

BEYOND PENSIONS PLUS

Developing the Fortune Account

by Eamonn Butler, Madsen Pirie and Matthew Young



Beyond Pensions Plus
Defining the Fortune Account

By
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As the capital of an individual can be increased only by what he saves from his annual revenue or his annual gains, so the capital of a society, which is the same with that of all the individuals who compose it, can be increased only in the same manner.

Adam Smith
The Wealth of Nations
Book II, Chapter III

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1. The inevitability of reform

Recent upsurge of the debate

As in so many other countries with a mature welfare state, there is now no doubt in the UK that fundamental reform of the social-insurance system is both necessary and inevitable.

It is also clear that the broad direction of reform has to be towards:

- *greater personal responsibility* for events that can be avoided, insured, or saved for; and
- *individuation and funding* of people's provision for retirement.

The only really live issue, given the number of people with rights in the present system and the enormous cost of those present and future entitlements, is *how* reform can be made to work.

At least we are now debating things openly. For decades, no politician dared question the principles, and few the workings, of a system on which so many electors depended. When a *Labour* leader — John Smith MP — questioned the effectiveness and sustainability of universal benefits, the intellectual climate changed. His successor's willingness to "think the unthinkable" opened up the debate still further, even though neither effort led to truly radical proposals.

Interest-group pressure limited the impact of Norman Fowler's 1980s reforms too. From then on, the Conservative strategy became one of gradual tightening of benefit rates and conditions. That stepped up the public debate as more people began to doubt whether their future entitlements would be worth having.

On 5 March 1997, the debate took a dramatic new turn, with Peter Lilley announcing his *Basic Pension Plus* proposal to move the state pension to a funded basis over the next generation.

Public acceptance of change

With Labour too debating if it should embrace this idea and try to outdo the Conservatives on the details, there is probably no going back for the policy debate. The politicians are shedding their caution as they realize

that the public is willing to accept even painful change if it will secure the future of pensions.

Witness the virtual absence of complaint about raising the female retirement age to 65. Politicians were so nervous they chose to phase it in over decades. With hindsight, they might have raised both retirement ages to a more financially prudent 67 with hardly a protest.

But the public's willingness for change does not stop at pensions. It goes to the heart of the welfare system too. People know that a 1940s welfare state cannot fit 1990s lifestyles. Because it has not kept up, half of us now live in households claiming means-tested benefits, even though nearly 70% of families now run a car, 81% have central heating, 87% own a washing machine, 88% are on the telephone, and we take about 20 million holidays abroad between us.

Growing numbers of people have chosen to install their own protection alongside the state system. Our private pension funds, at £650bn, are now larger than the rest of Europe's put together. Their growth outstrips the government's entire pensions spending. More and more people have their own insurance or savings for private healthcare, long-term care, and income-replacement during periods of disability or unemployment.

The Fortune Account

It is to address all these needs, both pensions and insurable benefits, that the Adam Smith Institute has developed its concept of a personal lifetime saving and insurance account, called the Fortune Account. We believe firmly that the public is very willing to accept this comprehensive package of reform.

Funded pensions. Funded retirement savings will be a key element in each person's Fortune Account.

The advantages of funded pension systems over pay-as-you-go systems are now clear. Among many others, they include the following.

- The *returns are better*. Future pay-as-you-go benefits can rise no faster than the future tax take, while the benefits of a funded system can grow as fast as an investment made anywhere in the world.
- They can be *more portable* between countries, an increasingly important feature in Europe given the new labour mobility.
- People regard them more like *real savings*, instead of just a tax on income or payroll, making employment incentives much more positive.

- They are *more contractually secure* than the unwritten political bargain forced on future generations of taxpayers.

Replacing a state pension system by a properly funded system may take time; but almost everywhere, people are quite willing to contemplate that change.

Insurable benefits. The debate on the future of other benefits has moved in a definite direction too. People are less embarrassed to talk about the need for personal responsibility in lifetime risks, where once it seemed obvious that the whole population should share in them.

In this direct-line database age, perhaps more of us understand that real insurance is not about spreading risks, but about charging people precisely for the amount of risk they want the insurer to bear for them. Yet the state system does the opposite. By spreading the costs of misfortune equally among everyone, it gives people no reason to avoid misfortune or provide against it. The increasingly obvious social effects of this have caused many to ask whether real insurance and saving may be a healthier alternative than a system which subsidizes what we want to reduce.

The Fortune Account. The Fortune Account idea, outlined in the Institute's 1995 report *The Fortune Account* is a development of what had been sketched earlier in the Institute's 1994 collection *The End of the Welfare State* and gestated a decade earlier in its 1984 *Omega Project Social Security Report* and the 1983 paper on *The Future of Pensions* by Eamonn Butler and Madsen Pirie. More recently, the concept has been refined in the 1996 reports *What's Wrong with the Welfare State?, Over to You: The Transition to Funded Fortune Accounts* and *A Fund For Life: Pension and Welfare Reform in Practice*.

This present report explores in more detail the practicalities of how the Fortune Account will work, how it could be introduced, the commercial and political options that must still be decided, and the research agenda for the near future.

Its broad conclusion is that, while many specific strategies are possible, real and lasting reform is possible. Indeed, it is probable, if our politicians really are prepared to follow the lead of their citizens and think the unthinkable about the welfare state.

2. Ten objectives of reform

1. Financial soundness

The first thing people want from any reform of the national insurance system is to put it on an economically secure and sustainable footing. It is precisely the fear that the present system is so unsound that future benefits cannot be relied on, which has sharpened the current debate.

If we are to escape the Public Choice treadmill of politicians expanding today's benefits in the knowledge that the cost will fall on tomorrow's taxpayers, our redesigned system must be *actuarially* sound — with a direct link between the contributions made and the benefits earned. Such financial soundness may be deliverable through commercial contracts. It certainly cannot be guaranteed by the fragile promises of unknown future politicians.

2. Security

For any such market solution to succeed, the public must have the highest degree of confidence in how it works: perhaps more confidence than they have in private pensions and insurance today.

If people are to commit their lifetime savings to a private-sector alternative, they must regard it as more secure and more likely to pay larger benefits than the state scheme. They must feel certain that their funds will be protected against any failure of the provider.

3. Inclusive welfare protection

Any reformed system must provide a good standard of welfare protection for everyone who needs it.

Certainly we should be encouraging those who can to build up savings for their retirement, and to insure themselves against lifetime risks such as disability and unemployment. But those who cannot contribute must still be a part of this new system, enjoying access to the same package of social-protection benefits as everyone else.

4. Incentives that encourage responsibility

Reform must end the perverse incentives of the present system. Today's rights-based approach tempts people at the margin to adjust their circumstances downwards in order to qualify for relief — exactly the opposite of what we hope they would do. Where state support is automatic, people are left with no reason to provide responsibly for their own future needs. On the contrary, many benefits are explicitly denied to those who have saved for themselves.

5. Affordability for all

Any new system must be one which people can afford. Though it must be adequate to people's needs, contributions must be kept to a manageable level. In any move to an actuarially based system, we must still ensure that everyone can afford at least the basic package.

6. Simplicity and intelligibility

Any new scheme should be simple enough to encourage broad and active participation, and to avoid the confusion that abounds in private financial service products today.

It must be as simple as a bank or building-society account. People will queue up to open building-society accounts because those are plain and straightforward. People do not queue up to buy personal pensions, because the law has made those too complicated to understand.

Thus the rules on contributions, taxation, and benefits must promote the development of easily-understood plans. This in turn will help providers standardize their products and so keep charges down.

7. Portability and property

A crucial element of any reform is that people retain all the rights of ownership over the provision which they have made for their future.

Mobility is much greater today than in Lord Beveridge's time, and people want to take the full value of their savings with them when they move. They resent losing state pension entitlements when they move from one country to another. Nor do they want to end up with a string of pension rights from past employers, all of them inadequate because they were designed to reward long service. They want savings they can take with them during life, and leave to their survivors after death.

Giving people such a sense of ownership encourages them to make more provision for their future. Where there is no direct link between outlays and benefits — as with national insurance today — people regard their contributions as simply a tax, something to be minimized. If by contrast there is a clear link, and their outlays grow and come back to them in future benefits, then people regard those contributions as savings, something to be maximized. Ownership means better future provision.

8. Depoliticization of the system

Any new system should be designed on sound actuarial principles rather than to reflect the political power of different interest groups. This means that benefits should be linked to contributions and market returns on investment growth. The role of politicians should be confined to setting the broad regulatory rules and making welfare transfers within the system.

9. Transparency in operation

The welfare state confuses three very different principles: saving, insurance, and welfare. The cost inputs and benefit outputs cannot be separated, so we have no way to know whether we are achieving any of the three objectives efficiently, and no benchmark from which to improve our performance.

The workings of any new system should be utterly clear, with the saving, insurance and welfare functions distinguished. Only then can we make real choices about how much we ought to spend on each, or judge how effective that spending has been in terms of results. Interest groups would find it harder to manipulate the system by disguising their aims as something else. Being intelligible to users, it would ensure benefits went to those who needed them. There would be greater pressure from the public to keep the system and its benefit structure easy to understand.

10. Lifestyle choices

A reformed system must accommodate the diverse lifestyles which people have today, not the norms of the 1940s. It should reflect the choices they now make during their lives, leaving their protection intact when they move jobs, live abroad, or change their lifestyle or family circumstances.

Instead of forcing people into a single monopoly system, we should give them a choice between different providers, offering slightly different products and approaches. Having a real choice between providers would allow people to reap the gains of diversity and competition in how their protection package is designed and how their contributions are managed.

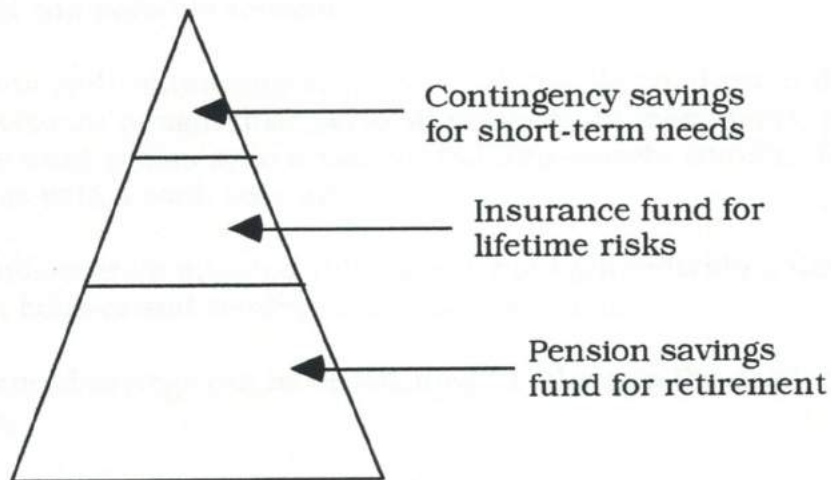
3. The Fortune Account solution

The Fortune Account is the Adam Smith Institute's proposal for a new system which meets all of the objectives of reform.

