2nd July, 1958

CABINET

PENSIONS

MEMORANDUM BY THE CHANCELLOR OF THE EXCHEQUER

I was invited by the Cabinet on 24th June to consider whether it would be possible to devise some variation of a graduated pension plan which, while incorporating the principle of contracting out, would provide a satisfactory and permanent remedy for the defective finances of the existing National Insurance Scheme (C.C. (58) 49th Conclusions, Minute 2). In this paper I deal with this matter in relation to the September Plan, and also with one or two other points which arose in our discussion. These things are very technical and I apologise for the length of the memorandum.

2. The fundamental point is that the present scheme involves steadily increasing expenditure on benefits and therefore, since there is no corresponding increase in contribution income, steadily increasing deficits. The rise in expenditure could be slowed down by increasing the minimum pension age; but clearly the growth in the deficits to be met from general taxation can be avoided only by some device which secures an adequate and automatic growth in contribution income.

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Curing the Deficits

3. In my paper C. (58) 128 I compared the future financial out-turn of the August and September Plans in terms of the overall cost (i.e., the Exchequer Supplement plus any deficit and minus any surplus) because that is the most realistic measure. But public judgment of the financial soundness of any new scheme will look mainly to the prospective annual surplus or deficit in the Fund—i.e., after allowing for the regular statutory Exchequer Supplement. We shall have to publish, with any new Bill, a report by the Government Actuary on its finances which will bring these figures out.

4. On the assumptions used in C. (58) 128 the September Plan will show a surplus of £12 millions in its first year, followed by deficits rising from £2 millions in its second year to £45 millions in its fifth. Thereafter the scheme will continue to show increasing deficits, apart from the checks every fifth year resulting from the quinquennial increases of 1s. in the flat-rate contribution. These increases temporarily reduce, but never extinguish, the deficits, so the scheme is never in balance after its first year.

5. The August Plan, on the same assumptions, will show a surplus of £6 millions in its first year, a balance in its second, deficits in its next three years (rising to £20 millions in its fifth), and surpluses thereafter in every year save three until at least the end of the century.
6. The average annual surplus (+) or deficit (−) over future periods is set out below:

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<tr>
<td>September Plan</td>
<td>−7</td>
<td>−10</td>
<td>−19</td>
<td>−35</td>
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<tr>
<td>August Plan</td>
<td>+9</td>
<td>+10</td>
<td>+19</td>
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(£ millions)

(It will be realised that on the basis of overall cost the contrast is not so sharp, because the August Plan has a bigger Exchequer Supplement. There would in practice be no sense in accumulating large annual surpluses under the August Plan; they ought, if not used for increasing benefits or reducing contributions, to be set off against the Exchequer Supplement. Hence is derived the table of “overall cost” given in paragraph 11 of C. (58) 128. The detailed figures are given in the Table annexed.)

7. It would be hard to present the September Plan, on the above figures, as financially “sound.” But if, instead of quinquennial increases of 1s, in the flat-rate contribution (6d. each from employer and employed), it provided for annual increases of 3d. (1½d. each), it would show only small surpluses and deficits for its first twenty years and could be presented as being in balance for any year in that period. My colleagues may think that this would be a material improvement. (The amount of the annual increases might have to be reconsidered when we know whether the actual amount of contracting out is more or less than the one third which is assumed in the above figures.)

8. I must however draw attention to an awkward point, which arises on the September, but not on the August, Plan. In estimating the future financial outturn of both schemes we have made a number of assumptions, including 2 per cent. as the long term unemployment rate. I do not regard this as unreasonable if we are assuming an expanding economy. But the unemployment rate hitherto publicly assumed for the purpose of the present scheme has been 4 per cent., and the “actuarial contribution” has been calculated on that basis. (The actuarial contribution is the amount which for a 16-year old contributor is actuarially equivalent to the insurance benefits currently secured to him—including sickness and unemployment as well as old age.) The present scheme—which is also the lower tier of the September Plan—in fact charges more than the actuarial contribution, and the excess is called the “overload.” In the present total contribution of 18s. 2d., the overload is 2s. 4½d. If the long-term unemployment rate were assumed as 2 per cent. rather than 4 per cent. the actuarial contribution would come out lower than at present (because of the reduction in the assumed insurance risk), and the amount of overload in the present contribution of 18s. 2d. would be shown as 3s. 10d. instead of 2s. 4½d. If on the other hand we adhered publicly to the 4 per cent. unemployment assumption, the future deficits under the September Plan would be shown as about £60 millions a year higher than in paragraph 6 above, and even if amended as in paragraph 7 the scheme could not be shown to be in balance. I assume from paragraph 15 of the memorandum by the Minister of Pensions, C. (58) 130, that the Minister is content to defend an increase in the overload. (A 4 per cent. unemployment assumption would also worsen the forecasts for the August Plan (by somewhat less than £60 millions), but since there is no flat actuarial contribution, no technical difficulty arises from taking a 2 per cent. assumption.)

9. The only other point to be made on the figures is that if the September Plan were re-assessed on the basis of an interest rate higher than 3 per cent., the scale of graduated benefits would be raised and there would be consequential increases in the deficits from the second decade onwards. Such a change would also increase the overload in the flat-rate contribution. I would myself hope we could avoid any material reassessment, because of its addition to the future emerging costs.

