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STATE PENSIONS

A JOINT COMMITTEE of the Institute of Actuaries and Faculty of Actuaries was set up after the Annual General Meetings of both bodies held in June 1957 to consider the subject of proposed extensions to the existing national arrangements for retirement pensions.

On 17 January 1958 the two Councils issued to each Fellow of the Institute and Faculty and to the press a Statement on general principles which it was hoped would be of assistance to those who might wish to study the economic and financial implications of the provision by the State of pension benefits.*

The text of the Statement is as follows:

INTRODUCTORY

1. Over seven million, or nearly a half, of the male working population of the United Kingdom of sixteen million are at present members of occupational pension schemes of one sort or another. Of the total working population of both sexes of over twenty-three million the number so covered is over nine million, or more than a third. In addition, the entire working population is covered by the existing national arrangements for Retirement Pensions.

2. The political, economic and financial issues involved in national pension arrangements are grave ones and require careful consideration when revisions—possibly of a drastic character—are being widely discussed. In view of the actuarial profession's special experience of the financial problems involved in pension schemes, both private and state, the Councils of the Institute of Actuaries and of the Faculty of Actuaries in Scotland have thought it desirable to issue this Statement in the hope that it will be of assistance to those who may wish to study the financial and economic implications of state pensions. The Councils recognize that it would be beyond their province to express any opinion on purely political issues and that, in any discussion of the problems arising when major extensions of the state pension scheme are under consideration, there is obvious need for expert advice from economists. But in discussing the financial aspects of these problems, which are the special province of actuaries, some reference to the economic implications requires to be made. While actuaries as such cannot claim to speak on the economic issues involved with the same authority as they can in regard to the financial aspects, it is believed that what is said in this Statement on the economic side reflects the general consensus of informed opinion.

THE FUNDAMENTAL ISSUES INVOLVED

3. In thinking about pensions on a national scale, there are two fundamental issues which must be faced, namely, the economic problem of providing the necessary resources in terms of goods and services, and the financial problem of providing pensioners with appropriate purchasing power.

* A report on the discussion on this subject at a meeting on 24 March 1958 appears later in this volume.—Eds. *J.I.A.*

PROVIDING THE RESOURCES

4. Pensioners, like other people, require necessities (food, warmth, clothing, shelter) and, in addition, such amenities as in the changing social climate of opinion are felt to be their due. In other words, when a man or woman has retired from work and has ceased to 'produce' (in the economic sense), he or she still needs goods and services, which have to come out of the current production of those still at work. It will be generally agreed that promises should not be made about payments to be met in the future (and especially the distant future) unless every practicable step is taken by those who make the promises to ensure that the resources will be available, when the time comes, to redeem the pledges. In modern industrial society steps are, of course, being taken all the time to increase the national productive capacity, whether by planning at the centre or by action by individual concerns. Better machinery, more efficient fuels, better factories, better transport, improved agricultural methods and, in particular, scientific and technical research all play their part. All imply the absorption of some part of current income to meet the capital investment involved.

5. The essence of the matter is that some of the hoped-for increases in production in the future will have to be diverted from improving the standard of living of those who are then still at work, in order to provide the promised standard of living of those who have retired. This would require careful thought even if we, as a nation, were planning to provide our pensioners, as at present, with no more than basic necessities; for it should always be remembered that, whereas at the beginning of this century there was one person of pensionable age for every fifteen persons in the population, there are now two, and in 20 years' time there will be three.

THE FINANCE OF PENSIONS

6. The second problem, namely, that of the provision of purchasing power to the pensioners, raises some important and difficult financial considerations. In discussing this aspect of state pensions, it is first necessary to explain the principles upon which private pension schemes are ordinarily financed, and also to consider the relevance of these principles to the finance of state pensions.

PRIVATE SCHEMES

7. Pensions by their nature are long-term commitments, maturing over many years ahead. Under private schemes, whether 'self-administered' or arranged through a life office, full financial provision to meet the commitments is made by building up a 'fund' on insurance principles out of actuarially computed contributions paid during the working life of the prospective pensioners. These contributions are so calculated that, with the interest earnings they are expected to attract, the accumulations of the fund will be sufficient to meet the monetary liability for the pensions payable to the survivors after they have retired. Such a scheme is said to be actuarially—that is financially—sound. Its soundness is independent of the flow of new entrants, who will themselves constitute self-supporting groups. It is on these general principles that the finances of the numerous private pension schemes, and for that matter life assurance business generally, have long been successfully

conducted. Nevertheless, as is obvious, financial solvency of any scheme, whether private or state, does not of itself ensure that the pensions, when they become payable, will represent in terms of effective purchasing power the standard of living in retirement which the scheme was expected to provide. The extent to which this will be so will turn on national economic and financial policy which, with appropriate guidance from economists, is a governmental matter.