The Fortune Account is a personal lifetime account which provides a simple alternative to the national insurance system. It is intended for the millions, not the millionaires. It is a basic way of providing lifetime protection for everyone, not a tax-shelter for the rich.

With a Fortune Account, people will be able to save towards their basic retirement pension, and protect themselves against lifetime risks such as unemployment, incapacity, and long-term care.

Figure 1: Outline of the Fortune Account



The Fortune Account comprises two main elements (Figure 1):

- *pension savings*: long-term savings, intended to grow over the Account holder's lifetime in order to provide a continuing income after retirement; and
- *insurance*: coverage for large-scale lifetime risks, such as long-term unemployment, incapacity, nursing-home care, and so on.

The insurance element is probably made more cost-effective by adding a third element to the Fortune Account, namely:

- *contingency savings*: to provide *income replacement* for a short period in the event of temporary unemployment, sickness, etc, and to provide *cash for small-scale expenses* that are not insured.

One reason for adding this third element is that insurance can be made much cheaper if policyholders pay the first tranche of a claim themselves. Processing millions of tiny claims is costly. If policyholders pay the smaller claims themselves, premiums can be reduced greatly. Similarly, people hesitate more about taking a few days off work for sickness or other reasons if they know that they must bear the cost personally. The third element of the Fortune Account allows people to build up savings for these expenses.

The *welfare* function remains the responsibility of the state. Welfare is not about each individual's personal saving or insurance, but about making transfers between different individuals. It might well be better for the state to have these welfare transfers *administered* through each individual's Fortune Account provider, rather than to maintain its own direct payments system. Making sure that resources are transferred to needy people still remains the duty of the state.

A personal and portable account

The pension and contingency savings which people build up in their own Fortune Account remain their personal property. In many ways, the savings element is similar to a bank or building-society account. For example, as with a bank account:

- the funds may be invested collectively, but each individual has a known balance and receives a regular statement;
- any unused savings can be bequeathed to others on the death of the holder;
- people can move their balance to another provider if they so choose;
- holders can change jobs without losing their savings.

Similarly, a building-society mortgage account may be packaged with a mortgage protection policy (an insurance that continues to pay the premiums should the borrower become unemployed or sick) and a household contents policy (to compensate losses caused by fire, theft, flood and other events). The Fortune Account too has an insurance package that pays out when the holder is in need. Though logically separate in its nature and management, it is bound in alongside the savings.

Making contributions

People in work would build up Fortune Account savings and benefits by paying in a regular required amount.

A spouse, partner, relative or friend could also pay into a person's Fortune Account. The state would probably make a contribution too, in recognition for people's past contributions into the national insurance system, and of the fact that they will not be drawing its benefits in the future.

Intended uses of the Fortune Account

The aim of the Fortune Account is to give people a basic income for retirement and a basic insurance protection for lifetime risks. There is little controversy about forcing people to make such basic provision, since without it they would undoubtedly become a charge on others. It is harder to argue that they should be forced to do more.

The aim of the pension savings element must be for the Fortune Account holder to build up savings large enough to provide a retirement income of some minimum acceptable size. We might hope that they will do more, but it is debatable how much further we should extend compulsion.

The insurance element, likewise, aims to provide a minimum cover for lifetime events, so that a Fortune Account holder will not become a charge on future taxpayers. People might be encouraged to protect themselves more generously, but forcing them to do so remains controversial.

Regulation and security

Because the Fortune Account is to serve people's basic needs, it must be secure. Some regulation will be needed, but this should be minimal. Regulation should focus on the package itself, rather than how it is sold, since the Fortune Account aims to be a basic product that should be perfectly appropriate for anyone. The existing Financial Services Act regulation, which covers very complicated products intended for people who already have basic protection through the state, would be a poor model to start from, as Chapter 8 below explains.

Regulation might require that funds are not placed in very risky assets, and that fund managers maintain a spread of investments. There must be mechanisms to guarantee people's savings and benefits in the event of provider failure. The right of holders to have clear information about their Account and to move to another provider must be guaranteed. Regulation should not aim to grapple with complexity, but to promote simplicity.

4. The nature of the Account

What the Account is and is not

The Fortune Account is property. It represents accumulated savings and lifetime insurances. Those savings and policies are the property of the person whose name is on the Account. The savings cannot be raided, nor the insurance contract torn up, by politicians. At the same time, holders can draw on their provision only for specified circumstances such as retirement, unemployment or disability.

The Fortune Account is not a welfare entitlement. The benefits it confers reflect the contributions that have been made into it, the growth of those savings over the years, and the insurance services packaged within it.

The Fortune Account is not a claim against other taxpayers. The benefits payable do not hinge on the power of political interest groups and the division of political spoils, but on the provision which individuals make for their own future.

Nor is the Fortune Account a claim against future taxpayers. There is no inter-generational bargain in which payments made today must be matched by future contributions by other persons. Payments made today remain securely available in the Account for the holder's own future use.

Insurance and saving

Present-day state benefits are a mixture of welfare transfers, insurance, and retirement savings. By separating out the welfare element, the Fortune Account allows the saving and insurance functions to be delivered more rationally and effectively.

As a logical matter, the savings and insurance principles are different too, so those two elements in the Fortune Account would be managed in different ways. But it remains a package rather than an amalgam. With the savings and insurance clearly defined, the Fortune Account is able to deliver lifetime protection more cost-effectively than the confused system run by the state.

Retirement saving. The first element of the Account is saving for retirement. These savings are invested and added to over the person's lifetime. Depending on the scale of the contributions and the returns

achieved by the investment manager, they could grow to any size. Yet *the fundamental objective is for everyone to retire with a fund at least large enough to provide an income, in retirement, of some minimum acceptable size.*

The exact size of that acceptable minimum income in retirement must be a political decision. Certainly it could be no lower than today's income support levels, since then the pensioner would then become a charge on the public's welfare funds, which is what the Fortune Account is intended to avoid. Equally, it cannot be so high as to impose an impossible burden on working contributors.

Insurance. Part of the holder's regular contributions will go directly to purchase insurance cover for the big-ticket insurable events such as long-term disability.

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 comparable to that presently provided by the state under the national insurance scheme, though it could well set the minimum benefit rates and conditions more generously.

Contingency savings. This element of the Account helps keep down the cost of insurance by allowing the holder savings to draw on in the event of small expenses or loss of earnings related to lifetime risks such as unemployment, disability, or sickness. It could be:

- *restricted to a specified total, calculated to be sufficient to provide reasonable security for short-term loss of income or uninsured out-of-pocket expenses, or*
- *allowed to build up to whatever level the contributor chooses.*

The decision between these options will probably turn on which of them is simpler and cheaper to administer, since it is important that the Fortune Account should be a straightforward and inexpensive product.

Who provides Fortune Accounts?

Fortune Accounts will be managed by a range of competing providers, selected by the individual contributors. The providers will have to bring together a wide range of skills and products for their customers. The market will decide what arrangements are most effective as it does today, but as Chapter 8 outlines, the successful providers might well be *consortia of financial institutions*, or new firms, acting like *agencies or brokerages*, which package together the products of different institutions.

The providers will be required to manage the Accounts according to the stipulated minimum contribution and benefit rules, and in line with any regulation on the allowable investment risk.

No doubt the personal finance supplements of newspapers will provide a source of information and comparison between the performances of different providers.

To promote competition, holders should be able to transfer their Account to another provider. However, too much churning would raise the providers' costs and produce lower eventual benefits for clients. A reasonable compromise is to allow people to change their provider at least annually without charge, but for the churn costs to be passed on to customers who changed more frequently.

Taxation of Fortune Accounts

Since those in work are required to make payments into a Fortune Account, some of the compulsion and cost should be offset through favourable tax treatment.

Tax benefits can be granted on *contributions*, on *fund roll-up*, on the *payment of benefits*, or any combination from the three. In today's personal and company pension schemes, the *contributions* and the *fund growth* are tax free, but the retirement income is taxed. In today's personal equity plans, the contributions must come from taxed income, but the *growth* and *benefits* are tax free.

The PEP model has proven attractive and simple for people to understand, and seems a good model for the tax treatment of a Fortune Account. Equally, it seems right to give Fortune Account holders an up-front national insurance rebate to reflect the fact that they are no longer using the state scheme. This combination of rebate and reliefs is like that envisaged in the *Basic Pension Plus* proposal.

What about those who cannot pay?

The Fortune Account gives people a package of savings and insurance benefits to protect them for loss of income due to unemployment, accident, sickness, disability and other events. If their income when in work is too low to purchase a minimum package, the state can purchase it for them by topping up their regular premiums.

Those never capable of working will always need help, and there are two main ways of dealing with this:

- retain part of the state benefit system, with the DSS continuing to support them as at present; or
- ask Fortune Account providers to open Accounts for them, and pay whatever it took to have them included.

Under the second option, the state would still pay for those in need, but it would be the Account providers who dealt directly with benefit recipients. Subject to minimum service standards and government scrutiny, providers would be responsible for assessing eligibility, paying benefits, and protecting taxpayers and themselves against fraudulent claims.

This second method has the benefit of being inclusive: it would integrate permanently disabled people into the same system which covers everyone else, instead of confining them to a ghetto of state-managed benefits. Furthermore, it does not require the government to maintain a vestigial system or assessment and administration, with large overhead costs, when a perfectly practical private alternative exists.

Young people who are unable to get a job when they leave school will also rely on the state to open a Fortune Account for them and pay in regular amounts to fund immediate cash benefits, managed by the Account provider, and for insurance against future risks too.

What needs will be covered?

The Fortune Account is a package that broadly replaces national insurance benefits. However, some redesign of the benefit package will be necessary: it is clear that, as presently fashioned, some national insurance benefits would not be insurable, while other benefits that are regarded as welfare transfers actually would be. Even so, there are large benefits for taxpayers in shifting those parts of the system that *are* insurable to the commercial market.

State insurable benefits. The Fortune Account should replace the basic state pension and more. It would have to provide retirement benefits at least as large as the income support level to avoid holders becoming a charge on other taxpayers. Some minimum figure above this level is clearly desirable. Widows' benefits are easily replicated through life insurance.

The various incapacity and disability benefits are potential candidates for insurance through Fortune Accounts, although the benefit terms may have to be redrawn to make this possible. The state may be obliged to plug any gaps that exist between the state and private benefit conditions, particularly for the transition generation.

Jobseekers allowance is harder to replicate in the private market, because recessions can produce widespread and long-term unemployment that is expensive to alleviate. Again, some unemployment risks can certainly be covered, and the state may have to stand in as a reinsurer for the widespread or longer-term problems.

There will be more debate on whether child benefit, one-parent benefit, and other state programmes are really welfare benefits or an insurable part of a Fortune Account package.

Insurance or saving cover for health care might be controversial, though there is already plenty of private-sector expertise in insuring health, and the saving-plus-insurance strategy of the Fortune Account would be very effective in covering these risks. In any event, since roughly 40% of NHS expenditure goes on the over-60s, it makes sense to consider healthcare within any debate on pension provision. Long-term care provision through savings or insurance would be natural to include within a Fortune Account benefits package.

