

THE FORTUNE ACCOUNT

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CONTENTS

1. The Nature of the Problem.	4
2. Examples of Reform from Overseas.	7
3. Issues for a UK Funded Welfare System.	13
4. The Fortune Account.	17
5. Conclusion.	28

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THE NATURE OF THE PROBLEM

The unsustainability of the welfare state

Today there is widespread and serious doubt whether we can much longer sustain a welfare state that is built on the principles of universal entitlement and inter-generational transfers.

Large and growing cost: Already the bill is large. The Department of Social Security absorbs roughly 40% of public expenditure. Its budget is twice the size of the next largest department (Health). Spending on social benefits stood at £84.5 billion in 1994/5 — equivalent to 12.6 % of GDP, or a cost of £15 per working person per day. And by the turn of the century, the bill is expected to be £93.6 billion.

Far from suffering "cuts", the total social security budget is up more than two-thirds in real terms since 1979. Despite growing wealth and incomes since the war, spending has risen sevenfold in real terms since 1949/50.

The broad economic effects of maintaining our present welfare state system have been calculated by the OECD as implying a tax increase between now and 2050 of 4.8% of GDP. The Rowntree Foundation, which came up with its own estimate of approximately 5% of GDP, regarded this as manageable. But if translated into practical figures, it represents a 20p increase in income tax, or a doubling of VAT.

Specific worries: Within the global figures, there are some alarming trends in the growth of particular programmes. Benefits to the long-term sick and disabled, for example, have trebled since 1979, despite generally rising standards of health. Housing benefit has likewise trebled to around £7 billion, despite the fact that over two-thirds of households now own their own homes. Single-parent benefit has increased by the same proportion: today there are nearly a million single parents who depend on benefits. Income support grew by 20% in a single year recently. Support for pensioners in residential and nursing care homes jumped from £10 million in 1978/9 to £2,500 million in 1992/3.

Real disposable income has risen by 80% since 1971; between 1979 and 1990/1, average household income rose 36% in real terms. And yet, income support expenditures continue to rise. If the welfare state were really fulfilling its prime purpose of relieving poverty, would such spending continue to grow?

Recent changes: The government has sought to contain some of this growth by

adjustments in rules and entitlements. These include the replacement of invalidity benefit by incapacity benefit, the change from unemployment benefit to jobseekers allowance, the equalization of state pension ages, the transfer of child-support obligations from the state to responsible parents, and the refusal to continue funding the mortgage interest payments of those on income support.

Such policy changes are expected to save £4 billion a year by the end of the decade. But even this large saving is eclipsed by the yet larger growth in spending that is expected by then.

**Projected social security benefit expenditure 1994/5 and 2000/1
£ billion at 1994/5 prices**

Benefit	1995/6	2000/1
Retirement pension		
• basic	26.9	28.3
• earnings-related	1.6	4.1
Widow's pension	1.0	1.0
Unemployment/jobseekers	1.3	0.7
Invalidity/incapacity benefit		
• basic	6.5	5.3
• earnings-related	1.5	0.7
War pension	1.2	1.2
Attendance allowance	2.0	2.4
Disability living allowance	3.1	4.7
Income support		
• pensioner	3.8	3.6
• non-pensioner	12.2	13.0
Child benefit	6.1	6.3
Family credit	1.4	2.0
Rent allowance	4.7	8.1
Rent rebate (DSS)	0.7	0.7
Council tax benefit	1.9	2.1
Other benefits	3.6	3.9
Total DSS	79.8	88.1
Rent rebate subsidy element	3.6	3.0
Total DSS & RRSE	83.3	91.1
Non-DSS housing benefit	1.5	2.5
Total benefits	84.5	93.6

Other countries: Other welfare-state countries are having to make similar adjustments. Contribution rates have been raised in France, Belgium, Germany,

Greece, Spain, and Italy; France, Germany, Italy and the Netherlands have all moved to index benefits to prices rather than earnings.

Even Europe's strongest economy is being weighed down by its welfare burden. A report by Prognos AG predicts an increase in German social insurance contributions from 39.3% to around 50% of gross earnings by 2040. Nor is this due merely to the added burden of the East, where welfare benefits cost DM6 billion in 1993. Between 1986 and 1993, welfare benefits in West Germany alone had risen about 85%, to DM43 billion.

Demographic change: One reason for the rapid rise in welfare expenditures is that changing demography has put increasing burdens on the working population — burdens that can only continue to increase over the next half-century, and perhaps beyond.

In 1901, average life expectancy was only 45 for men and 49 for women. By 1950 it had reached 66 years for men, 71 years for women. By 1990 it stood at 73 years for men and 79 years for women. It continues to rise at about 2 years per decade. There are two million Britons over 80, one million over 90. The Queen sent eight times as many 100th birthday telegrams in 1993 as she did in 1963.

This changing demography means that the support ratio (the number of people of working age per pensioner) is expected to worsen considerably, from a level of 3.4 workers per pensioner in 1990 to 3.1 workers per pensioner in 2010 and only 2.4 workers per pensioner in 2030. Most other European countries are expecting even worse figures.

So it is perhaps not surprising that retirement pensions, at £28.8 billion, already account for one-third of all spending on welfare state benefits. By 1992/3, spending on the elderly took 46.5% of the social security budget. Spending on health and community care is concentrated overwhelmingly on the elderly. The demographic figures make future welfare-state expenditure growth trends particularly alarming.

