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Pension Rights and Wrongs

A CRITIQUE OF THE CONSERVATIVE SCHEME

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THREE SHILLINGS

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I. Introduction

UNTIL 1961, the British system of social insurance was based firmly on the principle of "flat rate" benefits in exchange for "flat rate" contributions. This was the basis laid down in 1911, when National Insurance began. Subsequent amendments brought more people into the scheme, widened the range of benefits, and altered the rates of contribution and benefit. In particular, old age pensions were brought into the National Insurance scheme by the Contributory Pensions Act of 1925; previously they had been paid out of general tax revenue and subject to a means test. In 1946 the scheme was expanded to bring in the middle class, and 400,000 old people who had not paid a penny in contributions before 1948 began to receive pensions on a single day, ten years later, in July 1958. National Insurance has travelled far in half a century, growing from a scheme of sickness insurance for certain categories of manual workers and unemployment insurance on a still more limited scale until now it covers practically the whole population, not only for sickness and unemployment benefits, but for retirement pensions, widows' benefits, maternity benefits and death grants.

Yet, through all these changes and innovations, the flat rate principle survived. The Beveridge Report endorsed it unequivocally:

> "Social insurance and national assistance organised by the State are designed to guarantee, on condition of service, *a basic income for subsistence*. The actual incomes and by consequence the normal standards of expenditure of different sections of the population differ greatly. Making provision for these higher standards is primarily the function of the individual, that is to say, it is a matter for free choice and voluntary insurance." [1] (My italics.)

Whatever differences there might be in incomes derived from work, Beveridge argued, those whose earnings were interrupted or terminated must receive equal treatment from the State. And because all received the same, all must pay the same. There were, it is true, different rates of contribution for women and juveniles, for the self-employed and non-employed, and for those with very low earnings; but within these broad classes the flat rate principle was firmly adhered to in the post-war legislation and throughout the 1950s.

Meanwhile, outside the field of National Insurance the practice of relating benefits to the individual's previous earnings became increasingly common. In most other countries social insurance benefits are, in part at least, related to earnings; and the people of Britain—or the more fortunate among them—have been demonstrating their limited faith in the flat-rate principle by adding private "wage-related" pension and sickness schemes to their flat-rate National Insurance benefits on a rapidly growing scale. Most of these schemes are operated by employers and offer little freedom

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[1] Cmd. 6404, 1942, p. 121.

of choice to the individual employee. Nevertheless, and in spite of certain undesirable features (in particular the threat of losing pension rights on a change of employment), they are generally regarded as desirable fringe benefits.

The Labour Party's Plan

The Labour Party's "National Superannuation" proposals, published in 1957[1], rejected the limitation of State pensions to a low flat rate. The existing National Insurance pension, it was suggested, should become the foundation upon which a larger wage-related pension would be built, the two elements together giving roughly half pay on retirement to the average wage-earner, considerably more than half pay to the lower-paid workers, and a lower proportion to those above average earnings. A scheme of these dimensions, financed by proportional wage-related contributions, would offer pensions which were not only much better than existing National Insurance benefits, but sufficient to maintain the pensioner at a standard of living reasonably close to what he had known during his working life. National Superannuation could thus be expected to supplant, to a considerable extent, the pension schemes provided by employers. At the same time, by the use of wholly wage-related contributions to finance pensions which would be only partially wage-related, a considerable degree of income redistribution would be assured—an element conspicuously lacking in the flat-rate National Insurance scheme.

The Conservative Government's Plan

The following year, the Government announced its plans for a new graduated pension scheme. In some ways its similarity to the Labour proposals was striking. It was, however, a very different scheme, with very different objectives, which were listed in the White Paper of October, 1958, as follows:

1. To place the National Insurance scheme on a sound financial basis.
2. To institute provision for employed persons who cannot be covered by an appropriate occupational scheme to obtain some measure of pension related to their earnings.
3. To preserve and encourage the best development of occupational pension schemes.[2]

The scheme was duly enacted and came into operation in April, 1961, **The object of this pamphlet is to examine this first departure from the tradition of flat-rate National Insurance benefits and contributions, from the point of view of its stated objectives and of its effects on the rights and obligations of the employees concerned.**

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[1] *National Superannuation* remains the basis of Labour Party policy on pensions. *New Frontiers for Social Security* (1963) proposes more generous terms for the over-50's and an Income Guarantee for all pensioners, but otherwise leaves the main features of the scheme unaltered.

[2] Cmnd. 538, 1958, p. 13.

A brief summary of the main provisions of the scheme may be helpful:—

(1) Contributions are payable by employed persons at the rate of 4¼ per cent on a band of earnings originally between £9 and £15 a week, but since June, 1963, extending up to £18. This graduated contribution is additional to the flat-rate contribution. A similar contribution, both flat-rate and graduated, is payable by the employer.

(2) Every £7 10s. of graduated contributions paid by a male employee constitutes one "unit" and earns an addition to the retirement pension of 6d. a week. For women, £9 of contributions make one unit. When the scheme commenced in 1961, a man earning £15 a week or more paid £13 4s. 4d. in graduated contributions in the course of a year, thus adding about 10½d. a week to his pension for every year's contributions. The maximum graduated pension earned by 47 years' contributions (from age 18 to 65) would therefore have been £2 1s. a week for a man; and £1 11s. a week for a woman contributing at the maximum rate for 42 years (from age 18 to 60). These would be added to the flat-rate pension, £2 17s. 6d. a week in April, 1961, now £3 7s. 6d.

The extension of the earnings on which graduated contributions are paid up to £18 in 1963 increased the maximum pension that can be earned by a new entrant to £3 2s. for a man and £2 6s. 6d. for a woman. In the early years of the scheme the graduated additions will be very small. A man who retires in 1966 after contributing at the maximum rate for 5 years will get only 5s. 6d. a week; a woman, 4s. 6d.

(3) Employers who have private pension schemes which satisfy certain conditions (broadly, they must offer pensions as good as the maximum obtainable from the State scheme) may contract out of the State scheme in respect of their employees or certain categories of them. Contracted-out employees pay a higher flat-rate but no graduated contribution. The decision to contract out is made by the employer, who must obtain a certificate from the Registrar of Non-Participating Employments.

(4) If a contracted-out employee leaves his employment before retirement age, provision must be made for preserving his pension rights up to the maximum level offered by the State scheme for a similar period of employment. This can be done by leaving his rights under the employer's scheme in "cold storage" until he reaches retirement age; or by transferring them to another contracted-out scheme operated by his new employer; or by a "payment in lieu of contributions", generally known as a PIL. The PIL is paid by the employer to the National Insurance Fund and is equivalent to the difference between (a) the higher flat-rate contribution already paid and (b) the maximum contribution (flat-rate plus graduated) payable in respect of employees in the graduated scheme. The employee's share of the PIL can be recovered from any refund due to him from the employer's scheme.

(5) The Exchequer pays a supplement amounting to one-quarter of the minimum flat-rate contributions payable by employers and employed persons and one-third of the contributions paid by self-employed and non-employed persons (who are excluded from the graduated scheme), subject to a minimum of £170m. a year.

II. Who Pays for Pensions?

"To place the National Insurance Scheme on a sound financial basis" (first objective of the graduated pension scheme—from the White Paper on Provision for Old Age, 1958).

POLITICALLY, the White Paper of October, 1958, *Provision for Old Age,* was the Conservative answer to Labour's National Superannuation scheme. But there was another, more practical, reason why a Government which, on grounds of principle, would more likely have continued to accept Beveridge's view of the role of National Insurance, nevertheless adopted the idea of graduated pensions: the imminent threat of a rapidly spiralling deficit on the National Insurance Fund which the Exchequer would have to meet.

Ever since old age pensions were put on a contributory basis by a Conservative Government in 1925, it had been recognised that large annual deficits were bound to emerge in later years. The reason was simple. Existing pensioners were allowed to draw pensions which they had not paid for by contributions during their working lives. From the beginning, the contributions collected each year were used to meet the current pension bill, instead of being invested in the National Insurance Fund to provide for future pensions. There was nothing wrong in doing this: indeed, as is explained below, it would have served little purpose to build up an enormous fund invested (as it inevitably would have been) in Government securities. Nevertheless, the decision to put pensions on a "pay-as-you-go" basis carried with it an inescapable corollary: the level of contributions required in order to meet the pension bill each year would vary not only with changes in the pension rate, but also with changes in the proportion of pensioners to contributors. It was known that this proportion would rise gradually, as people were not only tending to live longer but were producing fewer children. The number of pensioners would thus rise much faster than the numbers of contributors. It was never envisaged, however, that the contribution rates would be raised sufficiently to bear the whole of the increase in expenditure. On the contrary, the Exchequer was to come to the aid of the scheme, making good the growing discrepancy between reasonable contributions and current outlay on pensions.

When the scheme was overhauled and extended after the War, the same assumption was made. In his report on the National Insurance Bill, 1946, the Government Actuary predicted that, on the assumptions then adopted, the Exchequer's share of the cost of National Insurance benefits would rise from 26 per cent in 1948 to 56 per cent in 1978. The graduated pension scheme is an ingenious device to prevent the realisation of this prediction, thus avoiding the obligation freely accepted by both Conservative and Labour Governments.

