.C. were disappointed by this feature of the proposed scheme and argued that benefit should be based on earnings during actual weeks of work, i.e., by dividing the tax-year earnings not by fifty but by the number of weeks of work. I explained that this would impose a greatly increased administrative burden which I could not undertake at the start of the new scheme, and that there were in any case objections of principle to what the T.U.C. had in mind. The additional cost of paying benefit in respect of notional earnings on which no contributions had been paid would have to be met by a general increase in contribution rates and this would mean that lower-paid workers in steady employment would be subsidising higher benefits for higher-paid workers. I pointed out, however, that automatic data processing might eventually enable us to make some allowance for periods of interruption of employment during the reference period and the T.U.C. seemed partly satisfied by my assurance that this would be carefully considered once the new scheme was established.

Duration of earnings-related supplement

7. The C.B.I. would prefer three months' earnings-related supplement, but are prepared to accept six months as the absolute maximum. The T.U.C. still feel that the supplement should be payable for a year (as proposed in New Frontiers) but did not press their view at all strongly. In the context of the proposal (paragraph 15 of C.112) to rationalise the duration of flat-rate unemployment benefit by providing a standard maximum duration of twelve months for every claimant (instead of the present system of from seven to nineteen months depending on a claimant's previous insurance record)
the T.U.C. asked about the position of the long-term unemployed and put forward their view that unemployment benefit, like sickness benefit, should be of unlimited duration. I explained that the question of provision for the long-term sick and unemployed was being looked at as part of the general national insurance review, and that the present interim scheme would not prejudice the ultimate decision on the structure of benefit for long-term interruption of employment.

Waiting days

8. The T.U.C. thought that the proposed twelve-day waiting-day period for earnings-related supplements was too long and argued that, if it was necessary for administrative reasons, the supplement should be paid retrospectively once the spell of sickness or unemployment had lasted for twelve days. I explained the reasons for the twelve-day waiting period (which were set out in paragraphs 16 to 17 of C.(65) 112) and pointed out that to make retrospective payments where interruption of employment had lasted for twelve days would provide a substantial and highly undesirable financial incentive for many claimants to delay their return to work. This would not only place an intolerable strain on the scheme but would greatly increase its cost.

B - Changes in contracting-out and the flat-rate abatement plan

9. Consultations on the proposals for changes in contracting-out and the flat-rate abatement plan have taken place with the four following interests: the actuarial profession and the Life Offices and other representatives of Pensions Funds and of private insurance interests; employers as represented by the C.E.I; employed persons through the medium of the T.U.C.; and Government Departments and other public bodies in their capacity as employers.

Actuaries

10. The Institute of Actuaries and their Scottish colleagues, the Faculty of Actuaries, sent me a detailed memorandum. They referred to previous documents which they issued when the present graduated pension scheme was being prepared, in which they argued that the present form of contracting-out would work satisfactorily only for so long as the scope of the scheme was limited. They say that the new proposals go a long way to meet this objection to the present arrangements. Their memorandum is distinctly favourable to my proposals.
Representatives of insured and other pension schemes

11. Representatives of the Life Offices and, generally speaking, of other organisations interested in occupational pensions in the private sector regard my proposals with favour, as they have practical experience of the drawbacks of the present system of contracting-out and recognise that it cannot be adapted even to relatively minor future changes in the State scheme. They see the proposals as a firm and lasting basis on which State and occupational pensions can operate side by side. Their main concern about flat-rate abatement is that the contribution reduction offered to contracted-out employers should not be so small that they may be tempted to wind up, or cut back, their occupational schemes rather than continue to contract out. The figures on which I have been working (see Appendix II, paragraph 6) would, I think, be accepted by responsible opinion in the pension world as a reasonable settlement.

C.B.I.

12. The C.B.I. accept the need for change and have told me that they do not wish to oppose my proposals.

T.U.C.

13. The T.U.C. were concerned that the time available for consultation did not allow them adequately to test the feeling of their affiliated bodies, and consequently consider that they must reserve their position on the Government's proposals. In general, however, they accept the arguments which have led us to propose flat-rate abatement, although they are concerned that this should not lead to the establishment of many different categories of pensioner with entitlement calculated in separate ways. It was clearly not possible for me to assure them that the level of abatement proposed to operate from next year would never be varied, but the T.U.C. regard it as a point in the scheme's favour that I was able to tell them that we did not intend that the abatement would be adjusted automatically when changes were made in other features of national insurance, and that indeed this was one of the objectives of the scheme.