Some people argue that the "demographic time bomb" has been quite effectively defused by the 1980 move to link state pensions to prices, rather than earnings. Yet although this limited default on future obligations has indeed saved a large amount of money already — £8 billion in 1994/5 alone — the financial strain imposed by our ageing population nevertheless continues to increase. And the indexation change has simply given us a new problem: those millions of future pensioners who had expected a state pension of reasonable size but who will now be sadly disappointed, and become a charge on income support and other benefits. The problem now may be not so much how to sustain the state pension, but how to replace it.

EXAMPLES OF REFORM FROM OVERSEAS

The Chilean pension reforms of 1981

In 1924, Chile was the first country in the Western hemisphere to introduce a pay-as-you-go state pensions system, and in 1981 it became the first country in the world to abandon the principle and move bodily to a private and funded system. Quite simply, the old system was bankrupt, its expenditures outstripping its income.

Individual retirement accounts: In the new system, benefits were to be linked directly to contributions, with the money that each worker paid into the system going into an account owned by the worker — a defined-contribution system which Chile called the "capitalization scheme".

The government of Chile sets the minimum contribution at 10% of wages, though workers may contribute up to 20% if they choose. The contribution is deducted from each worker's taxable income. The money is invested by one of 21 competing private-sector institutions, and the returns are untaxed.

By the time a worker reaches retirement age, a sizeable sum of capital has accumulated in his or her account. At retirement, the individual transforms that lump sum into an annuity with an insurance company. Such annuities must be approved by the government and must include survivor benefits for dependants. Otherwise, people can shop among different companies to find the plan that best suits their personal and family situation.

Choice of retirement age: The choice of retirement age is also up to the individual. Under the old system, the permitted retirement age was the result of political pressures rather than personal choice: blue-collar workers could retire at 65; white-collar workers at 55; bank employees after 25 years of work; and, that most powerful of groups, those who make the laws, parliamentarians could retire after only 15 years of work.

Under the new system, individuals select the age at which they want to retire, and their pension plan managers work out what percentage of income they must contribute to achieve it. They then instruct their employers to pay that amount from their gross wage directly into their chosen pension fund. If a worker's pension savings are not enough at the customary retirement age — 65 for men and 60 for women — to produce the minimum pension (85% of the minimum wage), the state makes up the difference.

Competitive fund management: The system is managed by competitive private

companies called AFPs (from the Spanish for pension fund administrators, *administradoras de fondos de pensiones*). Each operates the equivalent of a mutual fund that invests in stocks, bonds, and government debt. The workers are free to change from one AFP to another, which creates well-advertised competition among them to provide a higher return on investment, lower charges, and better customer service.

The AFP is separate from the mutual fund, so that even if such a fund-management business were to go bankrupt, the assets of the mutual fund — the workers' investments — would not be affected. The regulatory board would take over the administration of the fund and ask the workers to change to another AFP. None of the workers' money would be lost in the process. However, in fourteen years no AFP has gone bankrupt.

Financial and political guarantees: Given the revolutionary nature of the new system, the government wanted the new pension funds to spread their investments and avoid highly risky instruments. So clear investment-diversification rules were imposed on the AFPs. No less than 50% of each portfolio must be held in government-guaranteed securities; no more than 30% in common stocks; and no more than 7% in any one company. More recently, however, the rules are starting to be relaxed (allowing the funds to be invested abroad, for example).

The revolutionary nature of the scheme also demanded some political guarantees alongside the financial ones. For example, pension reform cannot work if it threatens those who have contributed all their lives. So the Chilean government began by assuring every retired worker that the state would guarantee his or her pension; that there was absolutely nothing to fear from the change.

Second, those already in the workforce, who had contributed to the state system, were given the option of staying put. Those who chose to move — as more than 90% did, often despite the protests of their trade union leaders — were given a "recognition bond" which acknowledges their contributions to the old system. When those workers retire, the government will cash the bonds.

New workers, however, are obliged to go into the new system because the old state system is bankrupt. Thus, the old pay-as-you-go system will inevitably die on the day that the last person who entered it dies. Then Chile will have no state pension system whatsoever.

Costs and benefits: By accepting the obligation to pay the pensions of retired persons even though no new contributors were coming in, Chile therefore faced a transition cost, calculated at around 3% of gross national product. However, alongside its enormous pension liabilities, the Chilean government also held enormous assets, and the proceeds from privatizing those assets helped close the funding gap. Thus it was able to make the change without raising tax rates, generating inflation, or pushing interest rates upwards.

After 14 years and thanks to the magic of compound interest, the new system is

paying pensions that are 40%-50% higher than those paid under the old system. In a decade when the Chilean economy averaged 7% real annual growth, the average AFP achieved 13% real annual returns on investment. Disability and survivor pensions are 70%-100% higher than under the old system. Disability and survivor benefits are not paid from the 10% contribution to the AFP: an additional contribution (which averages about 1.5%) is collected by the AFPs and paid to private insurance companies to purchase group insurance coverage for the contributors.

Economic effects: There have also been positive effects on the labour market as employment costs have fallen. At the start of the new system, employers were required to increase all employees' wages by 18%, but the old 29% employers' payroll tax was eliminated. The workers, who formerly paid employee contributions of only 8% now pay roughly 17% in contributions to the various social insurance programmes. The shared savings for employer and employee reflect the much lower administration costs of the privatized system.

The old pension contributions were seen as a tax on employment. But contributions to an individual's own retirement account are not seen as a tax but as a form of saving. People are willing to contribute far more to their own accounts than they were ever willing to contribute in taxes. This factor may explain Chile's 29% savings rate, now much higher than the Latin American or Western average, and comparable with the Asian tigers: although much of the surge simply reflects the move from public "saving" to private.