Flat-rate Contributions—A Regressive Tax

If the financing of National Insurance is to be properly understood, it must be seen in the context of the British tax system as a whole. One of the more obstinate myths of the post-war period is that, while the benefits of the welfare state are bestowed mainly on the poor, the resulting burden of taxation is borne mainly by the rich. The truth is more complicated. While some taxes are progressive (i.e. they take a larger proportion of higher than of lower incomes), others are regressive, taking proportionately more from those who have less. Income tax and surtax are the most obviously progressive taxes, though even they are not as progressive as is often assumed, if the various forms of allowance and exemption, tax avoidance and illegal evasion are taken into account.[1] Indirect taxes, except those on luxury goods, are on the whole regressive, as are local rates. But of all the taxes that are levied on the British citizen, by far the most crudely regressive is the flat-rate National Insurance contribution—for it *is* a tax, regardless of the name we choose to give it.

The present flat-rate contribution of 11s. 8d. a week payable by employed men (other than those who are contracted out of the graduated scheme) represents 5.8 per cent of a wage of £10 but only 1.2 per cent of a £50 salary. The implications of these figures are obvious. The more we rely on flat-rate employees' contributions rather than progressive taxes (or even mildly regressive indirect taxes) to pay for National Insurance, the greater the proportion of the cost borne by the lower-paid worker.

The incidence of flat-rate contributions paid by employers is more difficult to analyse. To the extent that they are borne indirectly by the employee in lower wages, they have a similarly regressive effect. Even if they are passed on in higher prices, they are more regressive than direct taxes on income. Only to the extent that they are paid out of profits can they be regarded as a progressive tax—though less progressive than a direct tax on profits. In short, while the flat rate contributions paid by employers may be less objectionable than the employee's flat-rate contribution, it would be a mistake to regard them as a method of "soaking the rich". They may, on balance, have the opposite effect.

There is another way of financing National Insurance—by means of graduated contributions by employer and employee, varying with the income of the employee. This was the method proposed in *National Superannuation*, together with a generous contribution from the Exchequer. It was adopted by the Government in the new graduated scheme, but the graduated contributions were imposed in addition to the flat-rate whereas the Labour Party's proposals would have abolished the regressive flat-rate pension contribution altogether (except for those contracted out of the scheme). Moreover they are payable only on the band of earnings between £9 and £18. In effect, therefore, there are now two levels of flat-rate contribution —the lower level paid by those with earnings of £9 or less, and the higher level by those earning £18 or more—with a sliding scale in between. This system is better than a single flat-rate contribution, but it still contains a

[1] See R. M. Titmuss, *Income Distribution and Social Change*, 1962, *passim*.

strongly regressive element: £18 a week is not much more than average industrial earnings for a man, and no additional contribution is levied above this level of earnings. For women, on the other hand, most of whom earn less than £9 a week, the scheme is almost as regressive as the original flat-rate system. The effect of the change on the incidence of employers' contributions is probably negligible. The Government's limited excursion into the field of graduated contributions has therefore softened only marginally the regressive character of National Insurance finance. It still remains true that any shifting of the cost of pensions and other benefits from the tax-payer to the contributor tends to increase the share paid by the lower-paid worker.

From the point of view of the Government, however, National Insurance contributions have obvious attractions. Quite apart from any theoretical arguments about preserving the insurance basis of the scheme, the hard fact is that they are a convenient way of raising very substantial sums of money. They arouse little resentment, because the contributor expects to share in the benefits which he is helping to pay for. Any attempt to exact a comparable levy from the lower-paid worker by any other means would certainly provoke bitter opposition. The pertinacity with which the Government has pursued its policy of raising the level of contributions rather than allowing increasing deficits to be met out of general taxation is therefore understandable; but it is totally inconsistent with the principle of "from each according to his ability".

The Exchequer's Contribution

The Exchequer contributes towards the cost of National Insurance in four ways. First, there are what are known as Exchequer supplements. These are the Exchequer's share of the tripartite contribution, usually calculated as a proportion of the contributions of employers and insured persons. Secondly, provision has been made in the past for additional payments by the Exchequer over and above the normal annual supplement. Thirdly, the Exchequer has to pay interest on the investments of the National Insurance Fund, since the Fund is invested in Government securities. Lastly, the Exchequer must make good the annual deficit on the Fund—the amount by which expenditure exceeds income from all other sources. Such a deficit could theoretically be met by disposing of some of the Fund's investments but, since these are Government securities, a decision to sell some of them would only be made in the light of the Government's general monetary policy. The Government therefore does not regard the investments of the National Insurance Fund as being available to offset a deficit on the current operations of the scheme.

If, on the other hand, the National Insurance Fund shows a surplus on the year's operations, that surplus goes to reduce the Exchequer's total contribution for the year. The Fund increases its holdings of Government securities, and the Exchequer thus receives back, as a loan from the Fund, part of the money it had paid in supplements, additional payments and interest.

This rather complicated explanation is necessary because of the way in which the accounts of the National Insurance Fund are presented. There is, however, a much simpler way of arriving at the share of the cost borne by the Exchequer in any year; and that is by subtracting the contributions of employers and insured persons from the total expenditure of the Fund. Purists may object that one is confusing outright payments with loans, but so far as the total sum to be found each year out of taxation revenue is concerned, the result is the same.

Using this method, we can now analyse more closely the problem which faced the Government in 1958 and the solution it adopted. Both the problem and the effectiveness of the solution are illustrated by Table 1, covering the period from 5th July, 1948 (when the provisions of the National Insurance Act, 1946, came into effect) to 31st March, 1962.

TABLE I.

The Exchequer contribution to the National Insurance and Industrial Injuries Funds, 1948-49 to 1961-62

Year	*Expenditure of N.I. Funds (including Industrial Injuries)* £m	*Gross Exchequer contribution* (See note 1) £m	*Surplus (deficit) for year* (See note 2) £m	*Net Exchequer contribution* £m	*Proportion paid by Exchequer* %
1948-49 (9 months)	281	114	102	12	4.3
1949-50	400	169	159	10	2.5
1950-51	404	178	164	14	3.5
1951-52	430	144	120	24	5.6
1952-53	512	96	23	73	14.3
1953-54	543	123	54	68	12.5
1954-55	557	133	59	74	13.3
1955-56	670	151	50	101	15.1
1956-57	698	159	51	108	15.5
1957-58	762	167	20	147	19.3
1958-59	976	235	16	219	22.4
1959-60	1018	243	—	243	23.9
1960-61	1034	248	(7)	255	24.7
1961-62	1201	258	30	228	19.0

NOTES

1. Gross Exchequer contribution = Exchequer supplement + "additional payments" + interest ± profit or loss on realisation of investments.

2. Surplus for year = current year's income less current year's expenditure.

The very low Exchequer contributions in the early years were due to the emergence of large annual surpluses resulting mainly from the fact that unemployment was much lower than had been allowed for in fixing the contribution rates. In 1949-50 (the first full year), for example, the Exchequer contributed, on paper, £169m., made up as follows:

Exchequer supplement to National Insurance Fund	£96m.
Additional payment to National Insurance Fund	£40m.
Contribution to Industrial Injuries Fund	£6m.
Interest, less losses on realisation of investments	£27m.
Gross Exchequer contribution	£169m.

But after adding to this the contributions paid by insured persons and employers, there was a surplus on the two funds for that year of £159m., and this sum was returned to the Exchequer as a loan from the National Insurance Funds. Thus the Exchequer's net contribution for the year—the amount that actually had to be raised by taxation or other means—was not £169m. but only £10m.

In 1951 the Government, taking advantage of the temporarily healthy state of the Funds, reduced the Exchequer supplements and suspended the additional Exchequer grants laid down in the 1946 Act. In 1952-53, therefore, the surplus on the two Funds was only £23m. It rose slightly in the next two years, but in 1957-58 the income of the National Insurance Fund balanced the expenditure almost exactly (the surplus of £20m. shown in Table 1 is nearly all attributable to the Industrial Injuries Fund). This meant that, although the Exchequer payments had been reduced in 1951, the real contribution made by the Exchequer was much greater in 1957-58 than it had been in 1949-50, since there was no longer a large surplus to set off against it. In 1949-50 the Exchequer had provided one-fortieth of the total cost; in 1957-58 it paid nearly a fifth. In subsequent years the Fund was expected to go into the red, with steeply mounting deficits falling upon the Exchequer, reaching £400m. a year in about 20 years. This process continued until 1960-61, when the deficit on the National Insurance Fund reached £41m. (largely offset by the continued surplus on the Industrial Injuries Fund). In that year, the Exchequer paid a quarter of the total cost. In 1961-62, if the scheme had continued unaltered, the proportion would have risen to nearly a third; but in April, 1961, the graduated scheme came into operation, and the Exchequer's net contribution immediately fell to 19 per cent.

This reduction in the Exchequer contribution, large though it was, was only a beginning. The graduated scheme, as originally presented in 1958, was carefully designed not only to wipe out the immediate deficit, but also to keep the scheme in balance in the later years when much larger deficits would otherwise have emerged. The new graduated contributions were expected to yield £196m. in 1961-62, rising to about £400m. by 1981-82. The Government Actuary was thus able to produce neat tables showing an almost exact balancing of income with expenditure for several decades ahead. "Pay-as-you-go" was for the first time officially declared to be the principle on which the scheme was to operate in future. At the same time the growing yield of the graduated contributions was to be used to reduce still further the proportion of the total cost borne by the Exchequer. From one-fifth in 1961-62, the Government Actuary predicted that it would fall to one-seventh in 1981-82 (excluding the graduated benefits which will be

financed entirely by graduated contributions; if they were included, the Exchequer share of the cost would be smaller still). Increasingly the cost of pensions was to fall on the regressive system of contributions.[1]

Exchequer Burden Further Reduced

Before the new scheme commenced in April, 1961, it was amended by the National Insurance Act, 1960, which increased the flat-rate contributions and benefits. In doing so, it had the indirect effect of reducing still further the proportion of the cost to be borne by the Exchequer, at least in the early years of the scheme. The Exchequer supplement is calculated as one quarter of the minimum flat-rate contributions paid by employees and their employers plus one third of self-employed and non-employed persons' contributions, with a minimum of £170m.[2] The higher contributions brought the supplement for 1961-62 above the £170m. minimum, but only by £17m. Even on paper, therefore, the Exchequer was to bear only £17m. of the total cost of the increase, estimated at £141m. In fact, however, the new situation was still more favourable to the Exchequer for two reasons.

