

OVER TO YOU

The Purpose and Practicality of Welfare Reform

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Adam Smith Institute
1996

"The man who lives within his income is naturally contented with his situation, which, by continual, though small accumulations, is growing better and better every day. He is enabled gradually to relax, both in the rigour of his parsimony and in the severity of his application.... If he enters into any new projects or enterprise, they are likely to be well concerted and well prepared. He can never be hurried or driven into them by any necessity, but has always time and leisure to deliberate soberly and coolly concerning what are likely to be their consequences."

Adam Smith
The Theory of Moral Sentiments
Part VI, Section I

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The need for welfare reform

By John Willman

Features Editor of the Financial Times

Former General Secretary of the Fabian Society and Member of the Joseph Rowntree Foundation Inquiry on Income & Wealth

There is no immediate crisis

The first observation I would like to make on the subject of welfare reform is that, contrary to some of the crisis-strewn reporting among some sections of the media, there is no immediate crisis of the British welfare state. Unlike most of western Europe, the UK is facing no immediate funding crisis in its social security system.

In large part, this is due to two factors:

- The very low level of the benefits paid by the UK social security system, which means that it is already a much cheaper system than many of our major competitors. This is not necessarily admirable, but it means we start from a lower base.
- Sensible policy adjustments made by ministers from Sir Norman Fowler onwards to curb growth in payments above the rate of economic growth. Such adjustments — for example, tightening the qualifications for invalidity benefit — have avoided turning budgetary control into the sort of high-profile political issue seen in many European countries.

The welfare state still needs a radical overhaul

My second point is that this is not an intellectually defensible position on which to rest reform efforts. Large sums of money continue to be funnelled to people who have little need for state help — much of it, no doubt, drawn from the taxes of people earning little more than poverty wages. The two main benefits this applies to are the basic state pension (which scoops up some £30bn a year — 10 per cent of all public expenditure); and child

benefit (a much cheaper benefit, but one that goes even to wealthy parents).

At the same time, insufficient funds are directed towards other parts of the welfare state — in particular, getting those capable of going back to work into employment. It is unfortunately the case

that the UK welfare state encourages people to stay at home on very low levels of benefit (often topped up in the black economy or through crime), rather than getting them into a position where they could support themselves. Any measures that will actively return people of working age to the labour market will cost more than our cheap benefits — but will have all sorts of virtuous consequences in avoiding the creation of an excluded underclass.

Funding such programmes must mean drawing funds away from benefits such as the basic pension and child benefit for which there is thin intellectual justification. When the welfare state was founded 50 years ago, there was a very close correlation between poverty and retirement, while millions of children lived in want of basic nutrition and shelter. Today, there is no correlation whatsoever between having children and need. And while many pensioners are in the bottom two-fifths of the income distribution, increasing numbers are in the top half.

On child benefit, it seems strange that the state should think that the mere fact of having children entitles anyone to a welfare benefit. Standards of living have quadrupled since the introduction of family allowance, yet we continue to believe that a child is a sufficient addition to costs to merit a negative tax payment. The size of a mortgage or the cost of a season ticket is a far bigger expense in most households than the cost of rearing children. And if child benefit is meant to compensate for the loss of the income of the partner who cares for the children, it is wholly inadequate. Yet we pay it to people who can afford to run a car, out of taxes paid by people who earn too little to buy a bicycle.

On pensions, most people in work have understood the importance of making their own provision, and the majority now retire with non-state pension income in excess of the state pension. But the main obstacle to further provision is the failure of the government to provide a rational and safe means for private provision. The pensions selling scandal was predicted by many pensions experts at the time of the Fowler reforms: the private pension schemes to be sold by insurance companies simply did not represent good value to people with much less than average incomes once costs were deducted.

Worse, there was no regulatory framework that could reassure savers that their money would be safe. The Maxwell pensions case indicated that there was nothing that prudential savers could do to avoid the risk of their pension funds disappearing — even people who had never worked for Robert Maxwell found their pension income under threat.

The state has proved no more attractive as a vehicle for pension provision. We see that successive politicians have changed the rules on state pensions in ways that effectively add up to reneging on the contract between those who are paying for pensions today out of their taxes on the understanding that the next generation

"the main obstacle is the failure of government to provide a rational and safe means for private provision"

will pay their pensions in retirement. In this context, I find the Singapore model less than appealing, since it privatises the state system as a monopoly under conditions that allows the state to tap the funds saved and leaves it equally open to future generations to renege on the pensions contract.

That is why I am glad that the Adam Smith Institute is focusing attention on the Chilean system, which provides real assets for pension savings in the form of property claims on competing private sector funds. Better still, the funds are highly regulated, giving savers assurance on their nest-eggs; by restricting the number of funds, Chile appears to have avoided the expensive competition between myriad providers that has eaten up growth in the UK. My only quibble with the Chilean system is that the over-regulation of the investments open to the funds has not allowed them to diversify their portfolios sufficiently — hence the decline in their performance this year.