Future uses. As society becomes wealthier and people aspire to higher standards for themselves, their families, and others, it is quite possible that they will want to see wider uses added to the basic Account. But this is yet another virtue of a flexible, funded system. Adjusting state systems to changing social needs is always difficult: some people gain, some lose, and each decision is instantly politicized between the opposing camps. Things are much easier when the contributor and the beneficiary are the same person.

5. Making the contributions

Compulsory or voluntary?

The Fortune Account is *voluntary* in the sense that nobody should be obliged to leave the state system if they do not want to.

However, the system is *compulsory* in the sense that everyone must either be covered by the state system, or have a Fortune Account. It is still compulsory for people to make provision for their future income security, but Fortune Account holders do it privately rather than through the state.

Many who want reform are still wary about bringing in a new system of compulsory saving which might be seen as simply a new tax — hardly an electoral asset for any political party.

The fact is that *we already have a compulsory system*, though people regard it as a tax rather than as saving, because there is no clear link between contributions and benefits. The Fortune Account replaces this compulsory system with a better one, instead of creating a new compulsory tier on top of the old. As such, it ameliorates the compulsion argument.

Contributions structure

Size of contribution. The basic aim of this compulsory saving is to ensure that nobody who can reasonably provide for themselves should end up as a charge on the state. On liberal principles we have no right to compel people to do more. Yet it might be much easier politically to advocate a percentage-of-income rate of contribution, which looks fairer on the low earners today and removes any threat of the better earners facing a huge drop in income at retirement.

Broadly, the available options might be as follows.

- **A flat sum for everyone.** For example, the National Association of Pension Funds suggests that an annual contribution of about £550 would produce an income at retirement 30% more generous than the income support level. Flat-rate contributions would not only give everyone the basic cover, but would be easy to administer.

- **A percentage of income.** A percentage-of-income contributions would mean that higher earners build up a retirement fund that is larger than those of others, but people may regard a percentage rate as fairer than a flat sum for lower earners.
- **NI-style contributions.** The NIC rules — a variable percentage of income between upper and lower limits — reflect the result of political wrangling over many decades, rather than rational policy. It would be a mistake to try to reproduce this complex compromise.
- **A progressive rate.** Progressive rates can be defended on the grounds of income redistribution through taxation, but the Fortune Account is about saving and insurance, making progressive rates inappropriate.
- **Hybrid arrangements.** The *Basic Pension Plus* formula of a £9 flat-rate weekly contribution, plus an additional 5% of income levy, has much to commend it. The first element reflects the contribution needed to provide a basic retirement income, while the second provides an easy way of saving for those on higher incomes.

For the *retirement savings* element of the Fortune Account package, the hybrid option of £x per week + y% of income seems the best available. Of course, the Fortune Account also contains insurance elements which might require some other pricing strategy, but this raises many other issues which we will consider shortly.

Employer contributions. At present, NICs are levied on employers as well as on employees. This is a political sleight-of-hand to conceal from electors the true size of their contributions. Economically, the whole of a social-insurance premium is best paid by the employee who will receive the benefits. For the employer, it is just a tax on job creation.

In the interests of transparency, one might end employers' national insurance contributions and move the whole burden onto employees. If employers did not raise wages by the amount they saved, however, this could cause hardship in individual cases.

There is also a case for retaining at least some of the employers' contribution as a pure tax, designed to help finance the transition to a secure and funded system.

The need for simplicity. Plainly, there is much to be considered in setting the shape of contributions in a Fortune Account system. In striving to balance the issues of compulsion, affordability, political acceptability and commercial realism, we could easily end up with a very complicated structure. Yet the over-riding need is to create a simple system: the Fortune Account will not work unless it is easy to understand and inexpensive to run.

Pricing the insurables element

Establishing a politically and commercially acceptable formula for the *insurance* element is difficult.

Political and commercial issues. An individual who is more likely to become unemployed, or disabled, or sick than another is naturally more costly to insure. The state system, for its part, simply ignores such risk and charges everyone on the basis of income alone. But if Fortune Account providers based their calculations on individual risk, some individuals would face very high premiums, or would be uninsurable.

Such effective exclusion of anyone because of high premium prices would be unacceptable politically. So we need to work out options for dealing with it. Three broad strategies are possible.

- **Make cross-subsidies explicit.** The first strategy starts by accepting that insurers will do whatever they can to put the right prices on the various risks they run. In one sense, it is good that they should, since prudent households are then no longer subsidizing imprudent ones. But if we allowed insurers to charge individual premiums, there would be big winners and big losers when people transferred over from the uniform-rate state system to the commercially priced one.

We can smooth out this effect by making the existing cross-subsidies explicit — taxing those whose commercial premiums were much lower than what they had previously paid in national insurance contributions, and giving cash or vouchers to those who faced a large rise in premiums.

We might even use the opportunity to rationalize the cross-subsidy process a little, and focus our cash or voucher support only on those in real need. In practice, however, this option would be very complicated to administer.

- **Community rating.** A simpler strategy may be to require insurers to price more uniformly.

This might seem like trying to buck the market, but perhaps we would not need to buck it all that much. After all, insurers would face high costs trying to establish the individual risk profile of each and every client. It may be more economical for them to categorize people roughly, charge everyone in that category the same, and accept the bad risks along with the good. Perhaps we can make this same commercial risk-pooling work to solve our political difficulties too.

If the aim were total equality, we might take the risk-pooling idea to its logical extreme, and require insurers to *charge everyone exactly the same premium*. To prevent them picking only the best risks and

refusing the unpromising customers, we would have to rule that they would have to *accept all applicants for cover*.

Even with such restrictions, insurers could still avoid bad risks, by skewing their advertising message towards the good risks and making it hard for high-risk individuals to seek them out. To prevent such cherry-picking, we really would have to start bucking the market: such as forcing insurers to show they have a representative cross-section of the population on their books, or (as in the Irish voluntary health insurance system), threatening them with profit-capping if they strayed from the market average. These policies seem fraught with difficulties.

- **Limited premium discrimination.** Many problems are solved if we allow insurers to discriminate on the basis of age. Much insurance today is already sold on the basis of age alone. Older people run a far higher risk of ill-health, sickness, incapacity, and disability — the very items we want to move from national insurance. So allowing Fortune Account providers to charge different premiums to people of different ages (but not to charge different premiums to different people of the same age) seems a workable option.

Allowing insurers to discriminate on the basis of gender would solve much of the remaining problem. Again, some risks such as death and accident are highly related to the sex of the individual.

If we accepted that insurers could discriminate only according to these major risk factors, then some people, mostly those in middle age and above, would still face higher premiums. It will be less severe than where premiums reflect individual risk, because good and bad risks average out at each age, but it still leaves us with a political problem.

A promising option here is to include within the Fortune Account a small savings fund which can smooth out the changing premium rates that the Account holder is likely to experience over his or her life. This solution is discussed in more detail in Chapter 6.

Tax treatment of contributions

It seems fair that those who provide for their pension and social insurance needs through a Fortune Account should not also have to pay for that same provision through the state. Some kind of tax concession for those who leave the system therefore seems reasonable.

Rebates or allowances? The first obvious model would be something like the state earnings-related pension system rebates that are available to those taking out private upper-tier pensions — or something like the $\text{£}x + y\%$ rebate in the *Basic Pension Plus* proposal.

The other model is the personal pensions model, whereby contributions are allowable against tax. At the moment, this is arguably of most benefit to the better-paid, who get the largest rate of relief. The idea of confining the relief to the standard rate of income tax has been mooted, but even so, those earning enough to pay tax will benefit more than those who do not.

Complexity is another problem of this model. At the moment, people may contribute only a defined percentage of earnings to a private pension plan. Eliminating this limit entirely, or setting an easily-understandable annual cash sum (say, £6000) may be more intelligible to the public.

The case is strong for making the tax treatment of Fortune Accounts more akin to that of PEPs. For low-income families — the very people we are most trying to help most with a Fortune Account — tax-free *premiums* provide little incentive because they pay little or no tax anyway. They are probably more interested in getting tax-free benefits. And as the standard rate of tax falls, the financial inducement of tax-free premiums falls too.

Equally, it still seems right to give people back some of their national insurance contributions at the front end, if they are not using the state service. The $\pounds x + y\%$ rebate, plus the absence of tax on fund growth and benefits, may seem generous but is entirely sound.

Additional voluntary contributions

Many kinds of savings and insurance vehicles are available in the market, and those will continue to attract people who want much more than the basic protections. But if people want to add a little bit more to their minimum Fortune Account package, they should be able to do so.

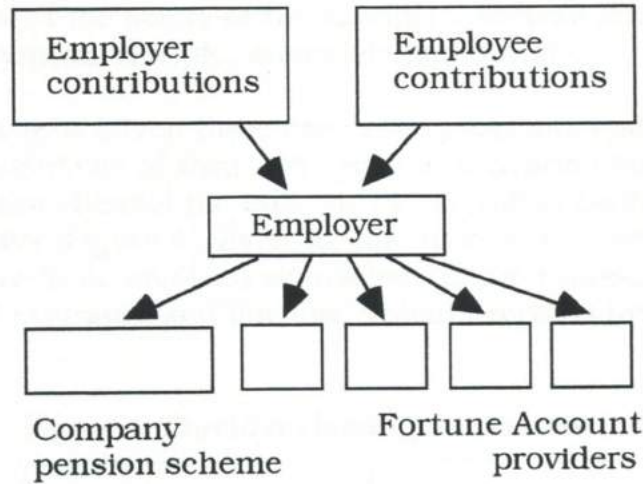
The Treasury may worry about extending the tax reliefs on contributions, or fund growth, or benefits, to any voluntary contributions, and how. Should such advantages accrue only to the basic, required contribution element, or be extended to all contributions made into the Account?

Policing any system with dual tax rules will be complex, and simplicity is crucial to the Fortune Account. In any case, politicians are keen to encourage people to save more than the minimum, and will probably think it right to give additional voluntary contributions the same tax treatment as the compulsory ones. The Treasury will no doubt oppose this concession as it does all others.

The mechanics of collecting premiums

Employers as collection agents. For employees, making contributions to a Fortune Account will be little different from making national insurance contributions. The money would be deducted at source by the employer.