First, the rate of unemployment assumed by the Government Actuary was reduced from 3 per cent to 1¾ per cent. The net increase in estimated expenditure was therefore not £141m. but £120m. Secondly, the increase in contributions from insured persons and employers was estimated to yield an extra £136m. in 1961-62; £16m. more than the increase in expenditure. Instead of paying £17m. more, therefore, the Exchequer was to pay £16m. less, its share of the total cost being thus reduced from the 20 per cent originally estimated for the year 1961-62 to about 17½ per cent. It is true that the Government Actuary now warned that there might be small deficits during the ten years 1966-76, but these were more than balanced by the surpluses expected in the first five years; and an unemployment rate of 2½ per cent instead of the 3 per cent assumed for the later years would convert the deficits into small surpluses. In any event, the scheme was certain to be amended again long before 1966.

In the event, the scheme proved slightly less profitable to the Exchequer in its first year of operation than the estimates had shown. The reasons for this were, first, that there was far more contracting out than the Government had allowed for, with a corresponding loss of graduated contributions; and secondly, the fact that graduated contributions take some time to reach the National Insurance Fund. The higher flat-rate contributions

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[1] The figures given in this and the following paragraphs relate to the National Insurance Fund only, excluding the Industrial Injuries scheme and National Health Service contributions, except where otherwise stated.

[2] The 1958 White Paper proposed a fixed Exchequer supplement of £170m., which would have represented a declining proportion of the rising cost of pensions. As a result of criticism, the present formula was introduced and the £170m. became a minimum. The supplement was expected to rise above the minimum after 1970-71, reaching £203m. by 1981-82. This apparent concession was a mere paper transaction, since any increase in the supplement would produce a surplus on the Fund which would flow back to the Exchequer.

paid by those contracted out only partly compensated for these factors, leaving an extra £24m. to be paid by the Exchequer. Even so, the Exchequer's share of the cost remained as low as 19 per cent for 1961-62. Moreover, part of the missing £24m. will be recovered in subsequent years in the form of "PILs"[1] when contracted-out employees change their jobs.

There are grounds for thinking that the National Insurance Act, 1960, may have been the second stage of what was conceived from the beginning as a single operation; the introduction of graduated contributions on the one hand and the simultaneous raising of the flat-rate benefit as a *quid pro quo* on the other. The treatment of the flat-rate contributions in the two Acts of 1959 and 1960 lends colour to this interpretation. One of the principal attractions of the original proposals in the 1958 White Paper and of the 1959 Act was a reduction in the employee's flat-rate contribution. This reduction was to have taken place at the commencement of the new scheme in April, 1961. The 1960 Act, however, increased the flat-rate contributions by almost the same amount as the promised decrease, in order to pay for the major part of the increase in benefits. The net result was a reduction of only 2d. in the flat-rate contributions (including the Industrial Injuries and N.H.S. elements) for a man in April, 1961, while the rate for a woman remained precisely the same. It is just conceivable that the almost exact balancing of the two sides of this transaction was a pure coincidence. The Government must surely have realised, however, when the details of the graduated scheme were published in 1958, that by the time it came into operation 2½ years later there would be strong pressure for an increase in existing pensions. The obvious time to give such an increase was at the commencement of the graduated scheme. The administrative nightmare of two changes in both contributions and benefits within a few months of each other would have been formidable at any time, but especially so at a time when the problems of collecting graduated contributions were being faced for the first time. If it is true that the whole operation was planned in 1958, the effect of the 1960 Act in further reducing the Exchequer's share of the cost becomes all the more significant.

In April, 1961, the new scheme came into operation. It differed surprisingly little from the original blue print in the 1958 White Paper. The graduated scheme itself was virtually unamended. The changes introduced by the 1960 Act related only to the flat-rate benefits and contributions and, indirectly, the Exchequer supplement. To sum up the effect of the events described above on the Exchequer's share of the cost of National Insurance (excluding graduated pensions):

(a) If the new scheme had not been introduced, the Exchequer, according to the Government Actuary's estimate in 1958, would have borne 30 per cent of the total cost in 1961-62 and still more in subsequent years.

(b) The 1959 Act reduced the Exchequer's contribution to about 20 per cent for 1961-62 and 14 per cent for 1981-82.

(c) The 1960 Act further reduced the Exchequer's estimated contribution for 1961-62 to about 17½ per cent; but, as a result of the unexpectedly

[1] Payments in lieu of contributions (see page 3).

large number of employees contracted out, the actual proportion of the cost borne by the Exchequer in 1961-62 was 19 per cent.

The Government had succeeded in balancing the books of the National Insurance scheme by means of the new graduated contribution—essentially a regressive tax because it took as much from those earning £15 a week as from the highest-paid executive. The obligation, accepted by previous Governments, to meet the emerging deficits out of general taxation had been repudiated. It was more than a coincidence that in the same month as the graduated contributions began, the Chancellor of the Exchequer announced the raising of the starting point for surtax on earned incomes from £2,000 a year to £5,000, at a cost of £83m. in a full year. Without the graduated pension scheme, that £83m. would have been needed to meet part of the deficit on the National Insurance Fund.

The National Insurance Act, 1963

In January, 1963, the Government announced another increase in National Insurance benefits—the first since the introduction of the graduated scheme. The principal benefit rates were to be raised from 57s. 6d. to 67s. 6d. for a single person and from 92s. 6d. to 109s. for a married couple, adding £200m. to the cost in a full year. To pay for this increase, both flat-rate and graduated contributions were raised. Just as the introduction of a graduated scheme two years before had been primarily a means of increasing the contribution income of the scheme, so the decision now to increase the graduated contributions appears to have been dictated by the need to pay for higher flat-rate benefits rather than by a desire to expand the graduated pension scheme itself. For, although in terms of cost and numbers affected, the National Insurance Act, 1963, is mainly concerned with pensions, it was clearly inspired by the pressing demand that something should be done for the growing numbers of unemployed men and their families. The Government resisted the advice of the *Economist* and others that unemployment benefit alone should be raised—a policy which could hardly have been defended on grounds of either need or equity. But it would have been easy to raise all the flat-rate benefits, as was done in April, 1961, without amending the graduated scheme.

The Government must certainly have been reluctant to tamper with the graduated scheme so soon after its introduction. It had been conceived with the limited aim of raising enough money to cover the prospective deficits without seriously competing with private pension funds and insurance companies. To increase its scope by a half after only two years was hardly consistent with this aim. Moreover, any adjustment of the graduated scheme would necessitate the revision of thousands of contracted-out schemes, involving employers and insurance companies in a vast amount of administrative work. Given the Government's determination to keep the Exchequer contribution to a minimum, however, there were only two sources from which the additional £200m. a year could be found; the flat-rate contributions and the graduated contributions. There were a number of reasons for relying, at least in part, on an extension of the graduated contributions.

In the first place, a big increase in the flat-rate contribution would have been needed in order to meet the full cost, even after allowing for some increase in the Exchequer contribution. As it was, contracted-out employees had to pay an additional 1s. 11d. for men and 1s. 8d. for women (including Industrial Injuries and N.H.S. contributions). To impose flat-rate increases of this size on those in the graduated scheme, including the great majority of lower-paid workers, would hardly have been a popular solution. Secondly, the Exchequer supplement is calculated as a proportion of the flat-rate minimum contributions. Any increase in flat-rate contributions therefore entails a corresponding increase in the Exchequer supplement. The graduated contributions, on the other hand, do not attract an Exchequer supplement. By raising £48 million of the £200 million through an increase in graduated contributions, the Exchequer was able to keep its share of the total about £10m. lower than it would otherwise have been. Thirdly, the yield of the graduated contributions rises automatically with average earnings. Thus, while the yield of the flat-rate increase is expected to rise very slowly from £130m. in 1964-65 to £144m. in 1981-82, that of the additional graduated contribution will shoot up from £46m. to £135m., even on the basis of the Government's very conservative assumption of a 2 per cent annual increase in average earnings. Looking to the future, therefore, an increase in the graduated contribution is a useful nest-egg. Fourthly, an increase in contribution which counts towards a higher pension for the individual contributor is an easier selling line than a flat-rate increase which only benefits existing pensioners; and although a higher graduated contribution entails a higher pension bill, this does not have to be met in the early years of the scheme.

For all these reasons, the temptation to use the graduated scheme as a source of additional funds to meet the higher flat-rate benefits was strong. It is arguable that the Government genuinely felt the time had come to adjust the graduated scheme in line with the general rise in earnings since it was introduced. The nature of the adjustment that was made, however, does not suggest that this was the dominant motive. For, while the upper limit of earnings on which graduated contributions are calculated was raised from £15 a week to £18, the lower limit remained at £9. The £9-£15 band of earnings, it appears, was originally intended to bear some relation to the level of earnings at the time. During the Committee stage of the 1959 Bill, Mr. Boyd-Carpenter said:

> "The latest figure of average industrial earnings for men is £12 13s. 2d. a week. The £9-£15 bracket, therefore, straddles that figure fairly comfortably." [1]

It was reasonable that, since earnings had risen substantially, the band on which contributions were levied should also rise. But if the intention was to preserve the relationship between the band of income subject to contributions and the level of average earnings, it is obvious that the adjustment should have been made at both ends. During the Second Reading debate, the new Minister, Mr. Macpherson, was tackled on this point.