A free market purist might argue that the principle of *caveat emptor* — and fear of moral hazard — should keep the state out of such transactions. But there are two good reasons why the state should concern itself with regulating pensions:

The electorate expects it to — and will require it to bail out victims of regulatory failure. This is a human characteristic which may irritate the rationalist, but it is real nonetheless.

The cost of bailing out failures is much less if the system is well regulated itself — indeed it may be cost the state no more than 1 per cent or so of GDP, according to a World Bank study. This is clearly preferable to spending the sorts of sums the UK state spends on pensions to provide a much inferior product.

New welfare needs will emerge

My final point is that the welfare state must be a dynamic institution — and that is why it should be moving out of pensions and child benefit. But as someone who still sees himself as a radical of the left, I believe it should be equally active in moving into new areas of market failure. One of these is long-term care of the elderly, a consequence of rapidly increasing life expectancy. Since 1951 the number of people over 85 has quintupled to over 1 million. Over the next 35 years this number will double again. One in four of these will need a high level of care before they die and one in six will have to spend some time in a nursing home.

Concern over care for the elderly — and where the money will come from — is a growing issue, especially among people over 40 who have parents in this position. Just as 50 years ago, people feared unemployment or old age, now they fear being elderly and incapable.

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To identify this need is not to require that the state should meet the need. But the challenge for the government is to find solutions to meet the need in ways that encourage market solutions to emerge.

How socialists can solve the welfare problem

By Stephen Pollard

*Head of Research, Social Market Foundation
Former Research Director of the Fabian Society*

To begin with a quote from Tony Blair, given to the IEA in May 1994: "The history of workers' co-operatives, the friendly societies and the unions from which the Labour Party sprang is one of individuals coming together for self-improvement and to improve people's potential through collective action. We need to recreate for the 21st century the civil society to which these movements gave birth".

Tempting as it is to look for a Sir Ron Dearing to do for welfare what he is doing for higher education, the politics are very different. In education, everyone agrees that fundamental reform must happen. In welfare, there is real debate between and within the parties on the total spending level — between those who merely want to reorganise the way we spend our current welfare budget, and those who argue that the amount of state spending on welfare must be cut dramatically.

The postwar consensus

The NHS is for many the paradigm of socialism — a state co-ordinated nationwide health and welfare service, free at the point of use. The NHS is one of the proudest boasts of the Labour Party. But the problems of cost, demand, producer sovereignty and consumer powerlessness which the government's reforms sought in part to deal with are so apparent that even Sir Gordon Borrie conceded that "there is a pervasive sense across the UK that current [welfare] institutions and assumptions are inadequate to new challenges". With a Labour government now likely to see the UK into the twenty-first century, it is left-of-centre policymakers who will need to grapple with these issues.

The traditional Left response — to look exclusively to the state to solve society's problems, financed by tax revenue — is no longer an option, both because the electorate wants to take its own decisions and because it is unwilling to support higher taxation. Thus the Left needs to develop an alternative means of securing the same end: efficient, equitable healthcare and welfare provision.

Indeed, if it can discover such a thing, it might even have the potential to move beyond the new consensus that the triumph of capitalism and the market has engendered — and could provide a worthwhile retort to the well-founded jibe that only the Right has any ideas.

Would that they knew it, such a framework was developed in the UK in the eighteenth and nineteenth century, and was adopted by other European socialist parties. But such has been the dominance of the state-driven approach that the individualist socialist welfare tradition is almost forgotten.

Rise and fall of the co-operative model

Long before the post-1945 welfare state model arose, ordinary working people started to band together in the eighteenth and early nineteenth century into co-operatives and friendly societies to secure proper healthcare and social insurance. This took three main forms. The first, started by Robert Owen, sought to promote welfare provision, education and leisure within self-contained working communities such as New Lanark. The second was form of co-operative land and community ownership like the Chartist's O'Connorville. The third, a more focused form of co-operative, was the most impressive, such as the thriving Brighton Co-operative Society.

In 1801 F M Eden estimated that there were 7,200 friendly societies with 648,000 members. By 1910 this had risen to over 6.5 million members (plus those in the large number of unregistered societies). By 1900 the total funds acquired by the various provident institutions had reached £400 million at 1900 prices and 9.5 million people were covered.

From the 1830s onwards, trade unions made welfare provision a primary goal, to be delivered, owned and thus controlled through such mutual aid.

The role of these spectacularly successful organisations did not wither through their own inadequacy but through the rise of another strand of socialist thought: the Fabian, Marxist socialist approach which stressed the role of the state as provider, and which reached its zenith with the creation of the NHS in 1946.