THE STATE SCHEME

8. The question that arises, in connexion with any state pension scheme, is whether the state ought to build up a Fund, run on the same lines as the funds of the many private pension schemes already mentioned, and subject to the same kind of strict, i.e. actuarial, tests of financial soundness. No serious attempt has been made in this country (though it has in some others) to finance the state pension scheme in this way. It is true that the contributions paid under the scheme have been fixed by reference to a basic rate of contribution actuarially computed on the principle that, if paid into a fund from age 16 throughout working life, it would be adequate with interest earnings to support the benefits. But, when contributory pensions were first introduced in 1925, with a pension well below subsistence level, it was decided that, with few exceptions, those then over 16 should be accorded the right in due course to receive pensions at the full rate, although they would have contributed for a shorter, possibly much shorter, period than the 49 years from 16 to 65 which was presupposed in calculating the age 16 contribution. Later, in 1948, the scheme was extended with greatly enlarged benefits, though still barely at subsistence level, to cover the whole population and the contributions were increased accordingly, but were still related to the age 16 basic contribution. Once again, the existing working population and pensioners under the 1925 scheme were in effect credited with the increased contributions from age 16 which they (and their employers and the state) would have paid, if the enlarged scheme had been in operation from the time they started work.

THE DEFICIENCY IN THE NATIONAL INSURANCE FUND

9. This problem of the shortage of past contributions, when a state scheme is introduced or the benefits increased, corresponds to the problem of providing a credit for past service which arises on the establishment of most private schemes. In such schemes employers may reduce this liability by reckoning past service at less than the full rate, but in any event appropriate payments must be made into the fund to cover whatever credit is granted for past service. Very little specific provision, however, has been made under the present scheme for the large deficiency in the National Insurance Fund, due to this shortage of contributions; the deficiency was at the outset, in 1948, of the order of £10,000 million and is now over £15,000 million following the increases in benefit recently made. **This deficiency is not, as is sometimes suggested, a mere theoretical actuarial conception. It will become evident from the future annual cash shortages in the Fund, that is, the annual excesses of outgo over income. These shortages the Exchequer will inexorably have to meet year by year out of taxation. In the circumstances, there are now no growing accumulations in the Fund, attracting interest and corresponding to those in a private scheme; the contribu-**

tions in respect of the working population have been, and will continue to be, used up to meet the benefits of those who have already retired; and the National Insurance Fund will in future show a growing annual cash deficiency to be met out of taxation. This taxation burden (quite apart from the Exchequer's share of the total weekly contribution) will mount rapidly, and, in 20 years' time, will have reached roundly £475 million a year. In this way, the state will be bearing the bulk of the burden of 'past service' that is frequently assumed by the employers, at least in part, in the case of private schemes.

10. On the whole, bearing in mind the history of state pension finance in the United Kingdom, and particularly the problem of meeting the heavy burden for 'past service' referred to above, no major revision of the present method of financing the state pension seems to be called for so long as it is designed to provide little more than basic necessities. The actuarial profession has always recognized the impracticability as a matter of national finance of attempting to make formal provision to liquidate the large deficiencies to which reference is made in the previous paragraph. The same considerations apply whether the basic pension takes the form of a flat benefit with a flat contribution, as at present, or a variable benefit with a variable contribution related to earnings. But, even when the standard of pension is limited to basic necessities, the problem of building up productive capacity so as to enlarge the national income should be continually emphasized, particularly in view of the growing proportion of persons of pensionable age in the population. **We would strongly urge, moreover, that the financial transactions concerning the payment of the basic pension should be shown in a separate account on the lines of that of the existing National Insurance Fund, the finances of which would be reviewed periodically by the Government Actuary.** In these reviews, emphasis should be placed, as heretofore, on the future annual cost of the growing pension payments and the cash deficiencies which will fall directly on the Exchequer. In this way, the nature and the extent of the state's current obligations for 'minimum' pensions would be clearly visible to all concerned.