[1] *Hansard,* H. of C., Standing Committee A, 19th February, 1959, cm. 103.

by one of his back-benchers. The Minister had argued that " as average earnings rise, it would not accord with the design of the scheme that the span of earnings to which graduated pension provision is related should remain unchanged. . . ."

> *Sir Spencer Summers*: " While it is understood that there is a case for increasing the upper limit for the reasons which my right hon. Friend has given, when the limits were originally fixed it was thought proper to fix the lower limit at £9 to exclude some of the lower-paid workers. Is not the case equally strong for raising that at the same time as raising the upper limit? "
>
> *Mr. Macpherson*: " If we were to do that we would, in some measure at any rate, be taking away from people the prospect of benefiting from the graduated pension scheme. *In any case, we would be very greatly reducing the contribution to the general National Insurance Fund*" (my italics).

Further pressed from both sides of the House, the Minister added:

> ". . . I can see no prospect of the Government being able to vary the lower limit. The lower limit was fixed in 1959 and I think that it should remain at that level."

The upper limit was also fixed in 1959, which did not prevent it from being raised in 1963. . . .

The impression that this extension was a response to the immediate needs of the National Insurance Fund rather than a logically planned development of the graduated scheme is fully confirmed when its implications for the future are considered. Let us project forward to, say, 1980 the principle of raising the upper limit for contributions as earnings rise, while leaving the lower limit at £9. Assuming an annual increase of 5 per cent. in average earnings, which makes little allowance for inflation (the instructions given to the Government Actuary to assume an annual increase of 2 per cent. make no allowance at all for inflation), the average industrial male wage-earner will be earning over £36 a week in 1980, or about 2¼ times what he earned in 1963. In accordance with current policy Mr. Macpherson, who by then will have broken Mr. Boyd-Carpenter's endurance record as Minister of Pensions, will raise the upper earnings limit for graduated contributions to £40 a week (2¼ × £18). Pressed to amend the lower limit, he will no doubt point out that it was fixed at £9 in 1959 and should therefore remain at that level. Graduated contributions will thus be levied at 5¼ per cent. (following the four quinquennial increases) on all earnings between £9 and £40. The average male wage-earner, who now pays 1.9 per cent. of his *total* earnings in graduated contributions, will then be paying 3.9 per cent., or an extra 2 per cent. The man earning twice the average (now £32, in 1980, £72) will be paying 2.3 per cent. instead of 1.2 per cent., or an extra 1.1 per cent.; while the lowest paid male wage-earner, whose earnings will have risen from £9 to about £20 a week, will be paying 2.9 per cent., whereas now he pays no graduated contributions at all. By pegging the lower contribution limit at £9, an increasing burden

[1] *Hansard*, H. of C., 28th January, 1963, cms. 599-601.

will be laid on the lower-paid worker. This process has already begun in the period since the graduated scheme started in April, 1961. Even if a man's earnings have only increased in line with rising prices, so that he is no better off, he will be paying a higher proportion of his income in graduated contributions now than in 1961, simply because more of his earnings now fall above the £9 limit.

There is little doubt that, in practice, the Government would feel obliged to raise the lower limit from £9 long before 1980 in recognition of the general rise in the level of earnings. But if it is logical to do this in 1965 or 1970, why not in 1963? One reason, no doubt, is the embarrassment of having to explain to the £10 a week man that by being excluded from the graduated scheme he was being exempted from a tax rather than deprived of a privilege, since a large part of the graduated contribution goes—even in the long run—to reduce the Exchequer's liability for flat-rate benefits. The main reason, however, is undoubtedly that to exempt the lowest-paid workers from the graduated levy would " very greatly reduce " the income of the fund in the immediate future.

Future Policy—the Alternatives

The decision to raise the maximum graduated contribution in 1963, while leaving the starting point unchanged, is thus in keeping with the Government's policy of transferring the emerging cost of National Insurance from the tax payer to the contributor. Of the £200m. additional annual expenditure resulting from the increases in benefits, £48m. is to come from the higher graduated contributions in the first full year, 1964-65 ;[1] £130m. from flat-rate contributions, and only £23m. from the Exchequer, making the total Exchequer contribution for that year about 19 per cent. of total expenditure. In the following year, as a result of the first quinquennial increase in contributions, it will fall to about 16 per cent. Still more significant, however, is the effect on the scheme in future years of the automatic growth in the yield of the graduated contributions as earnings rise. The Government Actuary's latest estimates for 1981-82 show that, as a result of the changes made by the 1963 Act, the expenditure of the National Insurance Fund will be £264m. higher than it would otherwise have been. On the income side, the graduated increase will produce an extra £135m. and the flat-rate an extra £144m., or £279m. in all ; £15m. more than the increase in expenditure. This £15m. will go to reduce the Exchequer contribution. If average earnings rise by more than 2 per cent. per annum (as they almost inevitably will) the yield of the graduated contributions will be still higher, and the Exchequer contribution correspondingly lower. Even on the basis of the Government Actuary's figures, however, in 1981-82 the Exchequer will pay only 11½ per cent. of the total cost of National Insurance (excluding graduated pensions) compared with the 14 per cent. envisaged by the 1959 Act and the 56 per cent. predicted by the Government Actuary in 1946.

[1] The year 1963-64 is exceptional in that the increases in short-term benefits under the National Insurance Act, 1963, took place before the increases in contributions. The cost of this emergency operation fell on the Exchequer; but none of it related to pensions.

There is no simple answer to the question " Who is to pay for National Insurance? " There are those, mainly on the Left, who would use National Insurance as a means of redistributing income from rich to poor; and there are those, mainly on the Right, who would make each individual pay the full cost of all benefits to which he is entitled. But whatever view is taken as to who *should* pay, it is obviously important to know who actually *is* paying.

The policy of the Government, which underlies both the original proposals of the 1958 White Paper, *Provision for Old Age,* and the provisions of the National Insurance Acts of 1959, 1960 and 1963, is to pay for National Insurance benefits out of contributions rather than out of general tax revenue. Since the present system of contributions is extremely regressive, whereas the tax system as a whole is, if not progressive, at any rate markedly less regressive, this policy tends to result in a gradual increase in the proportion of the cost borne by those in the lower income brackets. Without knowing much more than we do about the way our tax system works, we cannot say precisely what proportion is paid by the different income groups. Nevertheless it is clear that the redistributive effect of National Insurance is reduced by transferring the cost from the Exchequer to the contributor.

It must be emphasised, however, that this need not be the case. The significance of the present emphasis on contributions rather than taxation as the main source of revenue for the National Insurance Fund does not lie in any inherent advantages or disadvantages of contributions as such. A system of graduated contributions such as that proposed by the Labour Party, eliminating the flat-rate contribution altogether, is not regressive and, since the benefits would be only partly wage-related, involves a substantial element of redistribution from rich to poor. This would be one way of concentrating the cost on those who can best afford it—a graduated contribution covering the whole range of earnings from the lowest to the highest.[1] Another way is to increase the proportion paid by the Exchequer out of the proceeds of progressive taxation.

The present modified flat-rate system achieves the worst of both worlds. The contributions are regressive, the highest percentage contributions being payable on the lowest earnings; and only a very small proportion of the cost is met by the Exchequer out of general taxation. This proportion is likely to fall still further in future years, according to the Government Actuary's estimates. And if past experience is any guide, the assumptions on which those estimates are based are likely to prove unduly pessimistic from the point of view of the Exchequer.

What about benefits given to worker?

[1] The Labour Party policy statement did not in fact propose a graduated contribution on all earnings without limit, but the limit was to be very high—possibly four times the average wage. It should also be noted that, while the incidence of the contributions below the limit would not be regressive, the effect of allowing them as a deduction from income for tax purposes *would* be regressive.

III. The Graduated Pension

"To institute provision for employed persons who cannot be covered by an appropriate occupational scheme to obtain some measure of pension related to their earnings."
(*Second objective of the graduated pension scheme.*)

THE Labour Party's National Superannuation plan defines an adequate pension as one which prevents a "catastrophic fall in living standards" on retirement. It therefore aims at providing, in due course, a pension equivalent to half pay for the average wage-earner; rather more than half pay for those with earnings below the average, rather less for those with earnings above the average. The "dynamic" formula on which the pension is based ensures that it will always be related to the average level of earnings at the time when it is paid, not to the level of earnings at the time when the contributions were made. The pension is thus not only protected from the effects of inflation but geared automatically to the rising standards of living of the nation.