Taking the wider view on welfare

The British Left has forgotten this tradition partly because it has never, as its continental partners have, acknowledged the concept of the *economie sociale* — organisations which trade in the market for a social purpose, such as mutual health insurers and building societies. Simplistic divisions of society into *private sector* and *public sector* handicap forward thinking, especially when the argument

**"to look only
to the state to
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longer an
option"**

then follows that 'private' — ie non-state — organisations should have no role in the provision of health care.

Other European socialist parties are free of this limiting view. Under the recent French socialist government almost 33% of hospital care was provided by the independent sector and French ambulatory care is almost exclusively private sector. The Spanish socialist government oversaw a system in which 31% of hospital beds were privately owned. Some 48,000 out of 77,000 Belgian beds are private. Across the rest of the European Union the story is the same — politicians of Left and Right treat such co-operation between state and independent providers as normal. Indeed, the widespread utilisation of non-state healthcare spending allows much more money to be spent in total on healthcare.

Health sector share of GDP %

	UK	EU Average	OECD Average
Independent	1.1	2.0	3.8
Public Sector	6.0	6.3	6.1
Total Share	7.1	8.3	9.9

Source: OECD 1994

The argument is sometimes put from the left that the British 'prefer' the state to spend their money for them. Sometimes this is true. But look at pensions. The total amount of private investment in pensions stands today at nearly £600 billion — more than in all the other EU countries put together.

The British Left needs to rediscover its ideological heritage. With the electorate unwilling to support a simple return to the old 'top down' approach to welfare provision, the Left should examine — mutual associations and friendly societies (comprised of ordinary citizens banding together to ensure they control their own service provision) can work with the state system. The Left's search for a 'Big Idea' to counter the New Right was always pretty pointless — not least because it need only have involved a look into its own past.

***"others are
free of this
limiting view"***

The transitional problems of welfare reform

Bernard Jenkin MP

Member of the House of Commons Social Security Committee

The future of welfare is a three-fold issue every developed country.

The problems of the state system

First, *how to control the ever-growing costs of welfare*. Countries such as France and Germany are now trying to make tough political decisions about their unsustainably high social security payments.

In the UK, welfare spending has mushroomed. From £6.6 billion in 1974/75, to over £90 billion today. Such growth could not be sustained, and we are fortunate that the Government has been grappling with this problems for some years.

- Linking benefits to prices rather than earnings is saving some £7.3 billion a year.
- Equalization of pension ages will save some £5 billion by 2030.
- Reforms to Incapacity Benefit, Job Seekers Allowance and the introduction of the CSA have allowed the Government to contain the financial burden even while giving an extra £1.2 billion a year more to less-off pensioners.

Second, *the problems of growing welfare dependency*. State welfare has developed around the consensus that the system should be a safety-net, but it has most damaging side effects as it impacts on the character, motivations, and behaviour of the individuals it claims to assist. By nationalizing care and usurping personal responsibility, the welfare creates and reproduces dependency.

Individual capacity for independent action, for self-reliance, for initiative, for family responsibility, for *moral autonomy* is corroded by the knowledge that the more adverse the circumstances presented to the authorities, the more will be the cash reward.

As Charles Murray has argued, irrespective of intentions, the system turns individuals with temporary problems into an

underclass of welfare dependents. Worse still, this underclass is characterized by fractured families, and has become a permanent fixture of society.

Third, *too many people fail to provide sufficiently for retirement*. Only some 50% of the working population are adequately saving for retirement. Many who are low paid, self employed, part-time, or carers seem destined to retire on income support.

Beveridge would be horrified by what his original plans have led to. He recognized the importance of limiting the state.

Today, there is truly vast expense, but little sense among the benefit programmes of "social security" in its true sense. Large numbers of the population will end their lives with no money of their own.

What would Labour do?

Given these problems, what would Labour do to address them?

It is important here not to confuse Labour with Frank Field, whose originality from the backbenches is a ray of sunshine amid the gloom. However much Chris Smith tries to look modern, the only comprehensive Labour thinking was initiated by John Smith, who set up the high-profile Social Justice Commission, asking it to "think the unthinkable".

Its results were disappointing. It was better at identifying difficulties than proposing radical solutions. Its basic line (uncosted of course) is that the government should spend more in the short term and that costs will fall in the future. This reflects Labour's basic instincts. They will not contain welfare costs: they have opposed *all* Conservative measures to do so. Nor have they learned that the state's heavy involvement with welfare is a large part of the problem.

And on pensions, they propose to introduce a state Guaranteed Minimum Pension (which is simply an extension of income support and dependency) and *compulsory* second pensions. The degree to which compulsion is part of any future system is contentious. Compulsory savings could all too easily become, like National Insurance, just another form of tax.

***"the system
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Future reform

What then should be the form of any future welfare system?

The Singapore system has found favour in some quarters. It has achieved a huge savings rate, and over forty years had few major problems. Interestingly, it has evolved into much more than its original pension-only plan. It is a truly personal savings-based welfare system, providing Singapore families with almost all of their welfare and health needs. But the Singapore system has drawbacks.