This in turn has contributed strongly to the increase in economic growth in Chile, up from 3.5% in the 1970s to the 7% of today. The AFPs have provided a third of the capital for the Compañía de Telefonos de Chile's £1 billion expansion, plus forestry and hydroelectric projects. The Santiago stock exchange has outperformed any other in Latin America over the past decade. Meanwhile, the typical Chilean worker's main asset is not his small house or used car, but the capital in his pension account. Chilean workers are now capitalists, and arguably much more attached to the principles of a democratic market economy as a result.

The trend is spreading: in the last two years, Peru, Argentina and Columbia have all privatized significant portions of their social insurance systems along the lines of the Chilean model, while Mexico has implemented a new privatized system operating alongside the old state-run system.

Singapore

To see one practical way in which a market-based health, pensions and welfare system might work, it is worth examining Singapore's system.

Philosophy of thrift: The philosophy of Singapore is that each individual should pay his or her own way, each family should pay its own way, and each generation should pay its own way. Progress towards that goal has been

remarkable; over the last decade or so, personal savings have soared and government spending on traditional welfare programmes has decreased dramatically. And the Singaporean economy is growing fast as a result.

Principle of self-provision: In Singapore, personal savings accounts are replacing the welfare state. The government there has attempted to identify all of the major lifetime needs that other governments approach with welfare and entitlement programmes. It has tried instead to meet those needs by requiring people to save.

For example, instead of a government-run pension system, Singapore's residents are required to save for their own retirement. These savings can be used to buy life insurance and disability insurance, to make a down-payment on a home, or finance a child's education. And instead of a government-run healthcare system, people are required to save 6% of their annual income, tax free, into medical savings accounts.

Medical savings accounts: The Singapore system makes sure that money spent on medical services is in the hands of the consumers of those services — the patients themselves. In general, 6% of a person's income over an individual's working life will cover the cost of hospital treatment for the vast majority of medical episodes that can occur, and only recently has Singapore thought about extending the system into catastrophic health insurance so that people can protect themselves against larger medical bills.

The funding mechanism: In 1955, Singapore introduced a compulsory savings programme that now covers about three-quarters of all Singaporean workers. Employer and employee contributions are made to the Central Provident Fund (CPF) run by the government.

In the beginning, the CPF invested its funds entirely in government securities, and withdrawals were essentially limited to lump-sum retirement benefits or widows/widowers benefits. Over the years, however, it has acquired a good deal of flexibility, and workers can now direct the investment of up to 40% of their CPF funds and can withdraw money to purchase a home and buy life or mortgage protection insurance. They can also borrow funds from their account to pay college education expenses for a family member.

Subject to these restrictions, the funds which accumulate in the individual CPF accounts of Singapore residents are their own property. They may be withdrawn at retirement, in the event of permanent disability, or if the individual emigrates from Singapore. The funds can be bequeathed and inherited, and at an account holder's death, are payable to his or her heirs.

Saving for hospital care: Beginning in 1984, the government of Singapore extended its programme of enforced savings to require that a certain portion of CPF contributions should be invested in "medical savings accounts" that would provide funds specifically for hospital treatment. The funds in these accounts may be used only for treatment at a government hospital or an approved private

hospital.

Strangely, they cannot be used to purchase outpatient care, including GP services or expensive outpatient procedures such as renal dialysis, or long-term care. Nor can people borrow against future MSA deposits to pay current bills at private hospitals — although members of the same family can pool their MSA balances to pay another family member's hospital bill, and people who enter some government hospitals can settle their bills from future MSA deposits.

Currently, the required 6% of an employee's salary is placed in a medical savings account until the balance reaches approximately £5,500. Once that total is reached and maintained, any additional contributions are automatically placed in an individual's ordinary pension account. In Singapore, £5,500 would be sufficient to cover hospital expenses except in very rare catastrophic cases. To cover this contingency, the Singapore government has negotiated with private health insurance companies with the idea of allowing some portion of people's MSAs to be used for the purchase of health insurance coverage.

Imperfections and benefits: The Singaporean system is far from perfect. Restrictions on the use of medical savings account funds encourage people to overuse hospital care and underuse less expensive alternatives. Other restrictions favour public hospitals over private providers (although Singapore is privatizing its public hospitals) and discourage the development of a competitive market in healthcare service provision. The restrictions against borrowing from future MSA deposits seem unreasonable, since medical expenses cannot be timed to match the build-up of individual funds, although allowing families to pool their funds offsets some of this deficiency in a culture where family support has always been important (and indeed, may well strengthen that sort of family collaboration),

The fact that Singaporeans can use excess balances in their pension accounts and medical savings accounts to help finance the purchase of a home, may in part explain why more than 90% of Singaporeans own their own homes, more than in any other country. Education is expending fast too. In other words, this developing nation is achieving, with pro-market ideas, things that seem to be but a dream for Western social planners — affordable health care, near-universal home ownership, a well-educated population, and retirement funds that people can draw from the age of 55.

ISSUES FOR A UK FUNDED WELFARE SYSTEM

Principles for reform

Economic efficiency: Any redesigned social-insurance system should be actuarially sound and should impose a direct link between contributions and the actuarial value of the benefits earned. This strongly suggests that the redesigned system must rely on market solutions, and that the system should be entirely removed from the government finances. A government-run system is always subject to the familiar Public Choice pressures, whereby the initial design or the subsequent evolution of the benefit regime is forced to reflect the political power of different interest groups, rather than actuarial rationality. To put it bluntly, government is always tempted to buy votes by increasing benefits to levels beyond those which the system itself will support.