Adequacy in this sense was not one of the aims of the Government's graduated scheme. The emphasis was rather the other way—on the dangers of being too ambitious:

> "The Government believe that it would not be right to force everyone to contribute more through a state scheme than would be needed for a reasonable provision for old age. For the state to go further would be to arrogate to itself the individual's right to dispose of his income in what he thinks the right way, and would seriously undermine the individual's sense of responsibility for his own affairs." [1]

The objections to providing too much were not based solely on this nineteenth-century view of freedom and responsibility. The Government was also concerned as to the effect of its graduated scheme on private pension schemes. Although private schemes were to be allowed to contract out it was

> "certainly no part of the Government's policy to face those concerned with the bare choice between abandoning their schemes and contracting out, which would be posed by a state scheme that had been made on too ambitious lines." [2]

In other words, whereas National Superannuation had been conceived as offering an alternative to private pension provision, this scheme was deliberately pitched at a level which left room for private schemes to operate concurrently with it. Partly, no doubt, this policy derived from a genuine belief, not shared by the authors of National Superannuation, in the superiority of employers' pension schemes over any State scheme. Partly it reflected the influence of the insurance companies and others. Whatever the motives, the result was that the benefits of the scheme were set at a very low level indeed. This can be demonstrated by comparing the combined flat-rate and graduated pension for a married couple pro-

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[1] *Provision for Old Age,* Cmnd. 538, 1958, p. 10.
[2] *Loc. cit.*

posed by the 1958 White Paper with the National Assistance scales then in force:

Maximum pension for married men retiring in (including £4 flat-rate)	1971	£4 9 0
	1981	£4 17 6
	1991	£5 6 6
	2001	£5 15 0
National Assistance—basic scale + average rent,	1958	£4 15 0

After paying graduated contributions at the original maximum rate (i.e. on earnings between £9 and £15) for ten years, a married pensioner with no other resources would still have had to rely on National Assistance. Even after 20 or 30 years' contributions, the maximum pension would in many cases fall below National Assistance level, bearing in mind that most pensioners on assistance receive more than the basic sum laid down in the National Assistance Regulations.[1] Moreover only a minority would earn £15 a week or more consistently enough to qualify for the maximum pension.

It was of course quite unrealistic to assume that the scheme would continue unamended until the year 2001. As we have shown, average earnings could easily rise to £36 a week by 1980; and even on the Government's assumption of a rate of increase as low as 2 per cent. from 1958 on, they would have reached £30 by 2001. Mr. Boyd-Carpenter stated, during the Committee stage of the 1959 Bill, that "it is inconceivable that a new entrant today is likely to draw early in the new century a pension on the present basis." He suggested three methods by which additional revenue could be raised to pay for future increases in the benefit rates: "by increasing the flat-rate contribution or by raising the 'ceiling' for graduated contributions, or by increasing the percentage."[2] He did not, however, indicate what principles the Government proposed to follow in deciding on the amount of such increases. Since National Assistance rates would just as certainly have to be raised, there were no grounds for thinking that the net effect of the changes would be to alter radically the relationship between pension and Assistance rates. This impression was confirmed by subsequent events. After the increases of April, 1961, and June, 1963, the maximum pension for a married man retiring in 1981 would be not £4 17s. 6d. but £6 14s. 6d.; while the National Assistance rate for a married couple, including average rent, has risen slightly less since 1958, from £4 15s. 0d. to about £6 7s. 0d. On the other hand, the flat-rate pension for those earning £9 a week or less, and for existing pensioners, has risen only from £4 to £5 9s. 0d., so that it is now even further below the National Assistance level than it was in 1958. On balance, therefore, it cannot be said that the changes made in the scheme so far have reduced either the present or future dependence of pensioners on the National Assistance Board. It is difficult to see how they could

[1] In December, 1962, 65.5 per cent. of retirement pensioners on Assistance received discretionary additions to the published scales, averaging 8s. 4d. a week

[2] *Hansard*, H. of C., Standing Committee A, 24th February, 1959, cm. 173.

have done so without conflicting with the third objective of the graduated scheme—the encouragement of occupational schemes. The implications of this objective are discussed in the next chapter. First, however, the problems of amending the scheme as average earnings rise must be examined from another angle.

Retrospective Changes

Although the Government has never given any undertaking on the subject, it has generally been assumed that any change in the relation of graduated benefits to graduated contributions would apply only to contributions made after the date of the amendment. The significance of this assumption is twofold. First, it means that, for example, the graduated pension of about 10½d. a week earned by the maximum graduated contribution for a man in the first year of the scheme, 1961-62, will remain 10½d., no more and no less, whatever happens to the price level between 1961-62 and the man's death, and whatever changes are made subsequently in the contribution rate or in the size and pension value of a " unit " of contributions. If he is a young man, he may still be drawing 10½d. a week in return for that first year's contributions 60 or 70 years hence, though its real value may by then have been reduced by inflation to 6d., 3d., or even 1d. a week. Secondly, the assumption that there would be no retrospective amendments has entered into the calculations of employers considering whether to contract out of the scheme. Those who did contract out will have made the necessary provision to pay a pension of 10½d. a week on retirement to each of their male employees in respect of service during the year 1961-62. In many cases they will have paid insurance premiums calculated on this basis. These employers, or the trustees of their pension funds, could be very seriously embarrassed by having, at some future date, to increase the pension rights earned by employees' past contributions. To do so might involve making a very large lump sum payment to keep the scheme in balance—a payment which some of them might simply not be able to afford. It would be possible, at least in theory, to make a retrospective adjustment to the Government scheme without requiring a corresponding adjustment in contracted-out schemes; but this would deprive contracted-out employees of the equal treatment they have been led to expect.

Here, then, is a real dilemma for the Government. Sooner or later, it must face the uncomfortable alternatives of either allowing the pension rights earned in the early years of the scheme to be steadily eroded by inflation (a process which is already taking place), or making retrospective adjustments which will inevitably jeopardise the rights of employees and pensioners who have been contracted out of the scheme. In view of the traditional repugnance with which retrospective legislation of any kind is viewed in this country, it might be supposed that the first alternative was more likely to be chosen. Mr. Arthur Seldon, for example, considers that " the view that increases in benefits and PILs would be retrospective seems unrealistic and alarmist." [1] But somewhat different views were ex-

[1] *The Times*, 23rd January, 1963.

pressed during a discussion of the contracting-out proposals at a meeting of the Institute of Actuaries in November, 1958. Mr. W. G. Bailey, Actuary of the Eagle Star Insurance Co. Ltd., opening the discussion, said that:

> "The big danger, and it was a real danger, was that future changes in the basic scheme would affect retrospectively the graduated benefits, and that threw on to the employer an unknown liability for the future." [1]

Even employers whose schemes provided pensions based on "final salary," and who had therefore already accepted the liability of adjusting the pension to the current level of earnings at the date of retirement, would have to face the additional liability of adjusting pensions already in payment.

Mr. F. H. Spratling, Head of Establishments of the London Transport Executive, pointed out that the problem was not a new one. Public servants, employees of certain public utilities and railway clerks had been "excepted" from the original contributory old age pension scheme in 1925, and had therefore not benefited from the increases in State pensions in 1946 and subsequently. A series of Pension (Increase) Acts had provided only partial redress. As a result,

> "large numbers of old people, who had been excepted from State pensions insurance in the past because their occupational pensions had looked better than the state pensions, were in the event worse off than they would have been if they had not had occupational pension at all."

Against the remedy of placing a retrospective liability on employers he set

> "the practical difficulties that could surround the enforcement of such an obligation one or two generations after it had been incurred by an employer who no longer existed."

Nevertheless, the "craftsman of 2008" with his £40 wage would not be content with a pension of £6 1s.

> "It seemed clear that a continuing obligation on somebody would be required if history was not to be allowed to repeat itself. By that token, he judged that an employer who contracted out had to be prepared to sign a blank cheque on the future." [2]

The only dissenting view was expressed by Mr. G. W. Pingstone, Deputy Actuary of the Legal and General Assurance Society Ltd., who discounted the possibility of any retrospective liability being laid on employers.

> "Therefore, the only thing an employer could possibly suffer subsequently as the result of contracting out was not financial hardship but trouble with his employees, which was rather a different point, and in that connection it had to be borne in mind that they would have agreed to the proposition in the first place." [3]

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[1] *Jnl. of the Institute of Actuaries,* Vol. 85, Pt. I, No. 369, 1959, p. 33.

[2] *Ibid.,* p. 36.

[3] *Ibid.,* p. 43.

Since the White Paper had made it quite clear that an employer would be permitted to contract out against the wishes of a substantial number of his employees (though the Government took the view that " no employer would be well advised or likely " to do so), Mr. Pingstone was hardly justified in assuming that the employees would have agreed to the proposition. More to the point, however, is the fact that even Mr. Pingstone recognised the possibility of retrospective changes in the State scheme. It is not clear on what grounds he assumed that employers would not be required to make similar changes in contracted-out schemes.

Nothing has happened since 1958 to invalidate these views. It is true that the changes in the graduated contributions and benefits in June, 1963, did not include any retrospective adjustment, but this is little comfort since the graduated pensions payable in the first few years of the scheme are too small for inflation to reduce them significantly. It is also true that it would be possible to cover up the loss of pension rights on past years' contributions by periodic increases in future contributions. This method, however, can be no more than a stop gap. It offers no protection against the erosion of pensions by inflation after retirement; and every time contributions are increased to compensate older contributors for the decline in the real value of their pension rights, new obligations to the younger contributors are accepted, thus laying in store still greater problems for later years when these higher benefits are in turn threatened by inflation. In the long run, the value of accrued pension rights in the present graduated scheme can only be protected by a steady expansion of the whole scheme. Each step in this expansion would have to be greater than would be required merely to safeguard the rights of future contributors, since it would include a subsidy to past contributions. The spiralling process could not continue indefinitely, but it could affect quite radically the dimensions of the scheme and its impact on private employers' schemes.