First, the system is state run, and offers no choice, because it is intended to be the Singapore Government's financial war chest. These funds are open to plunder by spendthrift politicians.

Second, its rate of return has been low — averaging 2 per cent per annum since 1980, compared with an above average-inflation-rate of 7%-8% per cent annually for UK private pension funds.

Third, it has a very high mandatory contribution rate — currently 40 per cent. This may be easy to implement against a background of very low taxation and 9 per cent annual growth rate, but is impossible to envisage for the UK.

Frank Field took the Social Security Committee to Singapore long before Mr Blair got there. He now wants to take it to Chile.

The Chilean system is also a personalized savings system that has provided Chile with a high savings ratio, but Chile is interesting because they have moved from a state system a little like ours. Interest-bearing bonds are offered to cover past payments to the old system.

Critically, savings are managed by private fund managers, providing choice, accountability and better protection from meddling politicians. Savings earn a much higher rate of return — averaging 7.5 per cent today.

"a funded pensions system is the foundation of a truly savings-based welfare system"

Attributes of a new model

In the UK, any new model cannot simply scrap the old. The safety net must remain, albeit better managed, more rigorously policed and more tightly focused on those in real need. New Zealand's "Welfare to Wellbeing" programme has lessons for the UK. The Social Security Committee been there with Frank Field too.

But the objective must be to enable and encourage people to stay above the safety net. A funded pensions system should be the foundation of a truly savings-based welfare system. A continuation of the pay-as-you-go NI system is not only bad economics, but divorces what you pay from what you get. NI is a tax, not a savings scheme. Instead of pooled funds, savings must be *personalized*: the stakeholding that counts is cash that you own.

And these accounts must be *privately managed*, by a choice of institutions, competing to maximise investment returns.

The Adam Smith Institute's *Fortune Account* proposals embody these qualities.

How to get there

The problem of transition is less difficult than many believe. The Government has fostered a change in culture towards private pension provision. Already over three-quarters of employees have opted out of SERPS. Private pensions comprise £600 billion of savings in the hands of private pension fund managers.

Three principal steps need to be taken.

First, a new simplified regulatory framework for personal long-term savings accounts needs to be set up. This would establish a network of approved *Fortune Account* managers. We have a wealth of financial institutions in the UK appropriate for the task.

Second, the future liabilities accumulated by the state NI system should be capitalized in the form of interest-bearing bonds and transferred to individuals' savings accounts. The only real question is the rate at which such transfers are made.

Third, there needs to be a rationalization of pensions and savings tax reliefs. TESSAs and PEPs do not encourage long term saving. Current pensions tax reliefs are vastly complex. Everyone should have a basic tax allowance for pension saving. Tax allowances should be transferable so those earning plenty are encouraged to save for those in the family who are not earning enough to save.

I do believe that, given these simple reforms, the transition can be made. More importantly, it is vital that such a transition *should* be made.

"the problem of transition is less difficult than many believe"

Moving to a funded system

By Dr Madsen Pirie

President of the Adam Smith Institute

The welfare state is the last of the major institutions untouched by systematic and thoroughgoing reform. Since 1979 we have seen the transfer of state industries to the private sector. Similarly, new bodies have been created from the public utilities, and these, too, have been privatized under an innovative regulatory regime. The education service has seen schools opened up to parental choice and influence by means of the introduction of an internal market. The National Health Service has seen the separation of purchasers from providers, and has been driven to greater cost-effectiveness by a similar internal market.

Some of these reforms will need to be honed and polished and added to, but the broad principles which they embody are clearly in place, and will be retained by subsequent governments for some time to come. Only the welfare state stands unchanged. It has been improved in some ways, made worse in others, but the changes have been piecemeal.

It was against this background that the Adam Smith Institute opened a debate two years ago with its modestly titled volume *The End of the Welfare State*. In that book we set out the view that the welfare state, as presently constituted, is ultimately insupportable. The balance of beneficiaries to contributors is changing adversely, and the remorseless appetite of the welfare budget eats ever more into the national economy. Further than that, we made the case that the welfare state fosters what we described as its *social pathology*. It gives perverse incentives against self help, support for family, thrift and provision for the future.

The Fortune Account idea

At the close of last year we unveiled our solution in the shape of *The Fortune Account*, showing for the first time the clear shape of the system which will replace state welfare. Briefly, the *Fortune Account* is a personal savings fund, started at birth, into which money is paid both by the holders themselves and by their employers. These *Fortune Accounts* can only be drawn upon for designated welfare purposes. They are handled by approved private sector providers, and contain two elements. Part is a savings fund invested for growth to meet the retirement needs of

the holder, and part is used to cover the insurable benefits such as unemployment and disability.