10. It will be realised that the financial improvement over the present scheme which the September Plan secures is achieved by two means: first by future increases (whether annual or quinquennial) in the present flat-rate contribution, with no increase in the present flat-rate benefits; and second by starting a new scheme and using its income to support the old one, without making provision to meet the new costs.
scheme's emerging costs. Neither of these financial devices is easily defensible, and I have not concealed from my colleagues my view that they are not the right way of tackling the task of reform: in my opinion the key to a solution of the fundamental problem posed in paragraph 2 above is, in an expanding economy, to substitute a graduated for a flat-rate contribution in the basic scheme itself and not to add a second scheme and a second set of emerging costs. From the purely budgetary point of view the September Plan, if it is amended as in paragraph 7 above, and if we assume 2 per cent. unemployment, is by no means unsatisfactory for at any rate 20 years, but I fear that it will attract great criticism from the financial point of view, and on the whole I find it very difficult honestly to advise my colleagues that it represents a "satisfactory and permanent remedy."

Meeting the Deficits for the Next Two Years

11. Pending the introduction of any new scheme the annual deficits in the existing scheme must be met either from taxation or from borrowing. If we introduce legislation next session and it is reasonably clear by the time of the next Budget that the legislation is going to get through, and is going to be operative within, say, two years, then I am inclined to think that there would be ground for deciding that until it is operative the deficits should be met by running down the present balance in the Fund (i.e., by borrowing) rather than from Votes. My colleagues will realise that although this will have a favourable effect on Votes and will reduce the prospective total of Government expenditure as so measured, it will not in fact reduce total expenditure and will not necessarily have any effect on the amount which ought to be raised by taxation.

Other Considerations Arising from the September Plan

12. Some of my colleagues are disposed to favour the September Plan. I think it is most important that we should not publicly commit ourselves to it without realising the risks we run.

13. The scheme makes it obligatory for all employees earning over £10 a week (with their employers) to make provision for old age over and above the basic provision. This obligation, if not satisfied through an occupational scheme, must be satisfied through the State. The principle of a statutory compulsion to make more than basic provision can be expected to encounter opposition from many quarters.

14. Contracting out does not of course mean contracting out of the obligation to make provision. It means that employers have an option as to how they and their employees are to meet that obligation. If employers prefer that it should be met through an occupational scheme, that scheme must satisfy certain (perfectly proper) criteria. We have been warned that the administrative and technical difficulties of applying appropriate criteria, both for the State and for employers, are formidable.

15. A "contracted out" scheme becomes subject to continuous State control and virtually every occupational scheme now in existence would have to be modified, in greater or less degree, before it could satisfy the necessary criteria.

16. It is urged against the August Plan that it would compel many employers to cut back their existing schemes. But we must realise that this feature is not absent from the September Plan. We have learnt from employers' replies that the majority of private employers would probably not contract out but would prefer to cut back their existing schemes instead. What is gained, in these cases, on current Exchequer account is lost to savings in the economy as a whole.

17. It would therefore be a mistake to think that a State scheme incorporating the principle of contracting out means freedom for occupational schemes to continue and to develop as at present. It means considerable interference with them.

18. The risk we run is that these things become more widely appreciated in the public discussion of our proposals we shall find them attracting more and more criticism, and may even have to abandon them. The sheer feasibility of devising and applying the "contracting out" provisions is mainly a matter for the Minister of Pensions to advise us on. (No other country has as yet carried through such a scheme.) The public reception of them is largely a matter for political judgment. I confess to grave misgivings myself, and I feel bound to draw attention to the risks which we incur to our credit as a Government.
Considerations Arising from the August Plan

19. Size of the Plan.—If, on the other hand, we were to decide in principle that we ought to adhere to a single basic and universal scheme and thus avoid any question of contracting out, then it is of course for consideration whether the August Plan as at present devised represents a satisfactory conception of what basic provision ought to be. It would be possible to reduce its benefits if they are thought to be too big, but they could not be reduced far without also reducing the contributions, and that would seriously diminish the financial attractions of the scheme. There are various possibilities of adjustment which might well be further considered; but I would myself think, as the Life Offices do, that the scheme is pitched about right. It is of roughly the same size as the United States scheme (though that scheme is more sharply slanted against the higher-paid), which has proved in practice to be a satisfactory basic scheme on top of which occupational schemes have been able to flourish and multiply.

20. The self-employed.—The treatment of the self-employed was mentioned in our last discussion. This point must be kept in perspective. The self-employed man at present pays a flat contribution of 12s. a week. Under the August Plan his contribution would vary from 10s. 1d. to 20s. 3d. according to his earnings. Thus many self-employed (small farmers and shopkeepers, for instance) would pay little more, or even less, than at present. If nevertheless it were thought necessary to reduce the contribution by a shilling or two, that could be done at comparatively little cost, because there are only about 1½ million self-employed altogether.

21. Abatement.—Mention was also made of the problem of abatement, which is already with us but would be accentuated by the August Plan. We should not, I think, exaggerate the difficulties of effecting abatement, which may well be less than the difficulties of contracting out (as witness the intention of so many employers to choose abatement rather than contracting out if faced with the September Plan). Nor should we exaggerate the extent of abatement which might be necessary. Teachers were mentioned in particular, but perhaps the precise effect of the August Plan was not appreciated. Teachers at present pay to the State scheme a contribution of 9s. 1d. (in addition to paying 6 per cent. of their earnings to their own occupational scheme). Under the August Plan (taking existing salary scales) they would pay to the State scheme, instead of 9s. 1d. flat, a contribution varying from 7s. 9d. to 12s. 9d. according to their place on the scale. (All these figures are for men; they would be lower throughout for women.)

D. H. A.

Treasury Chambers, S.W. 1,
2nd July, 1958.

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ANNEX

**Table of Overall Cost**

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