Regulation and security: The public must have the highest degree of confidence in any privately-provided alternative to state welfare if it is to succeed. For although people may have their doubts about size of the eventual benefits they might get from the state system, it is still regarded as highly secure. If people are to commit their lifetime savings into a single fund vehicle, then they must regard it as equally secure, and more likely to provide larger benefits. They must feel certain that their funds will be protected from bankruptcy, incompetence, or misfortune.

Depoliticization: Any new system should be immune from the effects of short-term political changes. Again, this powerfully suggests a market-based system, based on market prices and market rates of return on investment, with politicians being limited to setting the regulatory rules at the outset and unable to change the outcome for political motives. People will not wish to feel that their funds can be raided by a future government which takes a different approach. This suggests that they should be entirely outside of the political process.

Transparency: The new system should be utterly straightforward and understood by the electorate, and nothing should be hidden. That in turn implies that the system should be narrow in its focus, stripped of all non-insurance or non-saving elements, and directed purely towards the provision of minimum pensions for the retired population and minimum social insurance benefits for all.

A corollary is that participants must be kept well informed of their personal financial stake in, and property rights to, the accumulating fund balances of the system. Confidence in the system will be enhanced by individual participants being able to see their growing fund balances, and by the understanding that this

property cannot be raided by politicians.

It also implies that the state's role as a provider of welfare must be more clearly defined too. Certainly the consensus will remain that needy groups must be helped by the government; but this is more clearly and efficiently achieved by overt contributions to individuals' own social-insurance funds rather than by the state providing social insurance for everyone in order to make sure that the minority who need help are covered.

Simplicity: In addition, the new scheme should be simple in order to avoid the sort of confusion that currently surrounds individual and company pension schemes, and to encourage broad and active participation in the planning for and management of one's own retirement. One lesson from Chile is that, with enough public exposure and information, even a relatively uneducated and unsophisticated population can understand the principles of a well-designed, simple system, and choose actively and rationally for themselves between different offerings in the marketplace.

The rules concerning payments into the account, and their tax status, must be clear and direct. Similarly, the circumstances under which benefits may be taken out must be straightforward and easy to understand. Volumes of gobbledygook and arcane tax exemptions will not help to establish the funds in the mind of the public. Journalists in the field of personal finance will undoubtedly play a role in publicising the different funds and comparing their performance against each other, but the rules which define them should be accessible and readily comprehensible to members of the public.

Ownership: The crucial element of any market-based alternative system is that it should be based on the ownership of the fund by the individual saver. Any contributions which they make into it must remain their property, along with any growth achieved from the investment of their savings. They should be able to see it grow as they receive regular statements, and to know that it will buy their needs in the future. This is an important feature of both the Chilean and Singaporean models. In both cases the savers own their account, and know that the funds in it can only be used by them.

Responsibility: An important element of a redesigned system is that it should remove the notion that others have the responsibility to provide for a person's future needs. So long as this is seen as the responsibility of government, there will be a standing temptation for people to put as little as they can into the system, and to take as much as they can out of it. Because 'government' is an impersonal entity, people are more ready to cheat it. If government is providing services free to certain classes, others will attempt to be classified with those who qualify.

If the structure of the new system makes it clear that a person's future provision will depend overwhelmingly on what they themselves have put aside, the responsibility is clearly assigned to the individual. People are more ready to pay in if they know that they will benefit directly, and to the degree that they have

made those payments. The new system must overturn any idea that society collectively is responsible for the future needs of its members; that future provision is for themselves to determine by their actions now.

Choices: Finally it would be a desirable feature of a new system if it allowed for the different and varied lives which people lead today. The era which saw the birth and growth of mass state welfare was a period characterized by more uniformity of life style. People worked in similar jobs for most of their lives. They retired at the same time and faced a broad range of similar needs.

This is no longer true to anything like the same extent. The mass society which spawned mass provision of state welfare has been replaced by one in which people occupy a much greater number of economic niches. They have very different needs at different times in their lives. In consequence there is a need for a more varied and flexible system.

A redesigned welfare system should be able to offer people a range of choices at various points in their lives. They should be able to make decisions about contributions based on what they perceive their future needs might be. Individuals should be able to decide on the degree of cover they make against certain outcomes, and on what resources they set against different contingencies.

Practicability and affordability: It goes without saying that any new system has to be one which society can afford. This would be ensured by a firm actuarial link between the benefits paid and the contributions which sustained them.

There is a problem to be overcome, in that people have been given unrealistic expectations by government. It is quite widely believed, for example, that payment of National Insurance Contributions and taxes entitles a person to make virtually unlimited claims on the state. The supposition that the state must provide any medical treatment available, regardless of cost, has led people to sue the state's agencies when they have failed to do so. There has been widespread resentment that people are expected to pay for their own long-term residential care; they regard that as a legitimate claim on government.

Clearly the establishment of a link between what is paid in and what can be drawn out is crucial to the re-education process which must accompany the introduction of a new system. People's expectations must be formed around what their contributions are likely to be worth over the course of a lifetime. In most cases this might well be considerably more than the state can offer, once the unrealistic expectations have been exposed.

Any new system has to be one which is within the domain of the politically feasible. It has to be one which governments would think acceptable to their electorates. Further than that, it has to be one which could actually be introduced to replace the existing system either gradually or suddenly. It must have mechanisms which permit it to be brought in and built up. There have to be ways in which people are given time to grow accustomed to the new system, to prepare for it, and to transfer over to it. It has to be practicable.

THE FORTUNE ACCOUNT

What the account is

The Fortune Account is property. It represents accumulated savings put into it from a variety of sources, and it is the property of the person whose name it bears. It cannot be appropriated from that person by politicians or others. It resembles a bank account in that funds are added to it over a period of years, and those funds grow with the growth of the investment.