The only satisfactory solution would seem to be the adoption of an automatic " elevator " of the kind proposed in *National Superannuation*. This would have the effect of guaranteeing in advance that accrued pension rights in the State scheme, as well as pensions actually in payment, would be adjusted in proportion to the increase (or decrease) in average national earnings. Employers wishing to contract out would have to give a similar guarantee and show that they were, and would remain, in a position to honour it. The effect of such a requirement in reducing the number of employers able to satisfy the conditions for contracting out is discussed in the next chapter. The point to be noted here is that only in a scheme of this kind would it be possible to guarantee the real value of State pensions, and their position in relation to the living standards of those still at work, without unfairness to members, both past and present, of contracted-out schemes.

IV. Contracting Out

"To preserve and encourage the best development of occupational pension schemes" (Third objective of the graduated pension scheme).

IN the last half-century and particularly in the last twenty years, there has been a very rapid growth of pension schemes administered by employers and insurance companies. According to a recent estimate about 10 million employees are now covered by such schemes, of whom roughly 4 million are in public and 6 million in private employment.[1] The latter figure has doubled in a decade and is still growing rapidly, but there are still millions of employees with no private pension provision, particularly among lower-paid manual workers and in industries where labour turnover is high. While over half of all employed men are members of employers' schemes, the proportion of women covered is very much lower. Moreover, the schemes vary widely in the scale of benefits, the basis on which they are calculated, the proportion of benefits payable as tax-free lump sums, the provision for preserving pension rights on a change of employment, the degree of protection against inflation, the benefits payable to dependents in the event of death, and in many other ways. They fall into three main groups, with much overlapping.

(1) For manual workers, the pension offered is usually modest in amount, often related to length of service rather than to past earnings, with no provision for preservation on change of employment.

(2) For salaried employees, the pension is usually based on either final or average salary, often reaching half or two-thirds of salary after 40 years' service; up to a quarter of the total benefits can often be drawn on retirement as a tax-free lump sum, and provision is sometimes made for preservation of rights on change of employment.

(3) "Top hat" schemes are provided for individual highly paid executives, offering very generous benefits of which at least a part is taken as a tax-free lump sum. These schemes are tailored to individual requirements, taking the fullest advantage of opportunities for tax avoidance.

The Labour Party's National Superannuation plan was conceived largely as a response to the growing inequalities in retirement between those who enjoyed generous private pensions and those who had nothing but the 40s. National Insurance pension (as it then was) supplemented in some cases by National Assistance. It was designed to give everybody what the more fortunate already enjoyed—an adequate income in retirement related to the standard of living attained during working life.

Contracting Out—Whose Choice?

The question at once arose—should National Superannuation be universal and compulsory, as was the case with National Insurance, or should

[1] Arthur Seldon, "Contracting out of State Pensions," in *The Times*, 23rd January, 1963.

it be limited to those who were not already members of an equivalent occupational scheme? It was decided that members of employers' schemes offering benefits as good as those provided by the State scheme should be given the option of "contracting out" of the State scheme. The choice was to be made by the individual employee, subject to the employer's willingness to continue operating his scheme.

The following year, details of the Government's much more modest graduated scheme were announced. With its maximum benefit of £2 1s. after 47 years, it seemed unlikely to have much effect on the growth of private schemes. Employers with good private schemes could reasonably be expected either to ignore this very small addition to their employees' income in retirement or to make a minor adjustment to their schemes so as to take the State graduated pension into account in calculating the benefits. Nevertheless, the new scheme contained provision for contracting out, perhaps as a concession to the insurance companies and to lend substance to the declared aim of encouraging the growth of private schemes; and perhaps also in half-conscious recognition of the possibility that this very small scheme (in terms of the benefits offered) might one day grow into something bigger. About 4½ million employees have been contracted out—including the majority of those in the public services and nationalised industries and about a quarter of the private employees who are members of occupational schemes.[1] This figure is nearly twice the Government's original estimate of 2½ million.

Unlike the Labour scheme, the Government proposed that the decision whether to contract out should be made by the employer. Employees were to be informed of the employer's intention to apply to the Registrar of Non-Participating Employments for a contracting-out certificate, but there was to be no question of individual choice by employees.

The 1958 White Paper merely stated that an employer applying to contract out "should be under a statutory obligation to give a prescribed period of advance notice of his application" so that "normal processes of consultation" could operate. The 1959 Bill was amended to allow the Registrar to consider any representations from employees or organisations representing them before issuing a contracting-out certificate. It is questionable to what extent employees are in a position to make use of these rights of consultation and appeal, limited though they are. To make them effective it would be necessary to place before each employee a detailed statement of the alternatives. To most people such a statement would be largely incomprehensible. In view of the uncertainties surrounding the future of the scheme, it is doubtful whether it could be other than misleading. Nevertheless it would give at least a minority of employees some basis on which to make an intelligent assessment of the situation. All that the contracting-out regulations require the employer to do, however, is to inform employees of his intention to contract out, either by notifying them individually in writing, by posting up a notice in a conspicuous place, or

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[1] *Ibid.*

in any other way that may be appropriate in the circumstances of the case. Not only is individual notification not compulsory; the original draft regulations submitted to the National Insurance Advisory Committee did not even specifically mention it as a possible method. It was apparently assumed that a notice pinned on the works notice board was sufficient in the absence of exceptional circumstances.

The conception of industrial relations implied by the Government's handling of this question is, to say the least, hardly appropriate to the second half of the twentieth century. It may have been felt that the employee had nothing to lose by being contracted out of the scheme and that there was therefore no point in making elaborate provision for consultation. The 1958 White Paper had claimed that "no employee who was a member of a contracted-out scheme could be in a less favourable pension position than if he had been in the State scheme at the maximum rate." If this were true and nobody stood to lose by being contracted out, the case for individual choice, or even for effective consultation, would be somewhat theoretical (though a case could still be made). In addition to the risk of retrospective adjustments to the graduated scheme, however, there are, as we shall see, a number of other ways in which contracting out may adversely affect the rights of the individual.

During the Parliamentary debates on the National Insurance Bill, 1959, the Labour Party had second thoughts on the practicability of allowing individual employees to contract out of National Superannuation. Although no definite statement of policy was made, the possibility of group contracting out by majority decision of the members of a private scheme was mentioned. On neither side of the House of Commons, however, was there any serious consideration of the implications, in terms of the rights of the individual employee, of leaving the decision on contracting out to be made either by the employer or by a majority of the employees. Nor was there any discussion of the desirability in principle of allowing people to contract out of a State pension scheme.

The Case for Allowing Contracting Out

The question of contracting out presents itself, at first sight, as a simple issue of individual freedom. Since everybody is agreed that freedom is desirable, the only question to be considered is whether contracting out is practicable and, if so, on what terms. But the issue is not as simple as this. If it were, contracting out would be a feature of all our social services, provided that the individual could obtain equivalent benefits through private arrangements.

The question of individual choice is of course one consideration. But contracting out can only be justified on these grounds if it does in fact involve a free choice by the individual employee. If the decision to contract out is made by the employer or by a majority of the employees, the only way in which the individual can exercise free choice if he disagrees with that decision is by changing his employment.

Supposing, however, that individual contracting out were practicable, how desirable would it be? It would clearly be necessary to ensure that

each individual was in full possession of all the relevant facts, and understood them before making his choice. Assuming this to be possible (a large assumption) on what grounds would be decide? He would have to compare his situation, regarding both benefits and contributions, in his employer's scheme on the one hand and in the State scheme on the other. One of the main factors to be considered, therefore, would be whether he was likely to draw out of the State scheme more or less than he paid in. His choice would be guided by the probability of making a profit from the State scheme and the probable size of that profit. Is this the basis on which National Insurance ought to operate? It is a complete reversal of the principle on which it has been based hitherto—that all should share the cost so that those who need may benefit. To substitute the principle of personal gain for that of mutual aid, in the name of individual freedom, is not an exchange that all would regard as advantageous—though some certainly would.

What, in any event, would this freedom consist of? Not the freedom to choose whether to provide for one's old age or not; for it is generally agreed that contracting out of the State scheme should only be permitted if equivalent benefits are secured through a private scheme. Not even the freedom to choose more generous provision than that offered by the State scheme; for even if there were no contracting out, any employer would remain free to supplement a universal state scheme with an additional private scheme and some would undoubtedly do so—though it is possible that the emphasis in employers' schemes would shift from retirement pensions to benefits payable on sickness, redundancy or death, family allowances and other welfare schemes.

The theoretical case for permitting contracting out is not, therefore, overwhelmingly cogent. The loss of personal freedom in a universal State scheme is small. Indeed, the infringements of individual liberty resulting from the operation of private pension schemes—especially those which deprive employees of their pension rights if they leave the employment before retirement age—are far more serious than anything threatened by a State scheme and were one of the main reasons for the production of the Labour Party's National Superannuation plan.

The Dangers of Contracting Out

If employees are to be contracted out of the State scheme, not by individual choice, but either by their employer's decision, as at present, or by a group decision with which some of them may disagree, one essential condition must be satisfied. It must be certain, beyond any reasonable doubt, that no individual will suffer as a result of a decision to contract out for which he was not personally responsible. If there is genuine individual choice, there may be some justification for arguing that those who choose unwisely or unluckily must be prepared to accept the consequences of their choice. Once individual choice is abandoned, this argument is untenable.

Under the present scheme, however, the rights of contracted-out employees are not adequately safeguarded. The decision on whether to contract out depends mainly on whether the employer thinks he can obtain

better value for his money outside the scheme. The interests of his employees are not seriously considered, because it is generally assumed that the contracting-out conditions will ensure that they get at least as good a pension from a contracted out scheme.