The reaction to *The Fortune Account* was favourable. People have recognized that the debate is on, and that the welfare state has to be tackled. This discussion is now taking place on all sides of the political spectrum, and it is a declared aim of the Adam Smith Institute to have both major parties committed before the next election to replacing the present unfunded welfare system by a fully funded one based on personal savings accounts.

We published the outline of such a system in *The Fortune Account*, and we answered systematically many of the questions which are raised by the idea. Now the attention has to turn to the process of transition. The bemused traveller, on asking directions in Mississippi, is sometimes told, "You can't really get there from here." This is roughly how governments feel when they stand amid the wreckage and chaos of their present welfare systems, staring into the distance at the shining city on a hill.

It is an essential part of the process of policy formulation that we address the questions raised by that transition, as well as those raised by the final objective. It is of huge value to this country that other countries do have fully funded welfare systems based on personal accounts, and that one of them at least has successfully made the transition from a pay-as-you-go system like ours to a funded alternative. The Adam Smith Institute published *Singapore versus Chile* in order to give a detailed insight into two different types of funded system, each of which has its advantages.

Our conclusion is that the Chilean system has the enormous benefit that the funds are handled by private institutions, gaining many times the growth rate which the government of Singapore has achieved with its monopoly of these savings funds. On the other hand, we pointed to the flexibility of the Singapore funds, which have gradually incorporated many benefits other than simple retirement income. They now include medical funds, and people can even use part of them for education or to secure a loan on house purchase.

We take the view that no system can be transplanted from one culture to another, but that we can learn from overseas in devising the system that will work best in Britain. In effect, we should incorporate the best elements of what has succeeded elsewhere.

The workings of the Fortune Account

The first question people ask is whether the new *Fortune Accounts* will be compulsory. The answer is ultimately yes, but no more so than the present system. At present you are compelled to pay taxes and national insurance in nominal provision for your future

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welfare and retirement needs. The same will be true with the new system but the money will go instead into an account bearing your name, and it will be your property. Any growth will be yours.

At its introduction, the *Fortune Account* will be compulsory for everyone entering the labour market. Indeed, it will be opened at birth. Our rough estimate is that it should also be compulsory for those aged under 30, who have little confidence that the state pension system will exist anyway when they retire. Those over 30 will be given a choice of staying with the present system or moving to the new one, but the benefits and added security of the new system will be such that a very large proportion will freely make that choice.

The key question is what happens to the money these leavers have already paid to the state over the years. We know that this money was never paid into a fund. It has been spent and is no longer there, but people will be reluctant to lose the entitlement which they feel that it secured them. The solution has already been implemented successfully by Chile. It is for the government to provide a *recognition bond*, representing some proportion of their previous payments, and which can only be redeemed on retirement.

The bond will be paid into their *Fortune Account*, will be interest bearing, and can, indeed, be traded if the holder so wishes. It will represent the state's discharge of its obligations under the old system. Of course, from the Treasury's point of view, the advantage is that the money does not have to be paid now; the bond falls due only on retirement. The funds for the transition will therefore be spread over many decades.

**"the solution
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Some will die before retirement and, just as the entitlement to a basic retirement pension is not inherited, it may be appropriate to make a similar rule apply to the bonds. The *Fortune Account* itself, however, is inheritable, and anything left in it at death can be bequeathed, attracting no tax if it goes straight into the *Fortune Accounts* of the heirs.

People ask what will happen to those who suffer unemployment or disability. The answer is that these misfortunes do not happen to most of us, and are therefore insurable. They form part of the insurable benefits covered in everyone's *Fortune Account*. In the event of these, or similar mishaps, the victim will not only receive cash benefits during the period of unemployment or disability, but money towards retirement savings will continue to be paid in from the insurance company whose policy provided cover. Thus the retirement fund will continue to accumulate even during the period without earnings.

There will be some people who, through disability or other reasons, have never been employed and so are unable to build up a fund sufficient to meet their welfare needs. The answer is

probably that this group will continue to be welfare-dependent, as at present, but that the government will pay funds into their private *Fortune Accounts* during this period. The aim is that everyone will have such an account and be supported by it, even if government has to top up the payments into it of those who cannot make their own.

Securing the safety net

Any politician, any honest one, who considers this transition asks a very straightforward question: Will the state continue to honour the obligations it has made? The answer is yes, it will. For those who remain with the state system, it will continue to deliver what it promised. It will give incentives to people to move to personal funded accounts instead, but its promises will still be good if people stay with it. The number who do so, and the size of those obligations, will start to diminish immediately after the transition, leaving a dwindling number of those who still have entitlements under the old scheme. The transition will only be complete when the last of them dies.

The safety net therefore remains secure. Everyone is either in the new scheme or the old one. They are covered one way or the other. Provision is built into the *Fortune Accounts* for account providers to have industry indemnity, covering each other so that they can pick up the obligations of any provider unable to meet them.