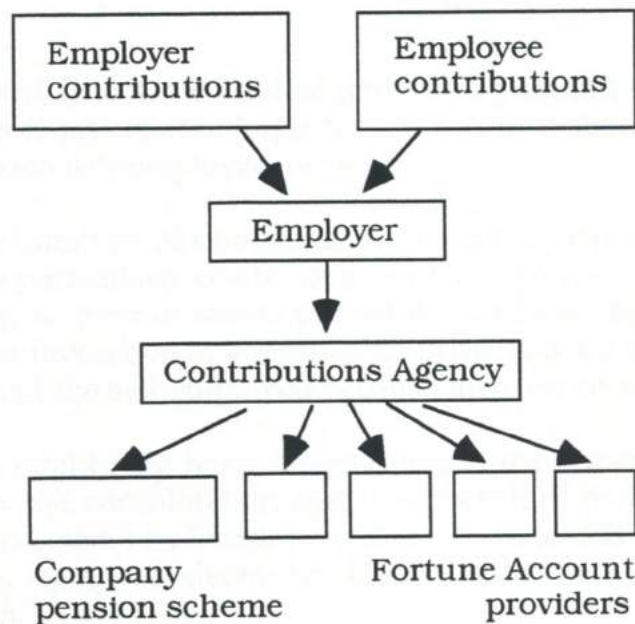
Figure 2: Employers as collection agents



There is still a question of how the money gets from the employer to the various providers chosen by the individual workers to manage their Fortune Accounts. It is a big burden on employers if they have to send cheques to a large number of different providers each month (Figure 2).

Consolidation through NI system. Another option would try to reduce this burden by using the present national insurance contributions mechanism. Thus employers would deduct each employee's payments and send the total amount to the contributions agency. The agency would then consolidate them and send the appropriate totals to the various providers. Figure 3 illustrates how this works.

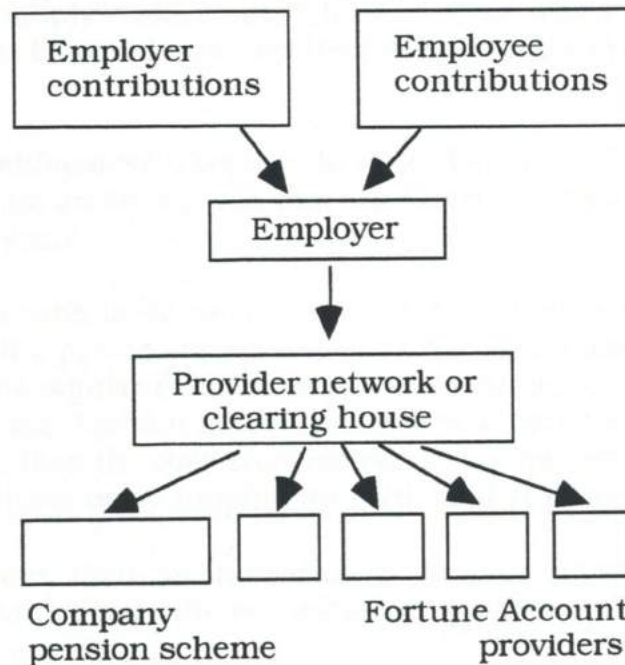
Figure 3: Contributions Agency as a clearing house



This second option involves employers in very little extra work, though it has its disadvantages. Some potential Fortune Account providers are frankly sceptical of the ability of the national insurance system to process the relevant payments cheaply, accurately and quickly.

Collection networks. Given these problems, providers may well develop new, low-cost solutions of their own, such as a clearing-house or network system which can channel the millions of individual contributions to the various providers (Figure 4). Even so, the national insurance recording system will have to be involved somewhere in the process, if only to match national insurance and Fortune Account records for tax purposes.

Figure 4: Provider clearing house network



The self-employed. The same kind of networking should help Fortune Account providers process the large numbers of contributions which would be due from self-employed persons.

Collecting large numbers of small sums from such a disparate group of people could be particularly costly for providers. We want to make sure that the growing number of self-employed people have easy access to Fortune Account protection at a reasonable price, and we do not want providers to avoid the self-employed because they are costly to deal with.

Affinity groups might help here. Associations of the self-employed could act as collection and consolidation agents on behalf of their members; the banks which serve small businesses could do the same; as might credit-card companies. Again, an electronic clearing-house network would help keep costs down.

Irregular contributors

A Fortune Account system should help people who have irregular contribution records. Some people fall in and out of work, so retire without a full quota of national insurance contributions. Many women, in particular, reach retirement age with much less than the full entitlement because they have spent many years away from formal employment, running a home and raising children.

Non-working partners. In a Fortune Account system, we can solve both difficulties by allowing a spouse, partner, or indeed anyone else, to pay contributions into the Account of another person.

Thus in the common case of a working man with a non-working wife, the husband could simply make contributions into his wife's Fortune Account, so that she could build up the full basic pension entitlement by retirement age.

Periods of unemployment. People who suffer long periods of incapacity or unemployment are another group that are served poorly by the present state pension system.

In a Fortune Account, basic pension contributions will be insured as part of the package. If a person suffers a spell of unemployment or inability to work, those same regular contributions will continue, but the insurer pays them instead of the Account holder. If the person becomes entitled to welfare support, then the state pays instead of the insurer — either during the person's lifetime, or by topping up their fund at retirement.

Whatever happens, then, an individual in these circumstances will always retire with at least the full minimum pension entitlement.

Divorce and separation. Issues about the division of a Fortune Account on divorce or separation are analogous to those in the case of personal pensions. If people in working/non-working partnerships choose to share their contributions at the outset, with the working partner making an equal contribution to the Account of a non-working partner, then there is no problem. In other circumstances it would seem right to adjust the funds of each person as if equal contributions had been made throughout their partnership.

Contributions from elsewhere

Anyone can contribute. There should be nothing to stop a spouse, partner, relative, friend or employer contributing into the Fortune Account of another person. If there are tax-allowable limits on Fortune Account contributions, an Account holder should be able to use these up, even if the contribution came from someone else.

There might be merit in going further, and allowing donor individuals themselves to take some tax advantage for contributing into the Accounts of others: allowing parents or grandparents to take some tax benefit if they make contributions into a Fortune Account opened for a non-taxpaying child, for instance. Then, by the time that child came to participate in the workforce, he or she would already have savings that could be used towards a retirement fund, short-term contingencies, or to fund insurance.

Recognition for past contributions. Many of those who opt to start up a Fortune Account may have paid into the state scheme for many years. They will have built up entitlements towards a retirement pension.

Unfortunately, these benefits are unfunded, so when someone leaves the state system, there is no available pot of savings that can be simply transferred over into a Fortune Account. Nor does the government have the spare billions needed to make up the deficit.

As we have explained in past publications, this problem of people's past contributions and future entitlements is best resolved by issuing a *recognition bond* to everyone who leaves the state system. The bond would bear interest, and mature at retirement. Thus leavers get some recognition for their past contributions, while the government does not have to part with hard cash for some time. By then, future taxpayers will be in a better position to afford that cost, since they will already have built up their own pension funds and the burden of the unfunded pensions will be shrinking.

It would be pointless to delay the transition process by trying to work out exact entitlements and bond values for each and every person. That would be labour-intensive and unnecessary, since most people expect to get very little back for their past contributions. The best policy is to settle on a quick-and-easy formula that people accept.

6. Drawing the benefits

Pension benefits

The pension savings element in the Fortune Account is intended to fund a regular income for the holder, payable at retirement and until death. The minimum fund required should be enough to provide a pension that will prevent the individual becoming a charge on future taxpayers, but the exact amount will be a political decision. With additional voluntary contributions, the Fortune Account may of course buy a much larger than this, and people may have other savings to supplement it too.

State top-up. Some people who have been low-paid throughout their lives, or who have not been in work regularly and so have been irregular contributors, may reach the normal retirement age without the minimum fund required. In this event, we envisage that the state would top up their funds to the required minimum level, allowing them the same basic pension income as everyone else.

Top-ups could be made *regularly during an individual's life*, or in a *lump sum at the standard retirement age*. The former gives the individual the benefits of commercial investment and tax-free fund growth. The latter recognizes that some people have a poor lifetime contributions record but may nevertheless earn more or inherit money in later life, so that any previous state support would have been wasted.

Flexible retirement age. Logically, those who have built up savings large enough to finance the minimum pension should be able to retire, and start drawing that pension, at any time thereafter. Yet most private pension legislation presumes that, in return for tax concessions on contributions and fund growth, benefits should not be drawable until some *minimum* age. Some countries also set a *maximum* age at which people must start to draw their benefits, reflecting the fact that the tax concessions are intended to help the individual in retirement, not as a tax-free investment intended for heirs and successors.

Again, it is quite possible to have a range of minimum ages for benefit withdrawal — say 67 for the basic £x per week contribution, 60 for the x% of earnings contribution, and some lower age for savings from voluntary contributions or other pension plans. However, simplicity suggests we should set a single minimum age. Flexibility suggests we should set it low.

Method of drawing pension benefits. There are options about how people should be able to take their retirement benefits from the Fortune Account. Fundamentally, we can allow people to take out and live on that, or allow them to draw it subject to some safety restrictions, or make them convert it into an annuity.

- *Convert to annuity.* One could require people to convert the whole of their fund into an annuity at retirement, or (like pensions today) take some of it in cash and convert the bulk. Yet there are objections to forcing people into annuities, such as:
 - *Market fluctuations.* People retiring within a few months of each other can be left with very different pensions, depending on the state of the markets at the time.
 - *Inheritance.* Converting the fund into an annuity also denies people the chance of leaving any unused savings to friends and relatives when they die, thus discouraging this form of saving.
 - *Opacity.* The requirement to convert to an annuity is difficult for people to understand when they consider saving for a pension. When retirement comes, they also face choices which may not be clear to them.
- *Direct draw-down.* Another option is to let people live off their pension savings directly, without having to buy an annuity. Of course, some restrictions would be needed so that people could not simply to squander their fund and then come back to the taxpayer for welfare support.

One method is to let people withdraw their money over some set period, perhaps based on average life expectancy. Then those who die early can leave capital to their heirs. Those who die late may still give us a welfare problem, but then they may well have other savings that make welfare support unnecessary.

A final option is to let people withdraw their savings at a rate such that they would always have enough left to buy an annuity of the minimum required size. This seems flexible, fair, and safe.

Insurance benefits

The Fortune Account carries a package of insurance benefits, roughly akin to the insurable benefits presently provided by the state through taxation and national insurance.

However, one cannot expect the commercial market to duplicate the state package entirely. The main benefits presently paid by the state are a diverse

mixture of items that may or may not be suitable for commercial insurance to undertake. These include:

- insurable benefits;
- non-insurable (welfare) programmes;
- items that could be insured only if they were reformed in some way; and
- items that could be insured now but which would be much cheaper to cover if their terms were adjusted.

Some re-drawing of state benefits is inevitable if we are to move to a Fortune Account system. Generally speaking, private insurance is a good way of providing for random events which have a large but predictable cost, while saving is a good way of providing for events which are certain, or modest in their cost. State welfare is best at providing for large but unpredictable costs. Yet the insurance and savings principles are completely confused with this welfare principle in today's welfare state. We must unbundle them if we are to make progress.

Limits on insurers. Designing a Fortune Account insurance package requires us to be realistic about what insurers can and cannot do. Among the items that cause them problems are:

- *political economic and other future uncertainties* (for example, a future change in the law regarding minimum benefit rates, or a major economic recession that creates widespread unemployment);
- *self-selection*, where those who think they may need to claim rush to buy cover, while the better risks hold back (though this problem is reduced if membership is compulsory);
- *moral hazard*, where insured people take greater risks because they know any losses will be covered (a significant concern in the state system of today);
- *large numbers of small-scale claims*, which are costly to process.