Like a bank account, the Fortune Account can be drawn upon when needed, with the crucial difference that it can only be accessed for specific and designated circumstances such as retirement, or temporary periods of unemployment, disability, or sickness, or to fund insurance for more expensive or longer-term contingencies.

As property, the Fortune Account can be inherited after death by the heirs of the holder. Its value does not dissipate or decline with death; it is simply passed on to a new holder, and continues to grow under its new ownership.

Most probably the tax incentives given to Fortune Accounts would mirror those presently applied to private pensions. Funds placed into an account would not be subject to tax, subject to certain limits. Nor is any capital growth of the fund taxed. On death, the balance in a Fortune Account can be deposited in the Fortune Account of an heir without being subject to inheritance tax (if that still exists).

What the account is not

The Fortune Account is not a welfare entitlement. The benefits it confers reflect the contributions that have been made into it, the savings that it has allowed the holder to build up and the insurance services which the fundholder has purchased.

It is not a government promise of a defined benefit. The only government promises are to encourage this form of self-protection through tax concessions, and to make contributions into the funds of needy individuals.

It is not a claim against other taxpayers. The benefits that are payable do not hinge on the degree of political power which particular groups can exercise over the system. They depend instead on the provision which individuals have made over the years into their own accounts.

Nor is it a claim against future taxpayers. There is no inter-generational bargain

in which payments made today will be matched by future contributions by other persons. Payments made today remain securely available in the account for use by its own holder in the future. The holder does not need to rely on future contributors.

In other words the Fortune Account does not represent an income transfer between different groups of people; the only transfer which takes place is between a person now and that same person in the future.

Who holds a Fortune Account?

Since Fortune Accounts replace the present structure of universal state pensions and social insurance, the aim is for everybody to own one.

Transferring future generations into the new fully funded pensions and social insurance system is straightforward. The account is opened at birth in the name of the child, with the government paying in the first £1,000 or so to start it off. That £1,000 will grow, either by interest or by capital appreciation, even while the child is growing up. The child's account might well be topped up by payments made into it by other family members, free of tax up to the normal limits.

The adult population will shift over to Fortune Accounts more gradually. For those below the age of 30, the change will probably be compulsory, so that everyone in this group will have access to future pensions and insurance benefits without future taxpayers being required to finance them.

For those over 30 the Fortune Accounts will be voluntary, at least in the initial stages. In exchange for concessions on tax and national insurance contributions, individuals will be given the chance to opt out of various state benefits and into private alternatives providing cover at least equal to that promised by the state. Anyone who exercises such an option will thereby automatically open a Fortune Account.

As more and more people opt for the private alternatives, so will grow the proportion of the population holding Fortune Accounts. As people opt for alternatives to more state benefits, so will the importance and the size of those accounts also grow. Within a short time there will be a diminishing cohort of unfunded beneficiaries. The death of the last of that cohort would complete the transition to a fully funded system; but in practice government is likely to roll that group into the private schemes well before then by means of a block transfer to private firms to cover the future needs of the group.

What are the obligations?

Fortune Account holders will be required to make payments into their account. For most people in work, this will be a minimum percentage of earnings. It must be sufficient to pay for those elements social insurance cover that are covered in the individual's plan — with those opting for a wider range of benefits to be

covered privately paying more than those with lesser coverage — and to contribute towards the build-up of retirement savings.

Those not in work and earning money will not normally be able to pay into the account themselves. However, their accounts continue to be topped up by the appropriate loss-of-earnings insurance element of their plan, covering temporary unemployment, sickness, or disability. In more extreme or long-term cases the state will contribute the required contributions into the individual's Fortunate Account by way of a welfare payment.

Is the Fortune Account insurance or saving?

The account combines saving and insurance elements. The first element of the account will be savings for retirement. These savings are invested and added to over the person's lifetime until the account contains an amount large enough to purchase an annuity income of a certain minimum size. That minimum income would have to be at least the level of present-day income support levels in order to ensure that the annuitant never became a charge on public welfare funds, but it could be set higher.

The Fortune Account holder will also accumulate savings that can be drawn in the less predictable events of unemployment, disability, or medical expenses. This contingency savings element of the account may be sufficient to cover losses only for a short period; but it greatly reduces the cost of insurance against the time when those events become long-term or turn highly expensive.

The third element is insurance. Part of the Fortune Account holder's regular contributions will go directly to purchase insurance cover for just such big-ticket insurable events. Once again, in order to remove the risk of people becoming a charge on public funds, the government will wish to ensure that such coverage is at least as good as that presently provided by the state under the national insurance scheme; but it could well set the minimum benefit rates and conditions more generously.

A fourth element is discretionary saving. If an individual has already accumulated all the required minimum savings for retirement and short-term contingencies and his or her contributions more than cover the cost of the minimum insurance package, then the surplus might be used in a discretionary way. To qualify for tax relief it might have to be held for a minimum period, but otherwise it could be drawn at the discretion of the account holder; or it can be used to purchase a more generous insurance package, or added to the retirement savings to boost retirement income.

Present-day state benefits are a mixture of welfare transfers between individuals, insurance, and retirement savings. By separating out the welfare element, the Fortune Account allows the saving and insurance functions to be delivered more clearly. By retaining a mixture of savings and insurance to provide for lifetime contingencies, however, the Fortune Account delivers lifetime protection in a low-cost way.

Who handles the Fortune Account?

Fortune Accounts will be managed by provider institutions that are selected by the holders. Any reputable financial institution licensed as an approved provider. The holder will be asked to choose between competing providers, and the financial sections and personal finance supplements of newspapers will provide a source of information and comparison between the performance of different fund managers. Suitable providers of Fortune Accounts might include banks, building societies, insurers and friendly societies.