Finally the question of equality is raised. Under the present system people receive the same basic pension, and other benefits are awarded equally to those in similar need. The answer is that the new system will have some equality, in that people will probably choose to cover themselves to a roughly similar extent, and the providers will compete against each other, trying to match what their rivals have on offer. The basic answer is no, however. People are different, and they have different circumstances. Some will choose to put away more now in order to enjoy more later, and the new system will permit that. Some account providers will achieve better investment returns than others, and pay higher pensions on retirement. This is not all that different from the present one, in which people supplement their equal state benefit with additional private ones.

After addressing these transitional questions, we are left convinced that the changeover can be done smoothly and successfully if it is well planned and if the public is well prepared. Both were done successfully in Chile. We are also convinced that whatever the state currently does in welfare will be done better, more efficiently and more humanely by the *Fortune Account* system.

"for those who remain in, the state system will continue to deliver what it promised"

The design of a Fortune Account

By Dr Eamonn Butler

Director of the Adam Smith Institute

The Fortune Account is a simple alternative to the National Insurance system, by which people can save towards their basic retirement pension, and protect themselves against unemployment, incapacity, long-term care, and other lifetime risks.

The Fortune Account is for the millions, not the millionaires. Its purpose is to meet the basic retirement and lifetime insurance needs of everyone, not to provide a tax shelter for the rich.

Confidence and ownership

If people are to trust their basic savings and insurance to a Fortune Account, it must be as secure and as simple to understand as a bank or building-society account. Rates of return must be clear, and any management charges must be explicit.

The Fortune Account comprises two elements:

- savings towards a pension, which can be used only after retirement;
- insurance for lifetime risks, such as long-term unemployment, incapacity, nursing-home care, and so on.

The insurance element might also include some savings for short-term risks, such as temporary unemployment or sickness.

The savings which people build up in their own Fortune Account are their personal property. As with a bank account, the funds may be invested collectively, but each individual has a known balance and receives a regular statement. As with a bank account, any unused savings can be bequeathed to others on the death of the holder. As with a bank account, people can move their balance to another provider if they so choose. As with a bank account, people can change jobs without losing their savings.

Fortune Account providers

Approved standard Fortune Account packages will be offered by a range of licensed providers such as insurance companies, banks, unit trusts, and building societies. Some of these may buy in particular elements of the package from specialist insurance or investment companies, but each would guarantee the complete service to people who chose them.

The corporate finances of the providers who manage Fortune Accounts must be legally separate from the funds owned by their savers. Thus if a provider were to fail or suffer a change in ownership, the funds of Fortune Account investors would still be secure.

Building up and using a Fortune Account

People would build up Fortune Account savings and benefits by paying in some specified proportion — around 10% — of their income. Since the Fortune Account is an alternative to the NI system, they get back some or all of their NI contributions in return.

For people in work, employers will deduct their Fortune Account premium and send it off to the relevant providers, just as they deduct NICs and send them off to the government today. Employers might negotiate bulk rates in order to induce staff to place their Fortune Account with a preferred provider, so reducing their payroll administration costs.

A spouse, partner, relative or friend can pay in to a person's Fortune Account. This will help, in particular, non-working family members who at present accrue limited state pension entitlement and are not allowed to build up a personal pension.

We should let people retire when they want to, provided they have Fortune Account savings large enough to buy a pension annuity of a minimum acceptable size. People wanting to retire earlier would tell their employers to pay larger contributions into their Fortune Account; those willing to retire later could contribute smaller sums.

We should also aim to let people choose how they use their retirement savings: either converting them into an annuity, or drawing down their funds gradually, or some mixture of the two.

"the Fortune Account is for the millions, not the millionaires"

Straightforward regulation

Because the Fortune Account is to serve people's basic needs, it must be secure. We should insist that funds are not invested in

particularly risky investments, and that providers maintain a spread between gilts, equities, property, and overseas investments.

It would be sensible to allow the required investment profile to vary with the age of the investor (less risk as he or she nears retirement, for example). Setting 'default' rules for fund managers will achieve this without individual investors having to make complex decisions of their own.

Protecting individuals

If regulation and competition work properly, funds will be secure, poor investment performance will be checked, and nobody should retire with inadequate pension savings. Nevertheless, the government or the industry will have to stand by as ultimate guarantor to make up the pensions of anyone suffering from a failure in the system.

Income support and other strictly welfare functions would remain with the state. Instead of having to pay its own benefits direct to claimants, however, the state can achieve the same ends by topping up the Fortune Accounts of deserving individuals.

An alternative to National Insurance

The easiest way to start up a Fortune Account system would be to begin it solely as an alternative to the basic state pension. Already the UK has plenty of expertise in handling private pensions, and it would be easy to build up confidence in the standard pensions package. Then it would be a small step to allow people to add on a standard insurance package to create a fully comprehensive Fortune Account.