It is true that a contracted-out employee must be given pension rights (or a P.I.L. on change of employment if preservation of rights is not ensured in some other way) equal to the maximum of the graduated scheme for the period of contracted-out employment. Thus an employee earning £12 a week would have to be provided with a graduated pension at least three times as great as he would earn in the State scheme (ignoring, for the moment, the possibility of retrospective adjustments to the State scheme). On the other hand, the regulations do not state what proportion of the contributions to a contracted out scheme is to be paid by employer and employee respectively. It is therefore possible, if unlikely, that an employee may be called upon to pay a contribution to his employer's scheme which, together with the additional flat-rate contribution payable by contracted-out employees,[1] is more than he would have paid for equivalent benefits in the State scheme.

More serious in practice, however, is the fact that, despite the complicated contracting-out regulations, there are still a number of ways in which contracting out may adversely affect the benefit rights of the individual:

(1) However carefully a private pension scheme may be administered, it cannot provide the same kind of security as a State scheme. Pension rights are accumulated over a period of forty years or more, during which economic fluctuations may render the most prudently invested fund insolvent—and even insurance companies are not entirely immune from the perils of economic life. This problem is particularly serious in the case of benefits which are preserved in "cold storage" when a scheme ceases to be contracted out, since the limited supervisory function exercised by the Registrar of Non-Participating Employments only continues so long as a contracting-out certificate is in force.

(2) A contracted-out scheme must normally provide a pension for the individual employee at least equivalent to the maximum graduated pension that he could have earned in the State scheme in respect of the same period of employment. In some cases, however, the employee has already completed the qualifying period (e.g. 40 years' service) for maximum pension in the employer's scheme, even though he has not reached retiring age. If he is contracted out, he will earn no additional pension during the remainder of his employment, although he could have done

[1] The extra flat-rate contribution for contracted out employees was raised in June, 1963 from 1s. 7d. to 2s. 5d. for a man and from 10d. to 1s. 6d. for a a woman. How these figures were arrived at is by no means clear. The official explanation of the 1963 increase is that, since the span of earnings on which graduated contributions are paid was to be extended by half (from £6 to £9), a corresponding increase in the additional contribution payable by contracted out employees was justified. But while the increase in the man's contribution was roughly a half, the increase for a woman (from 10d. to 1s. 6d.) was 80 per cent.

so in the State scheme. Again, the employer's scheme may give benefits related to the age at which contributions are paid (the earlier contributions, earning more interest, will produce a larger "slice" of pension). In this case, an employee nearing retirement age may no longer be building up his pension at the same rate as he could have done in the State scheme which, because it ignores the interest factor, is more generous to older employees. In cases of this kind, contracting out is allowed provided that the whole pension, averaged over the period of service, satisfies the test of equivalence with the State scheme.[1] As one writer has put it, "the Registrar is being kind".[2] Kind to whom?

(3) The test of equivalency does not include provision for widows. In the State scheme, a widow receives at age 60 a graduated pension equivalent to half her husband's entitlement. A contracted-out scheme may offer less than this, or even nothing at all, to an employee's widow.

(4) A contracted-out scheme need not offer additional benefits for employment after pensionable age (65 for men, 60 for women). In the State scheme, on the other hand, graduated contributions continue up to the date of retirement, earning additional graduated pension rights, and half the pension foregone by deferring retirement is treated as an extra graduated contribution.

(5) The 1963 Act, by increasing the maximum benefit obtainable from the graduated scheme, makes a similar change in the test of equivalence, necessary. The benefits provided in future by a contracted-out scheme must be equivalent to those accruing in the State scheme to an employee earning £18 a week—the new graduated contribution ceiling introduced in June, 1963. But, because employers need more time than this to reconsider the pros and cons of contracting out and to make any consequential adjustments in their schemes, the new levels of "equivalent pension benefits" and "PILs" will not come into force until 7 months later, in January, 1964. Employers thus have nearly a year to amend their schemes (if they choose to do so) and to obtain the Registrar's approval of the amendments. Meanwhile, employees in some contracted-out schemes may be earning benefits which are inferior to the new level of graduated pension. It is true that the maximum loss of pension involved on this occasion is only 6d. a week, but the injustice, however petty, is real, and will presumably be repeated every time an adjustment is made in the graduated scheme.

The biggest question mark of all in the graduated scheme, for employers and employees alike, is the possibility of retrospective adjustments being made in the value of the benefits secured by past contributions. As was shown in the last chapter, the assumption that no such adjustments will be made, comforting though it may be for the trustees and administrators of private pension funds and schemes, rests on very insecure foundations. In the history of National Insurance, there is no precedent for a

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[1] See G. A. Hosking, *Pension Schemes and Retirement Benefits*, 2nd ed. 1960, pp. 301-2.

[2] " A Barrister-at-Law " in *British Tax Review*, Sept.-Oct. 1960, p. 323.

Government allowing the value of benefits to be eroded by inflation without at some point adjusting them. If this has been done with the flat-rate benefits of the past, there is no reason to think it will not be done with the graduated benefits of the future. If the right of contracted-out employees to equivalent pension benefits is to be maintained, their employers and ex-employers must not only be required to make similar retrospective adjustments but must be financially able to do so. Since no firm assurance has been (or, in the latter case, could be) given on these points, the position of many contracted-out employees may well prove less favourable in the long run than if they had remained in the scheme. The risks may not be very great where the employer's scheme is a generous one based on final salary, but few manual workers are members of schemes of this kind. The real danger arises where the employer has geared his scheme to the level of benefits offered by the State scheme, leaving little or no room for retrospective adjustments. The fact that, according to the Life Offices' Association, many new schemes have been set up with a view to contracting out suggests that large numbers of employees may be in this hazardous position.

The Future of Contracting Out

There can be no doubt that the present provisions for contracting out are unsatisfactory. Two further questions remain to be considered: can contracting out be placed on an acceptable footing in the context of the existing graduated scheme and, if not, can the present difficulties be overcome by introducing a new scheme on the lines of *National Superannuation*?

There is no reason why the present scheme should not be amended so as to make the conditions for contracting out more rigorous in a number of respects. It would be possible, for example, to insist on equivalent benefits in respect of postponed retirement and widowhood, and to require adjustments to employers' schemes arising from the National Insurance Act, 1963, and similar future legislation to be back-dated to coincide with changes in the State scheme. It would also be possible, at least in theory, to stipulate the maximum contribution which the employer could exact from his employees in return for benefits equivalent to those of the State scheme; but such a condition would be difficult to administer in practice because most contracted out schemes give more than the minimum benefit required of them, and would therefore be entitled to charge more than the maximum contribution.

The one serious risk which, in a scheme like the present one, there is no way of guarding against is that of retrospective adjustments. No Government can guarantee that such adjustments will never take place; and no employer can guarantee that he will be in a position to meet a retrospective charge of unknown amount imposed on him at some unpredictable future date. For this reason, if for no other, there appears to be no complete solution to the problems of contracting out in a scheme such as the present one. Moreover any move in the direction of extending the scheme beyond its present very narrow limits would at once accentuate the risks of contracting out, since the bigger the benefits the more those outside the scheme have to lose.

National Superannuation would not suffer from the unpredictability of the present scheme, since periodic adjustments of the pension rights derived from past contributions are built in as an integral part of the plan. Thus, if average national earnings double between, say, the first year of the scheme and the twentieth, the pension entitlement earned by contributions made in the first year will be doubled. An employee who receives the national average wage throughout his working life will retire on half pay or thereabouts, no matter what changes may have taken place in the levels of prices and wages during his lifetime. After his retirement, the pension he receives will continue to be adjusted as average earnings rise, so that if he draws it for twenty years or longer it will still be worth half the current average wage. As a condition of contracting out of National Superannuation, a private scheme would have to guarantee a pension calculated on the same principle and subject to the same periodic adjustments. An employer who decided to contract out would therefore know, in principle, what were the long-term obligations he was undertaking. He would not be allowed to contract out unless he could demonstrate that, on the basis of certain reasonable assumptions as to the future course of wages and prices, he would be able to fulfil those obligations.

If at some later date the assumptions made turned out to have been over-optimistic, an additional contribution might have to be made by the employer to restore the solvency of the scheme. In the event of his being unable, for any reason, to make such an additional contribution (for example, he might have gone out of business), the State would presumably have to guarantee the rights of contracted-out employees by making good any deficit.

In this way, contracting out could be made to work under National Superannuation without any risk to the employees concerned. But how many employers would be able to satisfy the conditions for contracting out, even with the ultimate protection of a State guarantee? No private or public occupational scheme at present offers "dynamic" pensions of the kind proposed by the Labour Party—rising automatically as the living standards of the working population rise. Salaried staff pensions, it is true, are often based on the final salary earned before retirement (a typical formula would be one-eightieth of final salary for each year of service), thus giving an income immediately after retirement directly related to the standard of living enjoyed just before retirement. Adjustments to the pension after retirement, however, are rarely large enough even to protect its real value from the effects of inflation, and are made at the discretion of the employer with no prior undertaking on his part. Recent attempts by a few of the insurance companies to provide pensions which continue to grow after retirement are a long way short of matching the Labour proposals. None of them links the adjustments to an index of any kind, whether of prices or of earnings. Even the best occupational schemes would therefore need to be amended in order to satisfy the conditions for contracting out of National

Superannuation.

It would seem, then, that the effect of introducing a scheme under which adequate safeguards can be given to contracted out employees would be to make contracting out much more difficult than it is at present. It is perhaps questionable whether, under these conditions, contracting out ought to be permitted at all. The administrative complexities would be very considerable in relation to the numbers involved and, as we have seen, the advantages to the employee are somewhat dubious. At all events, if it is permitted, the rights of employees and pensioners must be fully safeguarded. Under the present graduated scheme, this is far from being the case.