The providers will be required to manage the accounts according to the minimum contribution and benefit rules, and in line with any regulation on the spread of investments required and the degree of risk allowed. The funds in the account remain the property of the holder, and will have to be kept completely distinct from the corporate finances of the provider institution, so that in the event of the failure of the company, the funds of investors are still protected. The security of investors may be further advanced through an ABTA-style industry self-regulation.

The task of the provider chosen by the account holder will be to administer the account in accordance with these rules. They must ensure that appropriate contributions are collected, that the necessary insurance cover is arranged, that savings are invested with an eye to security and long-term growth, and that benefits are paid quickly and efficiently. The providers will be required to furnish their clients with regular and detailed statements of the performance of the account under their management.

Account holders must be able to change their designated account operator without penalty and at least on an annual basis, thus bringing the pressure of competition to bear on the providers.

What incentives will there be?

Those who provide for their pension and social insurance needs through a Fortune Account should not also have to pay for their provision through the state. Accordingly, there will be relief from national insurance contributions — and, since NICs do not cover the full costs of the welfare state — from income tax too, for those with the accounts. For those gradually transferring to the new system, there will be relief for each state benefit they opt out of by choosing a private sector alternative.

The model is that of the State Earnings Related Pension Scheme (SERPS), which gave tax concessions to those who opted for private alternatives to the state scheme. When Fortune Accounts become universal, no-one will be paying national insurance or tax to the state for their future pension and social insurance needs; they will be paying money instead into their accounts.

Those who opt for the private alternatives will not be excused from payment of

the whole of the national insurance and tax contribution which pays for it. Relief will be from that part of the payment which is hypothecated for their own cover. That part which is used to make income transfers to those too poor to afford to provide their own cover, the welfare element, will not be subject to relief, because welfare cases will still need to be funded.

The Rowntree study of 1995 estimated that three-quarters of the social security system comprises lifetime transfers within the same individuals, with only one-quarter comprising welfare transfers between rich and poor. Were these figures correct, it would mean that Fortune Account holders could be relieved of three-quarters of their hypothecated contributions, which would still be a major incentive for people to move to the new system.

Those thinking about opting out would know that, even if they did not get back the full amount that they spend on state social security, the superior performance of the private sector in insurance and savings plans would soon lead to the acquisition of benefit rights larger than anything the state can promise. In a private and funded system, benefits can grow as fast as the return on capital, which can be invested anywhere in the world; in the unfunded state system, future benefits can grow only as fast as taxation can be extended at home.

What about those who cannot pay?

Lobby group estimates of poverty in Britain may give the impression that most people cannot afford to make provision for the future needs of themselves and their families. This is patently absurd: most people already do so, though they do it inefficiently through a state system that is unfunded, confused in its objectives, and bled by fraud.

To the extent that there remains some who simply cannot make financial contributions to cover their present and future needs, the state does have a redistributive or welfare role. It can fulfil this role most efficiently not by setting itself up as an insurance company or savings bank, but simply by transferring cash into the accounts of those who cannot make contributions themselves.

Temporary loss of earnings are easily dealt with. Unemployed persons, for example, will have no earnings from which they can make contributions; but they will have unemployment insurance from the state, or (if they have opted for it) from their account provider.

For those in the state system, the government makes the appropriate minimum payments into the unemployed person's account, so that future needs are still covered, and the fund continues to build at the minimum rate required. For those who have opted out, the private insurance benefits cover the required contributions. In both cases payments into the account continue during unemployment. Similar principles apply for other insurable income losses: individuals will still be in the state system, or will have opted for a private alternative. Either way, the minimum required contributions are met.

What about longer-term inability to pay?

Temporary loss of earnings is quite manageable. Questions arise concerning two groups with problems on a different scale: the unemployed young people in their twenties who have never known stable periods of employment, and the long-term disabled who will never be fit and able to earn.

The problem of the first group could be largely redressed by several of the schemes currently under discussion to create work for the long-term unemployed, removing the option to sit at home while continuing to draw benefit. Proposals to create jobs by subsidies to employers who take on the long term jobless would certainly lead to an increase in the supply of jobs, provided job substitution could be avoided. Alternatively the government can pay those same individuals for charity, community and environmental work in the voluntary sector, removing the option to draw benefit if such useful employment is rejected.

In both cases the long-term unemployed would be in jobs, earning, and able to make payments into their account. Their employers — private-sector companies in receipt of government subsidies, or the government itself — would be paying their share as well.

A less attractive alternative, from the point of view of the community as well as the individuals, would be to extend all present welfare support to include payments into the accounts of needy individuals. Unemployed persons do not currently lose their future rights to other benefits simply because they are not paying national insurance. The difference under the Fortune Account system is that provision for those future needs would be set aside by regular payments, instead of simply being promised as a liability on future taxpayers.

Those never capable of working and building up a Fortune Account of insurance and savings will thereby always need help. At worst, we could accept that this will be a very tiny minority, exempt them totally from the new system, and continue to support them as at present, mindful of the shortcomings of the state system.

Better, we could ask Fortune Account providers to open accounts for such individuals, and pay whatever it took to have them so included. The state would still be paying their benefits, but it would be up to the account managers to administer the payments, assess needs, and guard against fraud. Payments by government could be sufficient so that even the permanently disabled were building up Fortune Account savings to fund their future pensions. This method does most to integrate permanently disabled people into a system similar to that which covers those who are capable of earning.

Who controls the use of the account?

There are, in effect, three groups which exercise some degree of control over Fortune Accounts. The first of these is government. It lays down the rules on

contribution rates, benefit levels, and provider probity.