PROVIDING PENSIONERS WITH PURCHASING POWER

11. As indicated in §3 of this Statement, one of the fundamental issues in connexion with pensions on a national scale is the financial problem of providing pensioners with appropriate purchasing power.

12. One method would be for money to be set aside and invested to earn interest during the working life of an individual to provide for the whole or part of his pension. In the case of most private schemes (see §7), the whole pension is provided for in this way and the transfer is in effect made over the working lifetime by the members themselves and by their employers. But, for the reasons explained in §§8 and 9, no financially self-sufficient fund has been built up under the existing state scheme, with the result that the Exchequer is now being called upon to meet a growing annual cash deficiency in order that pensioners may be provided with the purchasing power not covered by the contribution and other income of the present National Insurance Fund.

13. Another method would be for the whole of the money required for the pensioners during any year to be levied upon the people then at work. This is open to the objection that it could demand current payments from the

members of the working population bearing little or no relation to the pensions which they themselves would expect in due course to receive. Moreover, with an ageing population constituted as in the United Kingdom, the total levies would increase as the years went by and more and more of the working population retired on pension.

14. The formal relationship between contributions payable and benefits offered (described in §7) is the basis of the finances of private pension schemes, and goes to the root of most forms of thrift. Such a relationship is reflected in the mode of computing the rate of contribution under the state scheme, although little advance provision is made for 'past-service' benefit (see §§8 and 9).

15. The accepted principle in this country has been that the responsibility for the contributions to the state pension scheme should be shared between the working population, employers and the Exchequer, the last mentioned, of course, being obliged to collect its contributions from taxpayers along with the taxes which it imposes for other purposes. **This method has much to commend it as it gives practical effect to the underlying economic truth that the problem of providing pensions is one that must be faced by all.** The fixing of the amount of the total contribution which is to be shared in this way by employees, employers and Exchequer, i.e. the taxpayers, is a more complicated matter. The contributions could be fixed and varied from time to time quite arbitrarily on no definite principles by political decision. **There are, however, a number of reasons why it is desirable that, in fixing the contributions, the authorities should, as in the past, have regard to the rate of contribution which the Government Actuary calculates would be required in the case of an entrant into the state scheme if** (as in the case of private pension schemes) **a Fund were to be built up and accumulated at compound interest** (see §§8 and 9). Despite the fact that, for the reasons previously indicated, the state has not accumulated such a fund, this practice has important advantages. In the first place, the contributions are not fixed on a purely arbitrary basis, since the age 16 contribution serves as a standard against which to test their adequacy in relation to an entrant at the initial age. In the second place, as was remarked by the 'Phillips' Committee on the Economic and Financial Problems of the Provision for Old Age (Cmd. 9333), such contributions provide an important measure of social discipline since it is widely understood and accepted that increased benefits require increased contributions. It must, however, be added that a contribution related to a rate which is calculated actuarially does not by itself guarantee that a pension scheme is run, in other respects, on sound financial lines. The problem of financing the credit for 'past service', already referred to, is always present and is re-created every time the rate of pension is, for whatever reason, increased.

POSSIBLE EXTENSIONS TO A BASIC STATE SCHEME

16. The question whether it falls within the function of the state to provide under a national scheme for pensions in excess of the minimum standard set by basic necessities is essentially a political one. The Councils accordingly consider that it would be inappropriate for them to express any opinions on this question. Nevertheless, they feel it their duty to comment on some of the actuarial and economic implications if such an extension were contemplated.

17. **In the first place, it would be more necessary than ever that authoritative long-term estimates should be made of the financial burden which future generations would be called upon to bear.** Such estimates, if they are to be a proper guide, must extend over many years ahead and must not be confined to periods of time over which they appear to be least embarrassing. Admittedly such long-term estimates would necessitate numerous assumptions about, for example, future trends of marriage, fertility and mortality, from which, in the outcome, actual experience might well to some extent depart. Nevertheless, their value as indications of trend and of order of magnitude would be available for the guidance of those responsible for national economic and financial policy. Projections of this type are the basis of all long-term planning and would be indispensable in the case of the heavy and mounting obligations implicit in any extension of the scope of the state scheme.