Insurers try to reduce these problems by methods that do not completely parallel the state's approach, and we must be aware of these differences when we try to divide responsibilities between the two.

For example, state support usually starts immediately from the onset of a misfortune (sickness or disability, for example), while an insurer may specify a *deferred period* in order to reduce self-selection and small short-term claims. An *excess* or deductible in which the policyholder is responsible for the first £x of any loss also reduces the processing cost of

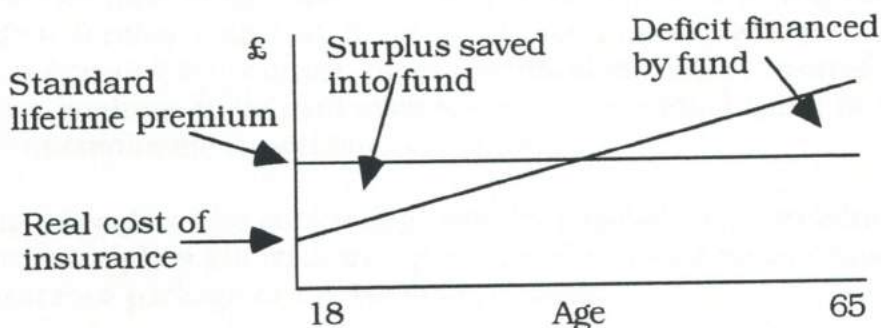
small claims. *Coinsurance*, by which the policyholder must meet a set proportion of any loss, reduces the moral hazard problem, as do limits on the *duration* or the *size* of any claims payable. Political and economic risks are hard to contain except through *reinsurance*, by which overseas underwriters, or domestic governments, agree to share in the larger losses.

Pricing considerations. The price which insurers will charge to undertake Fortune Account insurance business will depend on the level of the benefits, their duration, and the ability to reduce risks by reinsurance. It will depend also on the risk profile of the insured group.

As we have seen, the largest factor determining this risk is age. Older people are more likely to suffer misfortunes such as sickness or disability than are younger ones. This strongly suggests that the Fortune Account requires some mechanism to smooth out these changes in premium rates over a person's lifetime.

This smoothing can be achieved if people's insurance premiums are not paid directly from their regular contributions, but from a savings fund which their contributions build up (Figure 5). Thus people would pay in the same amount each year. A younger person's inpayments would more than pay for his or her insurances, and the rest would be saved. An older person's inpayments would be less than the cost of his or her insurances, but the accumulated savings would make up the difference.

Figure 5: Operation of the insurance fund



In practice, these financial manipulations would be done behind the scenes by the insurers and fund managers, without the customer having to worry. What the customer will see is merely a standard annual charge, not varying over a lifetime, providing a whole lifetime package of insurance cover.

Claims control. The minimum level of cover required from a Fortune Account insurance package will be set by the government, after discussion with insurers. Ultimately, the government has to accept the insurers'

view of what terms and conditions are feasible to insure, and it is up to our welfare policy to plug any gaps.

However, even if the state remains responsible for all long-term insurance and welfare risks, there is still a huge gain for the taxpayer. Even if quite small risks are transferred back to individual responsibility through saving and insurance, many of the state system's negative incentives begin to disappear. Private insurers may not be able to do the whole job, but there is a enormous benefit in getting them to do at least a part of it.

Naturally, the government must ensure that the specified minimum level of benefit is actually delivered. This will need monitoring by a regulatory office or an ombudsman, and some of their decisions will no doubt have to be tested in the courts. But the government's role is to ensure that an acceptable service standard is delivered, not to try to deliver the same benefits itself.

Many people may wish to add to their Fortune Account package, so that they can purchase a superior standard of cover without having to try to match up this basic provision to a top-up policy bought from elsewhere. Again, as long as people have all the minimum cover required, there should be no objection to this.

The range of benefits. A brief survey of the main state benefits (Figure 6) will help show what the private market could undertake.

- *Pensions.* The *state pension*, by far the largest item in the welfare state budget, is already provided in the pension savings element of the Fortune Account. In the state scheme, people with patchy contribution records will retire with less than the full pension entitlement. In the Fortune Account, by contrast, those contributions will be insured, so that they continue to be paid even when the individual is out of work due to unemployment, accident, or sickness.
- *Widows' benefits.* The continuing pension payable to a surviving spouse, is simply a life insurance policy, and it would be an element in the insurance package of the Fortune Account.

War pensions are a minor part of the state budget, which are probably best continued as a state welfare transfer.

- *Unemployment.* This is a difficult risk to cover comprehensively. The potential losses are large because recessions produce many claims all at once, while any individual can be unemployed for a long time. There is the moral hazard that people will not avoid unemployment if their insurance simply replaces all or most of their income.

However, private unemployment insurance does work if it is limited in size and duration. Thus instead of replacing past income, with the

Figure 6: The main national insurance benefits today

Cost (£m) 1997-8	National Insurance benefits	Rate (£pw) Apr 96
33600	State pension	
	Single person	61.15
	Married couple	97.75
1150	Widows benefits	
5681	Unemployment benefit/JSA	
	Single person	48.25
	Married couple	78.00
6700	Incapacity benefit	
	Single person	61.15
5000	Disability living/working allowance	
	Care component	
	Mobility component	
4450	Attendance, care, severe disablement	
	Attendance allowance, higher rate	48.50
700	Industrial disablement, death, injuries	
100	Independent living/motability	
7000	Child benefit	
	First child	10.80
	Subsequent children	8.80
350	One-parent benefit	
		6.30
15700	Income support	
	Couple with two children	126.30
	Pensioner couple	104.10
2050	Family credit	
	Maximum for family with 1 child	58.20
	Other (welfare) benefits	
50	Maternity allowance	
500	Statutory maternity pay	
0.5	Guardian's allowance etc	
1500	War pensions etc (non-contributory)	
100	Housing benefit	
250	Social fund	
5450	Rent rebates	
6300	Rent allowances	
2400	Council tax benefit	

moral hazard that brings, it can aim to replace only the regular family outgoings such as the mortgage, loans, and Fortune Account pension contributions. And instead of paying out indefinitely, it might have to be capped at (say) a year — acknowledging that unemployment of more than a year is best regarded as a welfare issue anyway.

An interesting model which shows how this could be made to work is the Pool Re model. This is a reinsurance company set up by the government in response to the large losses from terrorist activity in the City of London. It provides stop-loss cover which allows commercial insurers to continue underwriting normal business and property risks, in the knowledge that any catastrophic losses due to future terrorism will be shouldered by the government. A similar system could allow insurers to underwrite the risks of unemployment, while being protected against the catastrophic losses that would occur during a severe recession.

Other than this, the unemployment risk would probably be covered by the mixture of contingency saving and insurance in the Fortune Account, with people relying on the contingency saving for the first few weeks' loss of income, with insurance cutting in later.

- **Incapacity.** The private sector's permanent health insurance policies broadly mirror the objectives of the state incapacity benefit. Again, there are moral hazard problems: simple unemployment is often disguised as an incapacity claim; if the benefits replace past income, people exaggerate their past income in order to bump up the benefits. So, as before, this condition is most easily insurable if the benefits are modest, and perhaps related to outgoings.

There are administrative hazards too, since many people suffer brief periods of incapacity which would be hard to administer if they were all covered. A deferred period of perhaps 3-6 months would solve this problem, and once more it would be useful if the contingency savings element of the Fortune Account, or statutory sick pay from employers, could be relied on to ease people over this initial period.

There is a very high chance that anyone suffering incapacity for six months will be drawing benefit for a long time to come. These costs are predictable, but still there is a case for treating them as a state welfare obligation in the very long term.

- **Disability.** The various state *disability* and attendance allowances are intended to help people, usually older people, purchase the care and support services they need for daily living. In this sense they mirror a commercial long-term care contract.

These events are therefore certainly insurable, but as in long-term care policies today, it is very important to define the degree of disability

which the individual suffers, and therefore the scale of the service or benefit which is due.

- **Family benefits.** The future of *child benefit* is already under debate, since most of the expenditure goes to people who do not actually need state support. Likewise *one-parent benefit* has come under scrutiny as the number of single parents rises. This policy uncertainty makes it difficult to predict whether what eventually emerges from the debate could be matched by insurance.

In any case, child-bearing is to a large degree a matter of choice rather than an unavoidable risk, so insurers are wary of it. Some do offer *maternity benefits* as part of a general package, so in principle the reimbursement of hospital maternity costs is insurable, even if the provision of an income on the basis of motherhood is not.

- **Other benefits.** *Income support* and *family credit* are clearly intended as welfare benefits and are not insurable. However, the contingency savings element of the Fortune Account, covering temporary loss of earnings, might allow the state to reduce its own exposure to these risks. Asking people with Fortune Account savings to dip in to them for the first few weeks of need, for example, might simultaneously provide a very positive financial incentive to families while reducing the burden on other taxpayers. The same might be said of *housing benefit*, *rent rebates*, and *council tax benefit*,
- **Health care.** Insurance-based financing of the nation's health care would be controversial, though the Fortune Account could certainly perform this function well. Medical care services are already insurable privately, though the cost of small claims remains a problem. The contingency savings element of the Fortune Account can help. Not only would the use of those savings for small medical expenses make people more aware of the real costs of healthcare, but it would lead to very large falls in costs and therefore in premiums as the number of small claims evaporated.

Even if the NHS remains the nation's health insurer, or the reinsurer for the larger medical expenses, using Fortune Account savings for minor medical expenses would certainly relieve a great deal of pressure on the health budget.

- **Long-term care.** About one in six people need long-term care in retirement. This risk is already insurable privately.

Those with Fortune Account retirement savings beyond the minimum should be able to use the excess for long-term care expenses, or to purchase a single-premium long-term care insurance policy. However, long-term care can be financed much more cheaply through regular

lifetime premiums, and it might be best simply to include it in the annual insurance package.

Likely costs

It is difficult to put any precise figures on the likely cost of Fortune Account insurance premiums. The costs will differ from today's insurance rates because:

- Fortune Account membership is compulsory (reducing self-selection and selling costs);
- the core product is a simple and basic set of insurance covers;
- the state will reinsure many of the gaps in the commercial coverage.

Nevertheless, on the basis today's equivalents of the state insurables, we can compute some very rough costs. For a man of 40 or so, a permanent health (disability) insurance policy would cost around £200 a year. A long-term care policy would cost about £100 a year. Private medical insurance would be another £300 a year. So for about £600 a year we can cover most of the risks presently underwritten by the state, apart from unemployment and the accident and emergency services presently provided by the NHS.

To this must be added the pension contribution — say, the £550 which the NAPF says would buy a basic pension 30% higher than the current income support level. There will also have to be a contribution to build up the contingency savings element of the Account, though exactly how this should be levied remains an issue under research.