The state will also determine the range of conditions to be covered. These will include unemployment, sickness, disability, long-term care, retirement, and perhaps others such as maternity and parenthood.

It might also set minima on how much has to be left in the accounts at various stages of life, in order that adequate cover is maintained for future needs.

The investment freedom of account managers would probably be subject to official regulation. Government would want to ensure that the pursuit of high-risk investment strategies did not leave account holders too short of funds for their future needs.

The second group to exercise a degree of control will be the account managers. Always subject to the pressures of competition, they will offer certain differences in the quality of insurance cover, and in investment profiles, in an attempt to make themselves attractive to the account holders they seek as clients.

They will retain some discretion about when a holder qualifies for benefit payment, and will police claims made against the account. They have one advantage over the present system in this respect. If account holders do claim fraudulently, they will in some cases be defrauding their own accounts. In other cases they will be attempting insurance fraud of the type which the industry seems to deal with in a much better manner than the government can accomplish.

The third group which participates in the control of the accounts consists of the holders themselves. They have the choice of which operator should handle their account, and the published performance figures of the various firms will undoubtedly be a factor in their decision.

They can make other choices too. They can decide how much to pay in, anywhere between the minimum requirement and any ceiling on tax-free contributions. They can choose whether to forego spending power now in the interest of a better pension later. They may decide on policies which have a high premium but pay higher benefit.

For the savings element, the operator may well invite the holders to select between various investment patterns. Some may offer 'ethical' investment options, or 'environment friendly' packages. Others may offer a proportion in Pacific growth stocks. The point is that account holders will be able to participate actively in the handling of their accounts.

Some of the biggest choices will concern retirement. The age itself can be chosen, with the choice normally between early retirement with a lower pension or later retirement with a higher one. There will be choice between lump sums with lower payments, or high payments instead. Provided the principle is adhered to that the fund must adequately cover future needs, a range of choices can be

exercised. None of these choices is currently available within the state welfare system.

Can the account be used for other purposes?

It is quite possible for the Fortune Account to build up a surplus. More might have been paid into it, or there might have been better than expected capital growth, with the result that it contains more funds than are deemed essential to guard against future needs. This will be particularly true if the holder has benefited from gifts or bequests by others into the account.

If such surpluses are applied to the purchase of higher-quality insurance packages or retained to increase anticipated pension benefits on retirement, there is no problem. However, the rules have to specify the conditions under which surpluses can be withdrawn from the account for purposes other than the pension and insurance functions which are its prime purpose. The holder of a vast surplus might wish to withdraw funds to help start a business, or to assist with a house purchase.

The rules on such withdrawals will be clear. The first is that there must always be sufficient funds left in the account to cope with the minimum future needs of the holder. He or she must never become a burden to taxpayers. The amount required for this purpose will vary with the age profile of the holder, the number of years of anticipated earnings, and the number of years to retirement. It will be easy in practice to set actuarially based figures on this, and to insist that the appropriate balance be retained within the account.

The second principle is that, since the funds have been accumulated free of tax, they would have to be held for a certain time before they could be withdrawn. The tax concession is designed to promote personal savings, not tax-free spending.

Is growth guaranteed?

Growth is not guaranteed for the savings element in the Fortune Account. Any capital growth depends upon the performance of the sector in which investments are made. While government may insist that a high proportion is in low-risk areas, even these may be subject to cyclical ups and downs. Equities always perform better in some years than in others, and some sectors perform better than others do.

This means that growth will be better in some years and in some areas than in others, and this will reflect itself in the changing value of the account. While on average, given the history of capital growth, it should be possible to achieve steady growth above inflation rates, it will not be guaranteed for any year, or for any group of account holders. A run of poor years might well increase the amount which the holder has to pay in over subsequent years in order to maintain anticipated benefit levels. In a similar way a run of good years might accumulate a surplus which can be withdrawn.

The other factor which will determine the growth level of the account is the skill of the investment manager. Some financial institutions will achieve better results than others, and will probably attract more account holders as a result. Providers will have to publish regular performance figures, both to their account holders, and in the public domain for analysis and comparison. Most will offer slightly different products, so it will be up to individual account holders to take best advice and decide which performance maximizes their own personal benefit from the system, given the choices they wish to make.

Can the account be overdrawn?

The Fortune Account exists to cover future needs. The idea is that a person contributes to it over a lifetime's work, and draws upon it for specified contingencies. For those whose needs occur while they are young, and before they have built up any substantial fund, the question arises as to whether they can overdraw their account, and replenish it when able to make payments again.

The account comprises both saving and social insurance functions. Contributions go partly to pay for insurance premiums for expensive contingencies such as disability, sickness, and long-term care, and partly to build up savings for retirement and to cover short-term loss of earnings and similar expenses.

In the normal course of events for account holders, they are covered by insurance for these eventualities when need strikes; their insurance benefits including top-up contributions into their account when they are unable to make contributions themselves. So there is no question of the retirement savings fund being drawn down to finance insurable events.

Consequently the question of overdrawing the account does not arise for most people. For the small number of cases where people have no savings to provide for short-term expenses or any uninsured periods before insurance benefits become payable, it is possible that the state will have to bridge the gap. But it would not be a case of people drawing down their pension savings, or going into overdraft on them, in order to finance such risks.

At the other end of a working career, the rate at which retirement funds may be withdrawn is regulated by the need to retain sufficient to cover future needs. Account operators will probably purchase annuities, to ensure an income flow no matter how long the holder lives to enjoy retirement. They must certainly retain enough to purchase an annuity of acceptable size, even if they never in fact do so, in order to ensure that they could never become a charge on the taxpayer. Once again, there is no question of the account going negative.