Naturally we want to keep administrative costs low. Some people argue that a system involving a range of providers could never be as cheap to run as the universal National Insurance system. 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 the key is simplicity. Straightforward, products like PEPs and rebate-only pensions are no more costly to run than the NI system. If we keep the Fortune Account simple, annual administration charges of under 1% of funds under management seem perfectly feasible.

The National Insurance system has low administrative costs because its product is standardized and no selling costs at all because take-up is compulsory. But the Fortune Account package is standardized too: even though people will have a choice of

"the Fortune Account gives people a stake in their own security and prosperity"

providers, there will be little need for expensive marketing and advisory work.

The National Insurance system is also said to be cheap to administer because employers collect the contributions and a single agency in Newcastle processes them. Again, the Fortune Account industry would similarly use employers — or Newcastle itself — to collect the premiums and distribute them to the relevant providers, so there should be little or no extra costs from that source.

Fortune Account providers might even be able to gain an edge on the NI system by simplifying benefits, handling claims and payments more efficiently, and being more effective in controlling fraud.

Conclusion

There are many points of detail that still require answers. Some are questions of technical implementation and commercial viability; others are issues of policy, about what we want the Fortune Account alternative to achieve.

What the Fortune Account will certainly achieve, however, is clear. It will give people a stake in their own future security and prosperity. In so doing it will reverse the effect of those perverse incentives that have eaten down to the very core of our postwar welfare state.

"the key is simplicity"

Serious reform of the welfare state may need us to think the unthinkable about a few cherished beliefs. Yet the prospects for success are good. A welfare system that really works may not prove so unthinkable after all.

A model for practical reform

By Dr José Piñera

President of the International Centre for Pension Reform

Former Minister of Labour and Pensions in Chile

I will not explain the shortcomings of the old pay-as-you-go pension system in Chile. Those shortcomings are very well known because that is the system that is failing all over the world. It fails because contributions and benefits are actuarially unrelated, but are defined politically, by the power of pressure groups.

We decided to go in the other direction, to link benefits to contributions. The money that a worker pays into the system goes into an account that is owned by the worker. A capital fund that secures the retirement income of each individual.

Contributions and benefits

We decided that the minimum contribution should be 10 percent of wages. But workers may contribute up to 20 percent tax free. The money is invested by a private institution, and the returns are untaxed. By the time a worker reaches retirement age — 65 for men, 60 for women — a sizeable sum of capital has accumulated in the account. At retirement the worker transforms that lump sum into an annuity with an insurance company. He can shop among different insurance companies to find the plan that best suits his personal and family situation.

A worker can contribute more than 10 percent if he wants a higher pension or if he wants to retire early. Individuals have different preferences: some want to work until they are 85; others want to go fishing at 55, or 50, or 45, if they can. The uniform pay-as-you-go social security system does not recognize differences in individual preferences. In my country, those differences had led to pressure on the congress to legislate different retirement ages for different groups. As a result, we had a discriminatory retirement-age system. Blue-collar workers could retire at 65; white-collar workers could retire more or less at 55; bank employees could retire after 25 years of work; and the most powerful group of all, those who make the laws, the congressmen, were able to retire after 15 years of work.

Under our new system, you don't have to pressure anyone. If you want to retire at 55, you go to one of the pension-fund

companies and sit in front of a user-friendly computer. It asks you at what age you want to retire. You answer 55. The computer then does some calculations and says that you must contribute 12.1 percent of your income to carry out your plan. You then go back to your employer and instruct him to deduct the appropriate amount. Workers thus translate their personal preferences into tailored pension plans. If a worker's pension savings are not enough at the legal retirement age, the government makes up the difference from general tax revenue.

Account administration

The system is managed by competitive private companies called AFPs (from the Spanish for pension fund administrators). Each AFP operates the equivalent of a mutual fund that invests in stocks, bonds, and government debt. The AFP is separate from the mutual fund; so if the AFP goes bankrupt, the assets of the mutual fund — that is, workers' investments — are not affected. The regulatory board takes over the fund and asks the workers to change to another AFP. Not a penny of the workers' money is touched in the process.

Workers are free to change from one AFP to another. That creates competition among the companies to provide a higher return on investment and better customer service, or to charge lower commissions.

In 15 years no AFP has gone bankrupt. Workers have not lost a penny. Of course, we created a regulatory body that, along with the central bank, set some investment diversification rules. Funds cannot invest more than x percent in government bonds, y percent in private companies' debentures, or z percent in common stocks. Nor can more than a specified amount be in the stock of any given company, and all companies in which funds are invested must have good credit ratings.