All in all, it seems that a contribution rate of no more than 10%-15% of income would purchase the complete Fortune Account package for someone on average salary. A further Adam Smith Institute publication will report in more detail on the exact cost structures that could be expected.

Can the Account be overdrawn?

Account holders who have been in work and have already made contributions will have insurance and contingency savings to protect them in the event of unemployment, incapacity, or other misfortunes. So there is no need for them to dip into their retirement savings to finance such events.

Interestingly, in the Singapore system people are permitted to borrow against their retirement savings for a specified range of items (such as financing a college education for family members), and the United States

also lets people borrow from their 401(k) retirement funds. Indeed, this ability to borrow against funds that are otherwise tied up until retirement is cited as a major factor in the popularity of 401(k) plans.

It would certainly seem unwise to allow people to borrow against that part of their Fortune Account savings which is needed to finance their minimum pension. That at least should be ring-fenced. However, it is more open to debate whether people should be able to borrow, or even withdraw, from any surplus savings. Yet the simplicity imperative would favour ring-fencing the whole of an Account holder's pension savings.

There is a case that people should be able to overdraw the contingency fund element of their Account, provided they build it up again when they are back in work. This may be of particular value to younger people who may not yet have built up significant savings. Once again the simplicity principle may rule out this kind of borrowing.

Relationship of pension and other savings

When people contribute to a Fortune Account, what is the order or priority of the different elements — pension savings, contingency savings, and insurance? Do the contributions which people make each week or each month go first into their pension, or into their insurances, or into some combination of the two?

The first claim on people's contributions should be to provide their insurances. This protects them against large risks such as unemployment and disablement. If they are unable to afford the premiums, then it is for the state to top them up.

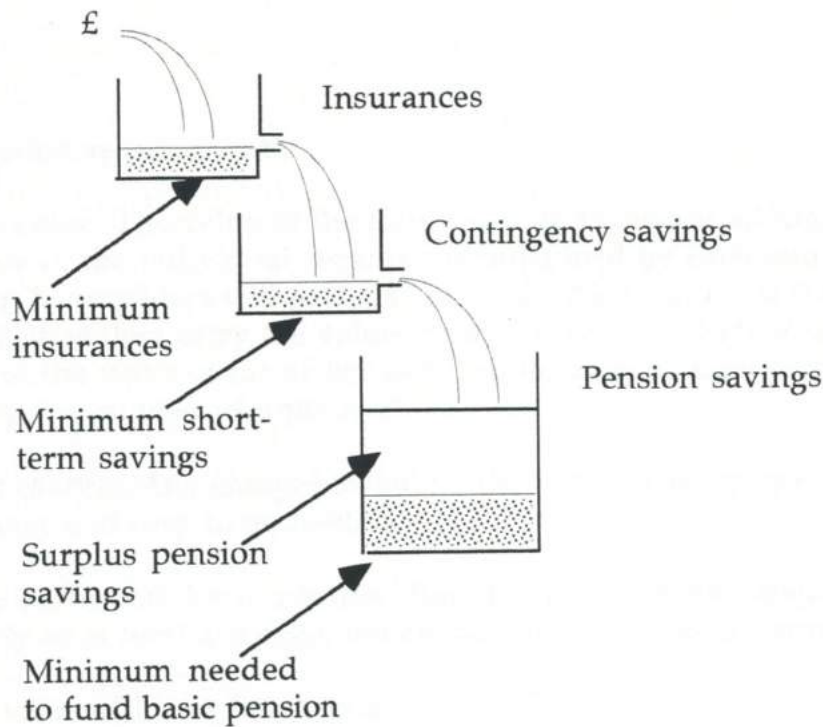
Once a person is in work and contributing regularly, *the second priority is the contingency savings against temporary loss of income.* Again, state top-ups may be required for those in need but with insufficient savings to help them, or families may be required to chip in.

Pension savings are probably the last part of the Fortune Account to be filled from contributions. We do not want to see people with large pension savings still calling on the state for assistance because they have no insurance or contingency savings.

The Fortune Account, then, can be imagined as a series of buckets, filling up and then spilling over into the next, as Figure 7 illustrates. The insurance bucket fills first from the individual's contributions, plus any state assistance. Then the contingency saving bucket is filled. Once the amount of cash in there has reached the minimum required, any further contributions spill over into pension savings.

Figure 7: Priorities in the Fortune Account

Contributions from
state, employers,
and individuals



Gifts and inheritance

The Fortune Account is the property of the individual, and should be transferable by bequest to another person, such as a family member, and should continue to grow as the inherited fund of this other individual. There should be no capital or inheritance taxes on such bequests.

There is no reason why some part of the pension savings in a person's Fortune Account should not be gifted into the Account of another during the holder's lifetime too — provided of course that the holder retains a fund large enough (in principle) to purchase an annuity at the appropriate minimum level to ensure that he or she is in no danger of becoming a charge on the taxpayer.

The Treasury will want to limit the gifting and inheritance of tax-free Fortune Account residues, on death or during a lifetime or both, just as it now limits any capital transfers between individuals. Deciding on the appropriate policy requires us to balance the possibilities of tax avoidance by a few over the benefits of capital accumulation by the many.

7. The rights of Account holders

Information requirements

Known value. The value of the fund must be known at all times, as must the value of the individual Account or units held by each individual member. Newspapers will probably carry the daily values of the different funds, just as they carry the values of unit trusts. The individual can then work out the value of his or her personal holding by multiplying the unit value by the number of units held.

Explicit charges. Any charges levied by the fund managers must be known in advance and easy to understand.

Regular statement. Each member should receive a clear statement, quarterly or at least annually, which indicates in a simple form:

- the value of his or her Account;
- any fees or charges incurred in the last year; and
- the rate of return on the savings element.

In the interests of simplicity and intelligibility, there may even be a case for ensuring that providers do not send *more* than this basic information to Fortune Account holders, unless they ask for it.

Known minimum insurance benefits. Customers must be able to predict the risk benefits offered by the Fortune Account managers. The exact terms will depend on discussions between insurers and governments about what items are commercially insurable and which are properly a welfare duty of the state, or are more economically reinsured as state liabilities. At the end of this debate, the aim would be to provide everyone with a package of insurance and welfare benefits that was at least as good or better than today's national insurance package.

Access to personal information. The details of an individual's Fortune Account are the holder's own information, and his or her access to it should be easy and costless. Information on the holder's contribution record, the size of the savings funds, and rights to insurance benefits should all be freely accessible. It is likely that Fortune Account providers will compete on their ability to offer customers easy access to such basic

information any hour of the day or night, and sophisticated systems to provide it will be one of their selling points.

Security of personal information. Fortune Account holders also have a right to expect that the information held on their behalf is secure and their funds are safe from fraud. Providers would have to guarantee that only the Account holder could authorize changes of address, withdrawals, and other operations on his or her own Fortune Account.

Is growth guaranteed?

One of the questions that most concerns reformers is how far it is possible to predict the size of their future pension benefits.

Like personal pensions today, the pension savings fund in a Fortune Account is a defined-contribution account. It is not guaranteed to pay out any particular sum in the future. Yet there are things we can do to make the final pension payout more predictable.

Investment performance. The main source of uncertainty is that investment growth can never be guaranteed. It depends on the performance of the particular investments which are made. Even low-risk investments may be subject to cyclical ups and downs.

This means that growth will be better in some years 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, returns will not be guaranteed for any year, nor for any group of Account holders.

Thus a run of poor years might well leave contributors with a smaller fund, and future pension benefits, than they expected. In a similar way a run of good years might accumulate a surplus. However, since pensions are a long-term investment, these ups and downs should broadly balance out.

Provider management skill. The other factor which will determine the growth level of the Account is the skill of the investment manager. Providers will compete on the basis of their record at swelling the funds of their clients. Some will achieve better results than others, and will hope to attract more Account holders as a result.

To provide customers with enough information to choose between these different offerings, providers will have to publish regular performance figures, both to their Account holders, and in the public domain for analysis and comparison. It will be up to individual Account holders to choose between providers to obtain the fund performance and service

package which they think is best for them, given their present and anticipated future needs.

Reserves. Politicians may want fund managers to maintain cash reserves in order to boost returns to Account holders should their investment performance fall below a target rate of return. However, any such rule, or any stipulation to confine investors to less volatile instruments only, will reduce overall returns and produce lower final benefits for clients.

Switching investment profiles. One way to make each person's final pension income more predictable is to switch his or her fund from riskier to safer investments as retirement approaches. Then the Account holder can hope to achieve the higher returns from more volatile investments (such as equities) when young, but enjoy the security and predictability of safer investments (such as government bonds) closer to retirement.

Thus the funds of a young person just entering the workforce might be invested almost entirely in equities, on which a real return of perhaps 5% might be expected. As that same person passed middle age, an increasing percentage might be invested in gilt-edged securities. While the expected real returns on these would be much lower, perhaps around 2%, they are less volatile, making retirement income more predictable.

Individual customers could not have the right to switch for themselves. This would add considerably to costs and complexity. Rather, there would be a default system, by which the investments in which each member shared would re-balance automatically, depending on age. This concept of a life-stage fund is perfectly routine in the pensions industry today.

Predictability and politicians. It is worth making the point that the future value of the state pension is far from certain too. Indeed, it depends upon the views of the politicians who will be in charge many years or decades from now. It is quite easy to imagine that there could be further changes in the indexation formula, or even that in future years the state pension became means-tested rather than being available to everyone.

A system so dependent on future politics is inevitably much less secure than one based on commercial investment and written contract. While returns cannot be forecast with precision, there is no doubt that contributions to a funded pension will produce greater benefits than the unfunded state scheme. The supposed problem of benefits being uncertain in a defined-contribution system is less worrying than some commentators suggest.

Transferability

Any Account holder should be able to transfer his or her Account to a new provider. Ideally, holders should be able to move as often as they wish,

and at no cost. However, if clients really did switch very often, this churning would be very expensive to manage.

The benefits of customer choice and competition must be balanced against the costs faced by providers when client lists turn over rapidly. Some time limit on switching might therefore be justified. Given the long-term nature of pension investments, we certainly do not want to encourage people to be moving constantly, on the basis of each quarter's performance figures — which in any case would be an irrational investment strategy. Perhaps a right to switch annually without charge would be sufficient, with an administrative charge being permissible on more frequent switchers.

Insurances. A person who switches to another Fortune Account provider will be switching both savings and insurance elements. The size of the saving fund is known, and this would simply be transferred to the new fund manager.

Insurances might pose a more difficult problem, especially if the individual is already drawing some form of benefit, or has a risk profile that has deteriorated since the insurance was first taken on. Various strategies are available to deal with these issues, and a future Adam Smith Institute publication will consider them in more detail.

8. Fortune Account providers

Approved providers and products

Fortune Accounts will work on the basis that they are *licensed products* offered by *approved providers*. Since they are a basic product, they should be suitable for everyone. No excessive controls are needed over selling, as long as the product itself is sound.

The licensing of the product will depend on whether or not it matches up to the rules on fund management and benefit provision already mentioned.