Will the accounts cover other needs?

Given their tax advantages, it is for society to decide the legitimate purposes to which Fortune Accounts may be put, and for individuals and families to choose

how to use their account within those limits. While the purpose of the Fortune Account is to replace with private funded cover the benefits presently promised by income transfer from future taxpayers, it does provide a useful vehicle for extending the range of services and comforts for which people might wish to make provision.

It is possible, for example, that Fortune Accounts might be used to provide a wider range of medical services than the core offered by the NHS, or to provide for a greater level of personal service and 'hotel and general' comforts than the NHS will ever be able to offer in addition to its purely medical treatments. This would seem to be a reasonable extension of present medical benefits, provided of course that sufficient remained in the account to provide a satisfactory minimum level of cover for basic needs in the future.

Similarly, the use of the Fortune Account to provide for long-term care in retirement seems to be a logical extension of its purpose. Rather than see home and property sold off to pay for long-term care, people might prefer to include some kind of long-term care insurance cover in their Fortune Account to guard against such possible needs. It is entirely within the spirit of the account that it could be extended to such socially beneficial purposes.

As society becomes wealthier and people aspire to higher standards for themselves, their families, and other members of society, it is quite possible that other uses can be added to the basic account. This is yet another virtue of a flexible, funded system. Making contribution and benefit systems respond to changing social needs is always much more difficult when the decision involves a play-off between one set of future beneficiaries and a different set of future taxpayers. Where the contributor and the beneficiary are the same person, it becomes much more a matter of personal choice than of pressure-group politics.

CONCLUSION

The social pathology of the welfare is well documented. Far from reducing the problem of poverty, it seems to have exacerbated it. Intended as a temporary cushion against adversity for the unfortunate, it has become in some cases a barrier against independence. By fostering the notion that government and society bear responsibility, the welfare state has destroyed the notion that individual people and families should make provision for their own needs. The welfare state has allowed some people to make destructive lifestyle choices, with the assurance that they will be supported by public funds in doing so.

None of the great founders of social welfare, including Sir William Beveridge, ever intended that it should become a vehicle of permanent support for a significant class of dependants. On the contrary, they saw it in a bridging role, to help through temporary situations people who had little or no access to help from any other source. Most importantly of all, they saw it as an insurance which people paid when they could in order to draw benefits when in need.

That the welfare state is none of those is self-evident. That it is an economic burden which becomes increasingly difficult to support is also true. Accounting for nearly 40 percent of public spending which itself is over 40 percent of GDP, the welfare state diverts approximately one-sixth of all economic activity in the United Kingdom. Far from declining as society grows wealthier, this burden has increased. Talk of welfare cuts is precisely that; it is talk. There have been cuts to the planned and projected increases to some programmes. The welfare bill as a whole continues to rise, and will rise even more as the demographic balance of the population shifts. There will be more burdens, and fewer shoulders to carry them.

Welfare pathology is not only personal, in its effect on the lives it blights. It is also political. Democratic government in the UK has been locked into a system which dare not stop the handout of rewards and favours to interest groups. Politicians have not dared to confront the vested interests of the beneficiaries and their lobbyists.

Yet there is an alternative. The purpose of this report has been to show that there is a valid alternative system which is tainted by none of the abuses of state welfare. It is a system, variants of which have already been introduced with success in other countries. It is a system which could be introduced to the United Kingdom in politically acceptable ways which could enjoy massive support if carefully presented.

The alternative system is a funded scheme. It is one which the benefits received by a person are for the most part the result of contributions made by that person, and which are paid from those contributions. The present unfunded system

pays today's benefits out of today's taxes, reassuring current taxpayers that their successors will be even more generous in their turn. The alternative system saves money, and uses those savings to fund benefits when they are needed.

The term *Fortune Account* is used to describe that personal fund. Not only will it guard its holders safely against whatever fortune life presents to them, it will also be for most of them a larger fortune than they would otherwise have encountered. Of greater value than their cars or houses, the Fortune Account will represent a substantial capital sum which can tide them over life's necessities, and whose remaining worth can be passed on to their heirs and successors.

At the heart of it lies the simple principle that people pay in when they can and draw out when they need. Because it is their own property, they are not making claims upon the resources of other people. Because it is a fund of real savings it is subject to capital growth, and can offer far more than a state scheme whose only growth can come from increased taxation.

The Fortune Account is the successor to state welfare, and it is a successor operated by financial institutions within the private sector. It keeps a good distance from the political word and from the temptations there to play off classes against each other for electoral advantage. The Fortune Account restores honesty to the welfare system.

There are problems of transition, of course, and of the small class of persons who cannot make sufficient payments over the course of a lifetime to sustain themselves through emergencies, or to build up provision sufficient for their retirement. These problems have been honestly addressed, and viable solutions proposed.

This presentation of the Fortune Account and its workings is not the end of a discussion; it is the start of one. It raises questions which have yet to be addressed, and it offers some solutions for which superior alternatives may make themselves available. But it does offer a valid alternative to state welfare. It is a coherent system, and one which we know will work because we have seen variations of it work elsewhere.

It will build up the largest pool of saving ever seen in this country, a pool which will have momentous impact upon our investment capability, and on the ability of our country to make its way in the world of the future. More than that, it will restore to people a sense of responsibility and rational prudence destroyed by the welfare mentality, and let them feel, correctly, that they are in more control over their own circumstances than they thought possible. It will give people and families the chance to shape their own lives and to control their own future.

Some party, some government, will have to replace the welfare state by a less destructive alternative. The Fortune Account is the shape of its replacement.