14. The T.U.C.'s principal reservation is that flat-rate abatement, while a reasonable provision for employees in private occupational schemes, cannot be applied in the public sector without considerable disadvantage to the employees concerned. The problem here is that, whereas the terms of employment allow an occupational pension and a flat-rate national insurance pension to be drawn together (in some cases with a modification of the occupational pension of up to 26/- a week), occupational pensions have normally been adjusted to take account of the whole of any graduated national insurance benefit earned. Thus a change in national insurance which meant
that contracted-out employees began to contribute towards graduated benefit, while losing a part of their flat-rate entitlement, would be doubly disadvantageous to civil servants and others in similar employments. The T.U.C. agree that a long-term solution must be found in re-negotiating the provisions for the adjustment of occupational pension, rather than in tailoring national insurance to the special circumstances of public sector employees, but in the meantime they are prepared to give their full support to representations by the unions which speak for public service employees and similar bodies against a worsening of their terms of service.

Local Authorities
15. The reactions of local authority associations are a little mixed. In general, they have concentrated attention not so much on my proposals, which they do not oppose, as on the methods by which they might adapt their own arrangements to them. No doubt they have in mind that, as at present less than half of their employees are contracted-out, they have room for manoeuvre in extending contracting-out and the net financial effect, for employers and the majority of employees, could well be advantageous.

Other public sector employers
16. The replies received from Government departments and public bodies through the consultation machinery of the O.C.O.P. have similarly concentrated on the anomalous results of applying flat-rate abatement to the type of occupational pension provision which at present exists for their employees. Some employing departments make the point that their staff whose total present contribution liability of 16/1 a week will in many cases increase (and in those cases the amount of the increase will be anything up to a further 4/11 a week) - will not stand to gain anything from the proposals, because they will not be able to qualify for the new earnings-related benefits, since they already receive full pay during six months' sickness, and unemployment is not a likely contingency for them. Hence they say that, from their point of view, it would be desirable for the present scheme to continue with as few changes as possible until the Government's long-term review is complete. But most of the replies accept that graduated national insurance liability has to be extended to the contracted-out, and that the flat-rate abatement scheme seems a sensible way of doing this; their concern is at the effect which, under present arrangements, the Government's proposals would have on their own employees' present conditions of service. But, of course, these are matters which can only be settled by employer-employee negotiations in the light of firm Government decisions on the national arrangements.
17. At the meeting at which the proposals were discussed the O.C.O.P. recommended that consideration should be given as a matter of urgency to establishing a type of pension provision in the public sector which was compatible with the extension of the earnings-related State pension scheme. One solution envisaged was "integration", whereby the Civil Service and other public bodies would contract in to the national scheme, and the occupational pension would serve to "top-up" the employee's eventual full State benefit to a pre-arranged level. It seems clear that working out and agreeing the details of any new arrangements (which would not of course be a matter for me, but for the Government as employer) will be a lengthy and controversial business, particularly perhaps for the Civil Service and the police; and I have been warned that resentment may well arise from the fact that the need for new arrangements will spring from the establishment of a scheme of sickness and unemployment benefit which is itself unlikely to benefit public sector employees. From the point of view of timing, however, the flat-rate abatement scheme will also take some while to have any appreciable effect: the graduated benefit earned and the flat-rate pension foregone under the scheme by a contracted-out employee will each amount to only two or three shillings a week by the end of 1968. This means that time will be available for occupational provision in the public sector to be put on to a revised basis before the anomalies caused by the flat-rate abatement scheme become too glaring or too burdensome in that sector.

Cost
18. It is the intention that the change to flat-rate abatement should be self-balancing - that is, that the extra contribution income which will arise from extending graduated contribution liability to the contracted-out should be used to finance a general reduction in flat-rate contributions in so far as the finances of the National Insurance Fund permit.
THE PRESENT CONTRACTING-OUT SYSTEM AND THE PROPOSED SYSTEM OF FLAT-RATE ABATEMENT

The present system
1. Under existing arrangements an employer with an adequate occupational pension scheme can contract his employees out of the graduated part of the national insurance scheme. Employer and employee do not pay graduated contributions and the employee does not earn graduated pension. But because the graduated contribution includes an element to support flat-rate benefits, they pay in place of this element a larger flat-rate contribution than others.

The need for change
2. There are two separate reasons for wishing to change the existing arrangements. First the new earnings-related short-term benefits must be matched by a contribution similarly related to earnings. (Otherwise the lower paid would be subsidising the benefits of the higher paid). Workers contracted out for pension cannot be excluded from the new short-term benefits and must therefore start to pay graduated contributions. It is administratively scarcely practicable to collect two different graduated contributions for different categories of worker counting differently for benefits.

3. Secondly, quite apart from the introduction of earnings-related short-term benefits, there are strong arguments for changing the present contracting-out arrangements which involve the following inequities:

   (a) Most occupational schemes do not make provision for an employee's widow. Thus when an employee is contracted out he loses the cover for his widow provided under the graduated pension scheme (when herself retired, she receives half the graduated pension her husband had earned) without any guarantee and usually with no prospect of alternative provision for her.