One provider per person. Simplicity and cheapness dictates that each person should have no more than one Fortune Account provider. While it might seem desirable for people to use different providers for different parts of their Fortune Account — one they think is good at pensions, for example, another they think is good at the insurables — this would increase the cost of splitting premiums yet further, and might make it hard to ensure that an individual's package really did add up to provide entitlements of the minimum level.

Indeed, individual providers may not have the expertise to provide every benefit that the Fortune Account package requires, but the market already has solutions for such problems, and applying the same principles to Fortune Account management will pose few problems.

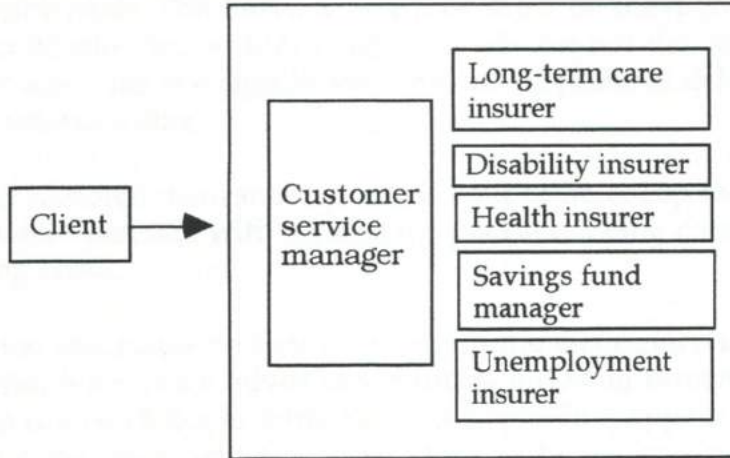
As mentioned earlier, two models which might prove workable are the *consortium* model in which different specialist institutions come together (Figure 8), and the *agency* model in which a client server buys in all the services needed (Figure 9).

Consortia. Potential Fortune Account consortium members would include (among others)

- banks and building societies;
- life and pension companies;
- unit trusts, PEP providers, and stockbrokers;
- employee benefit advisers;

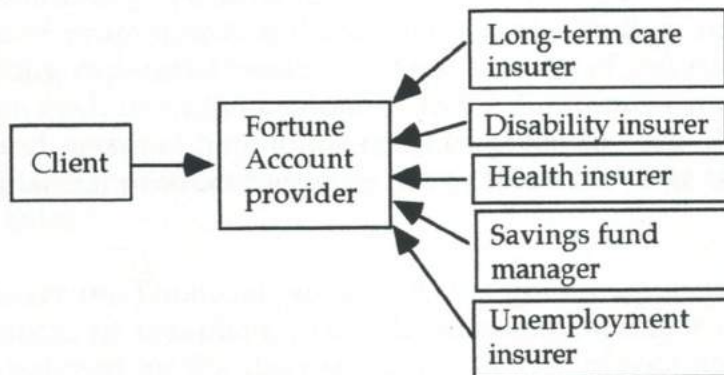
- reinsurers;
- existing company pension fund managers;
- information-technology and client service managers.

Figure 8: Consortium model of Fortune Account provision



Agency model. Equally, the provider which the client deals with needs to be no more than an agency or brokerage, which assembles an appropriate package of insurance and savings vehicles on his or her behalf, just as a travel agent will assemble a package of flights, hotels and car-hire for holidaymakers. Figure 9 illustrates this concept.

Figure 9: Agency model of Fortune Account provision



One advantage of the agency model is that the agency could be the client's gateway to the whole universe of insurers and fund managers, not just to consortium members. The agent may have some strong preferences, but in principle could shop around the whole market in order to assemble a package of specialist services that was right for the individual client.

It would also mean that a client could instruct the agent to switch from one insurance or fund-management company without having to switch the whole package. Thus a client who suspected that another fund manager might achieve better growth could switch to a new one, while leaving his or her existing insurances in place.

Essential features

Low bureaucratic costs. The Fortune Account must be inexpensive to market and to administer, so that holders' funds are not dissipated into bureaucratic costs. This is a significant issue in the political debate on welfare-state reform today.

At present the national insurance system is said to be cheap to administer because it covers everyone with a standard package. Being compulsory, it faces no selling costs.

Yet the national insurance system also suffers the customary inefficiencies of a state monopoly service, gives contributors a dismal return on their money, and is not so cheap to administer as might first appear. After all, it faces no marketing costs, which — given today's heavy regulation of financial services — may be 70% of a commercial insurer's expenses. Taking out that large item, it is clear that the private sector can handle the other administrative work much more cheaply.

Nevertheless, the point remains that, if people are to leave national insurance in order to make their own Fortune Account provision, costs must be kept down as far as possible. Through good design of the Fortune Account concept, we must limit marketing costs, complexity, the regulatory burden, and running costs.

Inexpensive marketing. Fortune Account customers must not share a heavy burden of promotional and marketing costs. Today's regulation makes marketing expensive because a large amount of information has to be collected on each potential customer, and voluminous product information and personal quotations must be given to each. Each person who buys a financial product therefore has to share the large cost of unsuccessful sales.

Regulation under the Financial Services Act is quite inappropriate for Fortune Accounts. Its compliance costs have become a major drag on the market. It is designed for the discretionary purchase of complex products, sold on commission — not for the compulsory purchase of basic products.

Commission structures are another point of issue. Full disclosure of the value of commissions, either in cash or in kind, may help reassure the public about the reliability of the advice they receive. Yet little advice should be needed on a Fortune Account, since it is so basic a product.

Providers will prefer to market directly, and to sell off the page, than to employ expensive independents.

There is, however, something in Fortune Accounts for independent financial advisers. At the moment, people put off making choices about their future financial security in the belief that the state will provide. In a Fortune Account system, they *must* make choices. Membership might be compulsory, but there are still many providers to choose from. In facing up to this choice, people may be inclined to think more deeply about what security they might need in addition to their basic Fortune Account package, so they will certainly seek advice at that stage.

Like the national insurance system, the cost of selling could be reduced significantly if membership of a Fortune Account scheme were made compulsory. This might be politically possible in the case of younger people (say under-30s) who have not yet built up significant state pension entitlements and do not cost too much to insure. But there is more difficulty (and less point) in extending compulsion to those nearing retirement.

Insofar as some Fortune Account scheme membership may be voluntary, the public will need objective advice on whether they are better to stick with the state system or move into a Fortune Account. The prevalence of bad advice on SERPS opt-outs remains a black mark against the personal pensions sector. However, there are various ways to ensure that people have easy access to at least some basic objective advice, and a future Adam Smith Institute publication will report on these options in due course.

Simple design. If costs are to be kept down, Fortune Accounts must be straightforward in design. This may mean the loss of some politically-desirable refinements and complexities, but it is essential. Providers should offer standard packages which customers know will give them a deal as at least as good as they can get from staying in the national insurance system. The tax rules should not add to complexity.

Inexpensive to run. As well as being simple in design and regulation, Fortune Accounts must be cheap to administer if they are to provide a realistic alternative to the state system. As we have seen, this will require creative thinking about how millions of regular contributions can be collected, as well as innovation in how claims are assessed and benefits paid out.

Low administrative costs. Some people argue that a system involving a range of providers could never be as cheap to run as the universal national insurance system. As we have seen, this is untrue. Competition between providers, better cost-awareness, greater innovation, and more efficient working practices, can all reduce costs — which is why contracted-out services are so much cheaper in many parts of the public service.

In the financial sector, simple products like PEPs and rebate-only pensions are no more costly to run than the national insurance system. Fortune Account providers might even be able to gain an extra edge on the national insurance system by simplifying benefits, handling claims and payments more efficiently, and being more effective in controlling fraud.

9. Regulating the system

As already indicated, the Financial Services Act is inappropriate for the regulation of Fortune Accounts. It loads large costs onto the marketing of financial products. Instead, the aim should be simply to license sound Fortune Account packages which are as good as or better than the state can provide, and which anyone can therefore purchase with confidence.

Strategy options

However, some regulation will be needed to assure people that their life savings are safe and that their Fortune Accounts provide good value for money. Apart from the approval of providers and the licensing of standard packages, options that might help ensure this include:

- separation of client money from providers' own business accounts;
- an industry self-insurance or customer guarantee mechanism;
- state guarantees to investors if funds could not pay adequate benefits;
- regulation or benchmarking of investment risks.

Assessment of the options

Separation of management and fund. The companies which manage the various funds must be legally and financially separate from the fund itself, so that the commercial failure of a management company does not rob members of their savings.

Industry guarantees to investors. Competition between providers, and the ability of Account holders to move to another provider if they see fit, is perhaps the most effective guarantor of good performance.

An industry self-insurance scheme (like ABTA in the UK travel-agency market, or the federal deposit insurance system in US retail banking) is another possibility. Under this arrangement, other Fortune Account providers would take over the management of one which got into difficulties, and indemnify customers.

There are, of course, moral hazard costs of this arrangement, in that providers may be more inclined to live on the edge because the downside risk is limited. However, the benefits of staying in business are much greater and this risk should not be overestimated. An industry running any such self-insurance system will take care that scheme members were managing their business to a reasonable standard.

Government guarantees. The government might stand in as the ultimate guarantor in case a provider failed completely and left customers with much reduced funds. It would in any event have to make up the funds of those who did not have enough to purchase a minimum pension, though it could go further in relieving the disappointment of those whose funds were still above the minimum but had been severely reduced.

The same moral hazard issues apply here. The taxpayer certainly cannot be expected simply to pick up the bill for bad investment performance by commercial fund managers. Equally, it would not be credible to construct a compulsory social-insurance system in which the government did not stand as ultimate guarantor. Such an obligation is quite reasonable: if the state forces people to tie up their money in long-term pension funds, then of course it must indemnify them if those investments go wrong.

Investment rules. The risk of people's investments failing might be reduced by controls over fund management, intended to ensure that savers are not exposed to very high risk. This may include controls over:

- the spread of funds between *different types of asset* (shares, bonds, property, etc);
- the spread between *different issuers* of an instrument (ensuring a spread of different equities, different bond issuers, etc);
- the spread between *different groups of instruments* (preventing, say, over-exposure to variable-rate instruments);
- exposure to *particular types of risk* (to eliminate concentration of the investment in high-risk assets);
- exposure to *issuers related to the fund manager* (to eliminate over-reliance on a manager's corporate partners and subsidiaries);
- the *spread of different investments and different ages*, as in the life-stage fund concept.

Debate is needed about such solutions. As we have seen, trying to curb people's exposure to higher-risk investments is counter-productive in a long-term investment strategy. Equities may be volatile, for example, but over the long term they consistently outperform the supposedly safer investments of cash and bonds.

10. Bringing in the reform

A whole package, or in parts?

Any new system has to be both practically and politically feasible. 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.

The Fortune Account has saving and insurance elements, so it is quite possible to split it into two (or three) parts and introduce the scheme a bit at a time. Such piecemeal transition might be attractive politically.