We set up such transitional rules with a bias for safety because our plan was to be radical (even revolutionary) in approach but conservative and prudent in execution. We trust the private sector, but we are not naive. We knew that there were companies that might invest in risky financial products and lose a lot of money. We didn't want the pension funds investing workers' money in derivatives in Singapore. If the system had failed in the first years, we would never have been able to try it again. So we set strict rules 15 years ago, but now we are relaxing those rules. For example, only three years ago we began to allow the funds to invest abroad, which they weren't allowed to do initially, because Chilean institutions had no experience in investing abroad. The day will come when the rules will be much more flexible.

Transitional arrangements

"I know I would do some things differently... but it has been a success beyond all our dreams"

Let me say something about the transition to the new system. We began by assuring every retired worker that the state would guarantee his pension; he had absolutely nothing to fear from the change. Pension reform should not damage those who have contributed all their lives. If that takes a new law or a constitutional amendment, so be it.

Second, the workers already in the workforce, who had contributed to the state system, were given the option of staying in the system even though we thought its future was problematic. Those who moved to the new system received what we call a "recognition bond," which acknowledges their contributions to the old system. When those workers retire, the government will cash the bonds.

New workers have to go into the new private system because the old system is bankrupt. Thus, the old system will inevitably die on the day that the last person who entered that system passes away. On that day the government will have no pension system whatsoever. The private system is not a complementary system; it is a replacement that we believe is more efficient.

The real transition cost of the system is the money the government ceases to obtain from the workers who moved to the new system, because the government is committed to pay the pensions of the people already retired and of those who will retire in the future. That transition cost can be calculated. In Chile it was around 3 percent of gross national product. We financed it with bridging debt and privatization proceeds. It will be done differently in each country.

Even though governments have enormous pension liabilities, they also have enormous assets. I am sure that the UK government, even after its many privatizations, still has gigantic assets. In Chile we calculated the real balance sheet and, knowing there were enough assets, financed the transition without raising tax rates, generating inflation, or pressuring interest rates upward. In the last several years we have had a fiscal surplus of 1 to 2 percent of GNP.

Results of the change

The main goal and consequence of the pension reform is to improve the lot of workers during their old age. As I will explain, the reform has a lot of side effects: savings, growth, capital markets. But we should never forget that the reform was enacted to assure workers decent pensions so that they can enjoy their old age in tranquillity. That goal has been met already. After 15 years and because of compound interest, the system is paying old-age pensions that are 40 to 50 percent higher than those paid under the old system. (In the case of disability and survivor pensions,

"pension reform has contributed strongly to an increase in the rate of economic growth"

another privatized insurance, benefits are 70 to 100 percent higher than under the old system.) We are extremely happy.

But there have been other enormous effects. A second — and, to me, extremely important — one is that the new system reduces what can be called the payroll tax on labour. The pension contribution was seen by workers and employers as basically a tax on the use of labour; and a tax on the use of labour reduces employment. But a contribution to an individual's pension account is not seen as a tax on the use of labour. So unemployment has fallen.

Chile's private pension system has been the main factor in increasing the savings rate to the level of an Asian tiger. Our rate is 26 percent of GNP, compared to about 15 percent in Latin America. The Asian tigers are at 30 percent. We now have an enormous pool of internal savings to finance our investment strategies.

Pension reform has contributed strongly to an increase in the rate of economic growth. Before the 1970s Chile had a real growth rate of 3.5 percent. For the last 10 years we have been growing at the rate of 7 percent, double our historic rate. That is the most powerful means of eliminating poverty because growth increases employment and wages. Several experts have attributed the doubling of the growth rate to the private pension system.

Finally, the private pension system has had a very important political and cultural consequence. Ninety percent of Chile's workers chose to move into the new system. They moved faster than Germans going from East to West after the fall of the Berlin Wall. Those workers freely decided to abandon the state system, even though some of the trade-union leaders and the old political class advised against it. But workers are able to make wise decisions on matters close to their lives, such as pensions, education, and health. That's why I believe so much in their freedom to choose.

Conclusion

Every Chilean worker knows that he is the owner of an individual pension account. We have calculated that the typical Chilean worker's main asset is not his small house or his used car but the capital in his pension account. The Chilean worker is an owner, a capitalist. There is no more powerful way to stabilize a free-market economy and to get the support of the workers than to link them directly to the benefits of the market economy. When Chile grows at 7 percent or when the stock market doubles — as it has done in the last three years — Chilean workers benefit directly, not only through higher wages, not only through more employment, but through additional capital in their individual pension accounts.

"there is no more powerful way to stabilize a free market economy and to get the support of the workers"

Private pensions are undoubtedly creating cultural change. When workers feel that they own a fraction of a country, not through the party bosses, not through a politburo, but through direct ownership of part of the financial assets of the country, they are much more attached to the free market, a free society, and democracy.

That has been our experience. Of course, there have been some mistakes. There are some things that should be improved. There is no perfect reform. With hindsight and experience, I know I would do some things differently. But on the whole, it has been a success beyond all our dreams.

"pension reform... is the most powerful way of relieving poverty"