18. **In the second place, the necessity to divert future increases in production in order to redeem the pledges given to pensioners becomes of first importance if consideration is being given to the promising of pensions on a much higher level than hitherto.** Such promises ought not to be made unless there seems to be a firm prospect that substantial additional economic resources would be created and made available in due course; and unless, at the same time, it is clearly stated and understood that special efforts would be required by the community to increase productive capacity to the necessary extent. The building up of the future national income through capital investment would be a vital element in minimizing the burdens represented by any increased scale of pensions and would be essential if the future standard of living of the working population were not to be adversely affected.

19. **In the third place, very careful consideration would require to be given to the position of the numerous existing private pension schemes.** As noted in §1, over nine million people are already members of occupational pension schemes of one sort or another and the numbers of such people are growing rapidly. Nearly all of these schemes are under proper actuarial control and, as already explained, funds are being accumulated to meet the future liabilities. If this growth of private pension arrangements were to continue, a substantial proportion of the remainder of the working population could doubtless expect to be included gradually in such schemes. **These existing financial arrangements for providing pensions which supplement the state pension have already been accommodated smoothly not only within the national economy but also within the economies of the individual industries and firms, and it would seem desirable that these arrangements should be disturbed as little as possible.** A case can, however, be made for the provision in all private pension schemes of some measure of preservation of the pension rights of a worker on moving from one employment to another. Arrangements on these lines are already in operation under certain schemes and, if it were thought desirable, as a matter of national policy, that such arrangements should be extended to cover all schemes, there is no actuarial reason why this should not be done.

20. It may, however, be decided that supplementary pensions related to earnings (over and above minimum pensions for basic necessities) should be provided through the agency of the state for those for whom satisfactory

provision by private schemes might, for one reason or another, be found impracticable. **If such a decision were taken, the rate of contribution should be adequate with interest earnings to support the supplementary pension, which should be related to contributing service, and therefore would come only gradually into effect.** Thus, no initial deficiency in respect of a credit for past service would arise, and so the supplementary scheme, as distinct from the basic scheme, could appropriately be financed on the same principles as those adopted for private schemes as explained in §7. The contributions for the supplementary pension should be segregated in a separate fund, the growing balances of which would represent the extent to which additions to the nation's capital resources should be made by investment, if the future standard of living of the working population is not to be adversely affected. In this way, public attention would be focused on the liabilities that were being incurred by the state, while the periodical investigations that the Government Actuary would be called upon to conduct would bring to light any deficiency in the resources that were being accumulated to meet these liabilities. Above all, the existence of such a fund, and the actuarial estimates of future income and outgo, would bring under continuous notice the need further to build up the future national income through capital investment so that the burdens represented by the increased scale of pensions might be minimized.

21. But it must be recognized that this separation of the finances of the supplementary pensions from those of the basic pension would not, taken alone, afford assurance that the national income would be correspondingly increased to cover the additional pension burden. Any major extension of the existing national scheme would almost certainly result in a material reduction in the volume of other savings. Moreover, in the wider context of the national Budget, it might well happen at times that money set aside or saved in one section would be offset by money spent or released in another. As the 'Phillips' Committee put it, 'the state cannot circumscribe its activities within the limits of a single fund'. **Nevertheless, if such a state pension fund is to have economic meaning for the purpose in view it should be reflected in real extra savings, that is, in additional capital resources.** To the extent that for any reason this does not occur, either the pensioners or the working population or both will have to accept a reduction in their standard of living.

22. If the state introduced an extended scheme providing pensions well above the existing level it would be necessary to make fair arrangements by which contributors to existing private schemes could be relieved of the burden of double contributions. Such arrangements would pose extremely difficult and complex problems which would require the closest investigation. These problems would be specially serious if there were any element of subsidy involved in the state scheme. Such a subsidy might occur directly in the form of an Exchequer grant, or indirectly under an arrangement whereby, in effect, one section of workers is subsidized by another, for example, older workers by younger workers or lower paid workers by the more highly paid. In many cases, indeed, the continued existence of private schemes might become impossible. For the reasons already indicated, the Councils would regard such a situation as against the national interest, and would strongly urge that in any development of the state scheme the need for the co-existence of the private schemes should be kept prominently in mind.