Pensions first, insurance package later? The easiest way to start up a Fortune Account system would be to leave the question of insurable benefits to one side and begin it solely as an alternative to the basic state pension. The UK market has plenty of expertise in handling pensions savings already, so this is a manageable step.

From there it would be a small further step to allow people to add on a standard insurance and contingency saving package to create a fully comprehensive Fortune Account.

Benefit by benefit? We could split things down further. For example, we could start with a national insurance rebate to allow people to make independent Fortune Account provision for their core pension. Then we might bring in the option of adding disability insurance in return for a further rebate; then long-term care insurance; then unemployment benefit, and so on, a benefit at a time.

This does not seem a good way forward. In the first place, it might leave us with a confusing patchwork in which some people were contracted out of some insurable benefits, and others out of others. It would be easier for insurers to manage risks if everyone is signed up to a package, rather than for specific risks of their own choosing. And such a piecemeal reform might well get bogged down politically before it was ever complete.

The conclusion of this is that the best way forward is to introduce the Fortune Account as a comprehensive saving and insurance package. Failing that, it should happen with the pension element being introduced first, and a package of insurables being added later.

Transition mechanisms

Younger people. Transferring future generations into the new fully funded pensions and social insurance system is straightforward. They never rely on national insurance benefits, but pay into a Fortune Account which covers them instead.

One option is for a Fortune Account to be opened at birth in the name of the child. The government might even start it off with the first £1,000 or so, and friends and family could contribute as well. The fund built up from those early contributions will continue to grow and provide a cushion of savings, even before the child enters the workforce and starts to make his or her own contributions.

Adults. Moving the adult population over to Fortune Accounts requires us to address a wide range of public sentiments on a very sensitive subject.

The *Basic Pension Plus* concept tackles the problem very cautiously. It is, of course, limited to pensions and does not cover the state insurables. Moreover, it applies only to new workers as they enter the workforce, so that the change-over to the new individuated and funded system takes a whole generation to put into effect.

Undoubtedly we can move faster than this. Transferring people below the age of 30 or so into a new system is not difficult. They do not expect to get much, if anything, from the state system anyway. For those below the age of 30, the change-over to Fortune Accounts should therefore be compulsory. Thus with immediate effect, everyone in this group will have their own provision for future pensions and insurance benefits without future taxpayers being required to finance them.

Indeed, it is hard to imagine how we could keep them out. An obvious criticism of the *Basic Pension Plus* idea is that it offers such enormously better value for the £9 + 5% national insurance rebate that people in their 20s, 30s and even 40s will almost certainly campaign for the same scheme to be made available to them as well.

Older people. However, many of the over-30s will have given more thought to their future pension needs, and will know that they have already built up some entitlement from the state as a result of their past national insurance contributions. Furthermore, the older people are, the higher their insurance premiums are likely to be. Older workers may therefore be far less willing to be forced into a new system.

Leaving the national insurance system and setting up a Fortune Account should therefore be a voluntary matter for this group.

Everyone who transfers into a Fortune Account should be entitled to at least something for their past contributions to the state system. Even if this

is only a rough settlement, even if it is payable only as an interest-bearing bond that can be cashed in only when they retire, and even if its value is far less than they are genuinely entitled to, many people in the over-30 group will choose to leave. They will know that any future contributions paid into a Fortune Account will give them a very much better return than those same contributions put into the state scheme.

Indeed, the state scheme offers such poor value for money that even if past entitlements are forgotten, a large number of people would still be better off by moving, rather than by sticking with the state scheme until retirement. In *The End of the Welfare State* we calculated that even up to the age of 47, an average worker who will retire at 65 would be better off if his or her future national insurance contributions could go into a funded plan, even if all past entitlements were abandoned.

Existing beneficiaries. People who are already drawing state insurance benefits (for disability, maternity, unemployment, widowhood etc) should also be eligible to take out a Fortune Account, though the state would have to continue carrying the cost.

As discussed earlier, it is best if the state's support is passed through the Fortune Account provider, rather than paid directly. There is no point in the state maintaining its own set of claims-management and benefit-payment systems — at great expense to the taxpayer — when these are already duplicated in the private market. Also, if the benefit is paid to Fortune Account providers on (say) an annual contract, there is a useful financial incentive on the provider to help the individual back to work before the year end. This incentive does not exist within the state system.

Full transition. As more people opt for the private alternatives, so the proportion of the population with Fortune Accounts will grow. In a short time there will be a falling number of unfunded beneficiaries. The death of the last one would complete the transition to a fully individuated and funded system. In practice, the government is likely to roll that group into Fortune Accounts well before then by means of a block transfer.

Individual or group? Some may argue that the new system is probably best organized through employers because then we can sign up large groups at a time, spreading the risk, and keeping the cost down. If we allow people to opt into a Fortune Account one at a time, we must expect some adverse self-selection, producing higher premiums, and higher management costs.

On the other hand, we do want to make Fortune Account membership a matter of individual choice. Only then can we guarantee portability and transferability, and ensure that people do not get trapped into schemes they feel are inappropriate to their own circumstances.

Yet employers remain the natural vehicle if we want to sign up large numbers of people into a new system. A plausible compromise might be

to allow employers to set up Fortune Account schemes for their workers, on condition that the employees can leave it whenever they choose, and transfer their fund and its management to another provider.

This is not too far from the 401(k) concept that has been so successful in the United States. Employers start the schemes, into which they and (usually) the workers contribute. But employees who leave the company do not have to stay in their old employer's scheme. They can transfer their part of the fund into an Individual Retirement Account, or to the scheme of their next employer. Allowing group start-up but some individual right of withdrawal seems a promising way to begin a Fortune Account system.

Start from existing institutions. Other investment vehicles that are familiar to people today could be expanded to provide the basis of a Fortune Account mechanism. For example, we could extend *personal equity plans* into lifetime savings plans and wrap insurance around them.

Existing *company pension scheme managers* might be able to widen their role, from providing an alternative to the state earnings-related pension scheme as they do today, to providing an alternative to all national insurance programmes through a Fortune Account. They already provide the upper-tier pension, and many of them provide top-up employee benefit insurance for disability, health, long-term care and other risks; so it seem quite natural to allow them to act as providers of Fortune Accounts.

Of course, the savings element of a Fortune Account is a defined-contribution scheme, which may not fit comfortably with today's defined-benefit company schemes. But more and more company schemes are changing to defined contributions, and the new prospect of providing a seamless basic and top-up coverage through a Fortune Account might well speed up the rate of conversion.

Funding the transition

The transition to a reformed system must be financially sound as well as politically acceptable. We must be sure that we can afford our escape from the chain-letter state pension system — without loading an enormous burden onto the new one.

Given the pay-as-you-go nature of today's unfunded system, allowing contributors to leave means that there is less revenue coming in with which to pay current beneficiaries. Governments see this funding gap as a problem: they worry that "one generation has to pay twice" — once to fund its own pension, and once more to continue paying the benefits of today's retired population. However, the problem is certainly much less than most people believe, and it might well prove to be no problem at all.

The *Basic Pension Plus* proposal relies on gradualism to spread the burden. Thus the gap is regarded as real, but plugging it becomes manageable because the process takes about 60 years to complete. The downside is that it also takes longer for significant pension funds to be built up, and thus for the economic benefits of a funded system to come to our aid in helping to finance the transition cost.

Another aspect of the *Basic Pension Plus* proposal is that the national insurance rebate which funds the new scheme is only partial. Employers' contributions, together with a large part of the employees', are still paid over to the Treasury, income which can help fill the funding gap.

A more radical option to ease the transition and help plug the funding gap is to stop paying the state retirement pension to everyone, but to *target our available funds solely on the needy* by means-testing it. Of course, that violates the unwritten contract between governments and contributors, though the income support system will still be there to help the poorest, and two-thirds of those retiring have private retirement savings to fall back on anyway. Such notions of restricting the state pension have entered the mind even of the Labour Party, so the proposal is perhaps not so controversial as it might appear at first sight.

A still more radical suggestion is to give those who opt out of the state system little or even nothing in return for their past contributions. However, a more politically practical strategy than denying people any entitlement for past contributions would be to value the recognition bond according to age, starting at zero for younger workers. A very low entitlement for past contributions will not prevent people from making the switch to Fortune Accounts, but it makes a big difference to the public finances in two decades' time as the oldest of the switchers begin to retire.

Another option is to do nothing, apart perhaps from winding up SERPS. The basic state pension, for its part, is already fading in significance as a source of income for the elderly, though for some individuals it is crucial. As rising incomes and falling prices see it fade even further in importance, it becomes progressively easier to meet the funding gap from general taxation, while still building up a new funded system.

Why we do not need to pay twice

Recent research suggests that it might be possible to pay off the existing obligations quite easily, without having to rely on these various complicated (and sometimes morally questionable) schemes.

The reason is that our national insurance system imposes a large drag on the economy. At present, that drag reduces our ability to finance the state pension, or any other spending programme. Removing it boosts our

economic growth, raises incomes widens the tax base, and otherwise allows us to finance the transition relatively painlessly.

There are three main causes of this economic drag:

- Benefits are hardly linked at all to contributions, so people regard the system as a tax, not as saving. Employers too see it only as a tax, and a tax directly on job-creation. These factors reduce job opportunities and raise the disincentives against work, so depressing UK industry.
- The rate of return which people get on their contributions is poor: they could be two or three times better off in a funded system. The benefits in a state pay-as-you-go scheme can grow only as fast as future taxes can be expanded — roughly in line with economic growth, about 2.5%. Funded pension plans, by contrast, grow as fast as their underlying investments, which can be placed anywhere in the world, and in recent years have grown at around 5% in real terms.
- Having to contribute into the state scheme leaves people with less money to apply to their own savings and investment. That part they pay over to the state is spent straight away and is not invested. So there is less capital available for UK businesses who need it to develop.

So large is the economic drag of the pay-as-you-go system, and so large are the benefits of funding, that we should expect a significant annual gain from transferring to a funded system. Some US estimates have put this gain as high as 3% of GNP per year, in perpetuity — roughly a doubling of economic growth.

It would take only a fraction of that to generate enough extra wealth to allow us to meet the entire costs of the transition within a single generation. By way of illustration, a boost to economic growth of only 0.02% would produce enough for the *Basic Pension Plus* scheme to pay for itself over the long and gradual transition period that is proposed for it.

If the boost to economic growth is even remotely near 1%, we could easily afford to make the transition to a fully funded system within a single generation, with enough new wealth being created for us to ensure, in principle, that nobody need be left any worse off (ie nobody has to "pay twice"). As time goes on we will become steadily better off, not being burdened by the cost of supporting an unfunded retired population.

These assertions are quite central to how politicians and economics will judge the country's ability to move from an unfunded to a funded system. Because of this, the Adam Smith Institute intends to report soon on the evidence for a boost to economic growth resulting from the transition, and its likely scale. From there we will develop more fully the case for moving as rapidly as possible to a funded system of pension savings and insurable benefits, such as that provided by the Fortune Account.