   (b) The graduated pension now being earned is fixed in the legislation in money terms. It will not be possible to up-rate the graduated pension already earned without doing an injustice to those who have been contracted out. The guaranteed occupational pension on the strength of which their employers were able to take them out of the graduated scheme cannot be increased by Government action.
(c) The higher flat-rate contribution paid by those contracted out bears harshly on the lower-paid employee and is over-generous to the higher-paid. In the extreme case the contracted-out man earning £9 a week is paying 2s. 5d. more by way of national insurance contribution than if he were not contracted out but gets no more national insurance pension in return. If his occupational scheme is contributory, as it usually is, the total contribution burden for him is excessive.

(d) The present requirement that even those with low earnings should if contracted out be assured an occupational pension at the rate appropriate to earnings of £18, can distort an occupational scheme and impose on it an excessive charge when young workers leave the employer and are brought back into the graduated scheme as if they had been earning £18 a week.

4. These flaws in the present arrangements all flow from the attempt to match unlike provisions for those contracted in and those contracted out. For the former the law provides a pension and a contribution varying with earnings, pension rights capable of adjustment by Parliament in line with changed money values and provision for widows; for the latter none of these provisions apply.

5. If we were prepared to support these inequities it would no doubt be possible for the present arrangements, unsatisfactory as they are, to continue as long as no other changes are made in the national insurance scheme. But they could scarcely remain tolerable if on the occasion of a future general increase of benefit rates it were desired to expand the span of earnings attracting graduated contributions. If for instance graduated contributions were collected on earnings from £9 up to £24, the amount payable by the contracted-in employee would vary (according to earnings) from nothing up to 12s. 9d. (in 1961 it went only as far as 5s. 1d.) and this wide range of contribution would still have to be matched by a flat-rate contribution for the contracted-out. The maximum amount of graduated retirement pension for widows (originally 21s.) would become 52s. 6d. but would still illogically be denied to the widows of men contracted out. The occupational pension to be guaranteed for those contracted out would be at the rate of £5 5s. for a working life (originally £22 2s.) and the lower-paid worker would have to pay contributions at a level geared to providing for him and his wife pension (State plus occupational) of £11 15s. - in some cases above his current earnings.
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The proposed scheme of flat-rate abatement is designed to fulfil the primary purpose of contracting out, that is to avoid undesirable overlap between national insurance and occupational provision, while getting rid of the objectional elements of the present arrangements. Its main features would be:

(a) The contracted-out would pay the same graduated contributions and qualify for the same earnings-related short-term benefits and the same graduated pensions, including graduated retirement pension for widows, as the contracted-in.

(b) The employer would be able to contract out his employees on the same conditions as at present. The level of pension to be guaranteed under the occupational scheme would also be the same as it is now. For a man this is about £1.41 a week for each year of contracted-out employment.

(c) The contracted-out employee would have his national insurance pension abated by a fixed amount in respect of each year during which he was contracted out. (This amount would, I propose, be £1.25 a week for a man — rather less than the amount guaranteed under the occupational scheme).

(d) In recognition of the reduced commitment of the National Insurance Fund and the commitment assumed by the employer, the contracted-out man and his employer would each pay a flat-rate contribution lower (I am proposing by £1.35 a week) than those for contracted-in employees.

The figures in sub-paragraphs (c) and (d) above have not yet been approved by the Treasury.

Advantages of the change

7. The basic advantage of my proposal is that instead of trying to equate, as does the scheme we inherited, a fixed amount of pension which the employer is required to provide with a variable amount of State pension which the worker forgoes, we should be balancing like with like; the employer would still be required to provide a fixed amount of pension for each year of contracted-out employment, but this would be in substitution for a fixed amount of State pension forgone. The immediate consequence would be to remove for the future the inequities listed in paragraph 3 above. Additionally the small but necessarily universal graduated contribution for the new short-term benefits would be easily collected along with the bigger graduated pension contribution now also universal in its application.
Reasons for making the change now

3. As we are anxious to introduce the new short-term benefits in the shortest possible time it is tempting to concentrate on that task and to postpone changes in the contracting-out provisions. The objections to this are over-riding. First, to collect for the contracted-out only the small graduated contribution for the new benefits but for others the combined pension and short-term benefit contribution would introduce very formidable difficulties both for my Department and for employers. Secondly, once the machinery existed for collecting graduated contributions for the contracted out it would be wrong not to use it to get rid of existing inequities, listed in paragraph 3 above. Lastly, if a change became inevitable, as sooner or later it must, a benefit increase Bill, necessarily rushed through against time, is not a suitable vehicle for structural changes which Parliament must be allowed adequate time to discuss and employers to operate.
NOTE

The attached memorandum by the Chancellor of the Exchequer (C. (65) 146) is for discussion at the meeting of the Cabinet arranged for Thursday, 11th November, at 10.00 a.m.

The contents of the memorandum are of a particularly confidential character. Ministers will no doubt ensure that it is treated accordingly.

The memorandum should be returned, under cover, after the meeting to:

Mr. V. C. Budgen,
Cabinet Section,
Room 140,
Cabinet Office, S. W. 1.

Cabinet Office, S. W. 1.

9th November, 1965