INFLATION

23. Because pensioners are a relatively unorganized social group, and because they suffer especially from the effects of rising prices, it has been suggested that arrangements should be made which would confer upon them immunity from the effects of inflation. We are of course in sympathy with all on fixed incomes who suffer from a continually declining standard of living, but we consider this a dangerous doctrine. Inflation—which it is the business of government to prevent or minimize—causes hardship to many, and to attempt to exempt any one section of the community from its consequences is to overlook the just claims of others. An automatic adjustment in relation to a rising price level, if accorded by the state to one group, would doubtless then be claimed by other groups; but even if it could be limited to a proportion only of the population it must, it seems to us, itself have an inflationary effect. It would tend to perpetuate, or even aggravate, the malady it sought to alleviate. **We think that such an adjustment of state pensions is a matter of policy which should be determined with due regard to the general economic and financial position of the country from time to time and to the many other calls upon the national resources.**

SUMMARY

24. The principal considerations to which the Councils have endeavoured to direct attention in this Statement may be summarized as follows:

(i) The fundamental issues to be faced in thinking about pensions on a national scale are first, the economic problem of providing the necessary resources in terms of goods and services, and second, the financial problem of providing pensioners with appropriate purchasing power (§3).

(ii) The provision of resources to meet the promised standard of living for future pensioners necessitates the diversion of future increases of production from improvements in the standard of living of those who are then working (§5).

(iii) The financial problem of providing pensioners with purchasing power corresponding to their pensions differs as between private schemes and the state scheme. In the case of the former, actuarially computed contributions are paid and funds are accumulated sufficient to meet in full the monetary liability for the pensions payable. Under the state scheme in this country, however, a similar procedure has not been adopted and, as a result, there is a substantial deficiency in the National Insurance Fund which will require to be met out of taxation. Nevertheless, the Councils do not advocate any major revision of the method of financing the state scheme so long as it is designed to provide little more than basic necessities (§§7–10).

(iv) The existing arrangement under which the contributions to the state scheme are shared between employees, employers and taxpayers has much to commend it as it gives practical effect to the underlying economic truth that the problem of providing pensions is one that must be faced by all (§15).

(v) The principle that the total contribution paid under the state scheme should be fixed by reference to the 'actuarial contribution' required for an entrant to the scheme at age 16 has much to commend it, but the adoption of this principle does not by itself guarantee the financial soundness of the scheme (§15).

(vi) The question of extensions to a basic state scheme involves political issues on which the Councils consider it would be inappropriate for them to comment. On the actuarial and economic implications involved, however, they make the following observations:

(*a*) Any extension of the existing national scheme would require to be considered in the light of authoritative long-term estimates of the financial burdens which future generations would be called upon to bear (§17).

(*b*) There would need to be a firm prospect that substantial additional economic resources would be created and made available in due course. It would require to be clearly stated and understood that special efforts would be called for by the community to increase productive capacity to the necessary extent (§18).

(*c*) The position of existing private pension schemes would require careful consideration. They already cover more than nine million people and the number is growing rapidly. It would seem desirable that the existing arrangements, which have already been accommodated smoothly within the economy, should be disturbed as little as possible. There is no actuarial reason why pension rights should not be preserved on moving from one employment to another, if this were thought desirable on national grounds (§19).

(*d*) As regards those for whom satisfactory provision by private schemes might, for one reason or another, be found impracticable, if it were decided that supplementary pensions related to earnings (over and above minimum pensions for basic necessities) should be provided through the agency of the state, the rate of contribution should be adequate with interest earnings to support the supplementary pension, which should be related to contributory service so that no initial deficiency in respect of a credit for past service would arise (§20).

(*e*) The contributions for such a supplementary pension should be segregated in a separate fund the balances of which should be reflected in additional capital resources (§§20 and 21).

(*f*) It would be necessary to make fair arrangements for relieving contributors to existing private schemes of the burden of double contributions. Such arrangements would pose extremely difficult and complex problems, which would be specially serious if there were any element of subsidy in the state scheme. In many cases, indeed, the continued existence of private schemes might become impossible. This is regarded as against the national interest, and it is strongly urged that in any development of the state scheme the need for the co-existence of the private schemes should be kept prominently in mind (§22).

(vii) The adjustment of state pensions because of inflation is a matter of policy which should be determined with due regard to the general economic and financial position of the country from time to time and to the many other calls upon the national resources (§23).

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