V. Conclusion

WE have examined the graduated pension scheme in the light of its three declared objectives: to put National Insurance on a sound financial basis, to provide wage-related pensions to those not in private occupational schemes, and to encourage the development of such schemes.

The first objective has been achieved by ensuring that the contribution income from employers and employees will cover, for the foreseeable future, over four-fifths of current expenditure on pensions. The prospect of large deficits falling on the Exchequer has been avoided. Whether this is regarded as a desirable development depends on one's views as to how National Insurance ought to be financed. What seems certain, however, is that it has meant that the burden would continue to be concentrated on a regressive form of taxation—the graduated contributions representing only a slight modification of the flat-rate principle. This is clearly at variance with the assumption made by successive Governments, both Conservative and Labour, that the emerging deficits would be met out of general tax revenue.

It would appear, moreover, that the scheme, although theoretically based on the "pay-as-you-go" principle, has a built-in tendency to produce surpluses in later years, thus reducing still further the proportion of the cost borne by the Exchequer, owing to the rapidly expanding yield of the graduated contributions. This tendency will become more marked each time the contributions are raised, as they were for the first time in June, 1963. Again, the mere fact of surpluses emerging on the National Insurance Fund is not an undesirable development. What is undesirable is that such surpluses should be produced by a regressive tax.

The second objective of the scheme has been achieved only to a very limited extent. The graduated pensions, especially in the early years of the scheme, are extremely small—so small that employers have in many cases continued their private schemes on top of the State scheme, rather than either reducing their schemes or contracting out. Indeed, it was the Government's intention that they should be able to do so. More serious than the size of the benefits offered by the scheme, however, is the lack of any guarantee that they will be protected in any way against inflation. Such protection could only be given by means of retrospective adjustments which would have grave repercussions on contracted out schemes. The attainment of the second objective will therefore inevitably conflict with the third—that of preserving and encouraging the best development of occupational schemes.

Judging from the number of employees who have been contracted out —some 4½ million—and the rapid growth of occupational schemes following the introduction of the graduated scheme, it is tempting to conclude that its effect on occupational schemes has been entirely favourable. The Life Offices' Association reports that over 900,000 employees were covered for the first time in 1961 by pension schemes operated by the insurance companies, and ascribes this achievement to the fact that the Government scheme "focused attention on pensions and many new pension schemes were set

up with a view to contracting out of the State scheme." [1] Comparable figures for schemes operated by trustees are not available but would probably give a similar picture. But, if contracting out has proved a success in terms of numbers, there are grounds for serious concern as to the possibility that contracted out employees may not benefit from retrospective adjustments to the scheme and may thus lose part of the real value of the pensions they have been promised. If, on the other hand, private schemes are compelled to make retrospective adjustments, there is a real danger that some of them may be rendered insolvent. Neither of these possibilities can be regarded as an encouragement to the development of occupational pension schemes. Even the non-retrospective adjustments made in 1963 caused misgivings in the insurance world. The Chairman of the Pearl Assurance Company warned that "further increases would steadily erode private occupational pension schemes and so defeat one of the Government's avowed purposes in introducing the graduated scheme. . . ."[2] But it is not only occupational schemes which stand to lose. The public confidence on which social insurance is built—confidence that obligations undertaken by the community will be honoured not only in the letter but in the spirit—is in danger of being undermined.

There is no escape from this dilemma along the road which National Insurance is now travelling. The present graduated scheme must founder on the rock of its own illogicality. It is a static scheme set adrift in a dynamic world. It cannot remain unaltered; but every amendment will make its weaknesses more apparent. The longer it continues, the more intractable will be the problem of preserving the real value of the pensions earned under it. The solution must lie in a scheme which either does not permit contracting out or provides adequate safeguards for the rights of those who are contracted out. Such safeguards can only be provided, if at all, in a scheme which (like National Superannuation) incorporates definite provisions for its future development and thus enables similar provisions to be written into private schemes. But there is an urgent need to reconsider the arguments for allowing employers to contract out of a State scheme on any terms. It is by no means clear that contracting out produces any real increase in personal freedom; but it is fraught with difficulties and dangers which must be foreseen if they are to be avoided.

One final conclusion may be drawn. It is that the rights of the citizen in the whole field of pensions are seriously threatened by the sheer complexity of the provisions made ostensibly for his benefit. It is easy to criticise Parliamentary debates which concentrate on broad issues of policy rather than the actual content of legislation; but the House of Commons is not a committee of experts and cannot be expected to function as one. Expertise on pensions is located in the civil service, where it can only serve the policies of the Government of the day, and in various professional groups of

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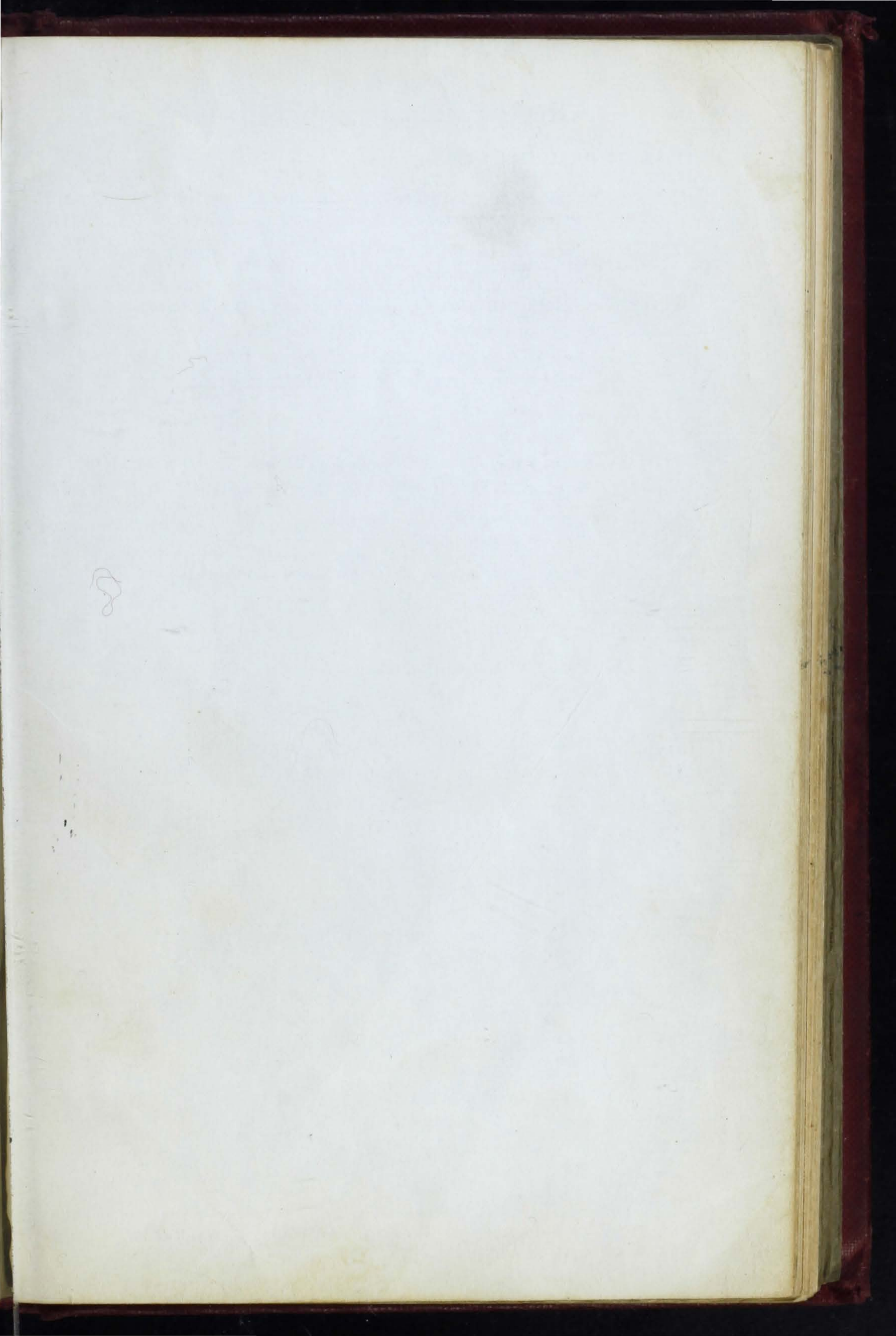
[1] The Life Offices' Association *et al.*, *British Life Assurance* 1957-1961, p. 8.

[2] Annual Statement to Shareholders, May, 1963 (see *The Observer*, 5th May, 1963).

actuaries, economists, pension consultants and others. But these groups also are too often employed in capacities which limit their effectiveness as guardians of the rights of the pensioner. Insurance companies and employers have access to their expert knowledge and judgment. The ordinary employee whose pension rights are directly affected by the terms of his employer's pension scheme or by a decision to contract out usually has no such access. Moreover, the experts themselves are divided on many issues affecting the individual's rights, and especially on the advisability of contracting out. In view of the uncertainty of the Government's intentions regarding the future of National Insurance and the probability that, whatever they may be, they will be upset sooner or later by a change of Government, this lack of agreement among the experts is not surprising, but it is none the less disturbing.

The most urgent need in the field of State pensions is for a scheme which will be adequate, in the sense of providing not merely a basic minimum income but an income related to that enjoyed before retirement; which will either cover all eligible citizens or offer a real guarantee of equivalent rights to those who are contracted out; and, not least, which will be comprehensible. The existing scheme fulfils none of these conditions.



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