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What's Wrong With The Welfare State?

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1. The origins of the welfare state

The history of the welfare state is a record of failing attempts to curb the costs of the over-optimistic promises made by politicians.

Modest beginnings

It began at the turn of the century. As Chancellor, Lloyd George introduced the first *state pensions*. They were modest and means-tested, but still the 1909 'People's Budget' that was needed to pay for them gave rise to bitter arguments.

In 1911 came the world's first *statutory unemployment insurance*. Far more restricted than today's, it covered only the one-sixth of the workforce in highly cyclical industries. Benefit ran out after fifteen weeks. At the same time a *compulsory health and sick-pay* scheme came in for all male workers — though it gave no right to hospital treatment, and no cover for wives and children.

This early welfare state was, like today's, contributory and compulsory; but its benefits were neither comprehensive or universal,¹ so there was still some hope of controlling their cost. Yet before long, the financial balance was well out of tilt.

Interwar sprawl

In the interwar period, Chamberlain extended the welfare state into *council housing*. It sprawled in other ways too, only to be hacked back when times grew hard. In 1920, *unemployment insurance was extended* to cover three-quarters of the workforce, but within weeks unemployment stood at one million. Peaking at three million, it killed the insurance principle stone dead: many exhausted their benefits, while others were never in work long enough to earn them.²

By 1941, *seven different government departments* were involved in providing cash benefits. There were *three different types of pension* and *three types of unemployment benefit*, with different rules and different benefit rates for each. There were odd exceptions to the general compulsion, and wide variations in the service offered by the friendly societies that administered many of the benefits.³

¹ Nicholas Timmins, *The Five Giants* (Harper Collins 1995), pp13-14.

² *Ibid*, p.27.

³ *Ibid*., p19.

The Beveridge revolution

The 1942 Beveridge Report, *Social Insurance and Allied Services*, was an attempt to bring order to this sprawling system and to build a truly comprehensive welfare state on its foundations. It would rely on *state insurance*, insofar as work incentives could be preserved. It would give us a *comprehensive national health service* and *universal child benefits*. And it would bid farewell to the local-authority means tests that had been so hated during the Depression.⁴

The report had not even been published before the arguments began about the affordability of this new welfare state. Sir Kingsley Wood, then Chancellor of the Exchequer, objected to the incalculable and open-ended burden which it would impose on taxpayers, ahead of all other claims upon them.⁵

Paying for universality. Unfortunately the post-war politicians (principally Aneurin Bevan and James Griffiths) who put Beveridge into practice were keener on making benefits *universal* than on worrying about their cost or impact on work incentives. Some thought that unemployment pay should be doled out indefinitely, checked only by an appeal to the public not to abuse it. Those called upon to raise the funds, however, were not so sure about the value of such a request.⁶

It was the same with the new, free, *National Health Service*. It cost twice what Bevan had forecast. It faced lengthening waiting lists and a large demand for services it could not finance. Within just three years, patient charges were brought in. Bevan resigned at this fundamental erosion of Beveridge-style universality.

NHS charges remained a political hot potato; scrapped, then reintroduced by Roy Jenkins in 1968 (in a budget that also reined in housing and education costs).⁷ NHS charges remain controversial even today: though they have never been able to restrain the runaway costs of a service where the demand is infinite and the benefits are not linked to contributions.

Doubts of the 1960s

Labour in the 1960s sought other ways to stem the cost of the welfare state. *Family allowances* were raised to help poorer families, but in a

⁴ *Ibid.*, p20-21 and p28.

⁵ Correlli Barnett, *The Lost Victory* (Macmillan, 1995), pp130-2.

⁶ *Ibid.*, pp135-6.

⁷ Nicholas Timmins, *The Five Giants* (Harper Collins 1995), p262.

spectacularly unpopular move the cash was *clawed back* from others through taxation. There was a growing view that *selectivity* was better than the enormously expensive universality. The *integration of taxes and benefits* was proposed, as a way of making benefits selective with an *overt* means test.⁸

The very sustainability of the welfare state was in doubt. Richard Crossman, in a celebrated lecture on *Paying for the Social Services*, found the cost trends 'truly terrifying'.⁹ Growing numbers of pensioners; the rise in unemployment; more primary school children; people demanding the costly medical treatments that were now feasible; rising expectations about the quality of housing, education, and living standards.... There were no brakes on the runaway train. And to top it all there was the moral question of whether we were creating a 'nation of scroungers'.

The Heath government considered fundamental reform, with a tax-credit plan, vouchers, and other ideas. But by now the welfare state had an electorate of its own. With so many on benefit, influential pressure-groups had grown up to defend their sectional interests. As Norman Fowler discovered in the 1980s, real reform became nigh impossible. Whatever the justice of the overall proposals, they would always be blocked by the vociferous representatives of the losers.

Recent reforms

As a result, more recent attempts to control costs have been piecemeal, though their effect has been profound. The decision to index pensions along with prices, rather than earnings, saves around £7.3 billion per year — equivalent to 4¹/₂p on the basic rate of tax.¹⁰ The move to phase in equal pension ages of 65 will cut the basic pension bill by another £4.3 billion by 2050, with other related changes bumping the total saving up to £12.5 billion.

The new *incapacity benefit* sought to restrain the abuse of benefits to the long-term sick and disabled (which had trebled in the fifteen years since 1979, despite generally rising standards of health — leading to calls for a more objective test of incapacity for work). *Jobseekers allowance* would similarly save money by improving work incentives. More *child support* was to be pushed onto responsible fathers.

⁸ *Ibid.*, p266.

⁹ Herbert Morrison Lecture, 1969.

¹⁰ Peter Lilley, *Politeia Inaugural Lecture*, 7 February 1996.

Mortgage interest benefit would be restricted. A push against fraud was predicted to save £2,500 million over three years.¹¹

Continuing worries, Some benefits still rise alarmingly. Housing benefit has trebled to around £7 billion since 1979, despite the fact that over two-thirds of households now own in their own homes. Single-parent benefit has increased by the same proportion: today there are nearly a million single parents who depend on benefits. Income support grew by 20% in a single year recently. Support for pensioners in residential and nursing care homes jumped from £10 million in 1978/9 to £2,500 million in 1992/3.¹²

Where we are now

Between 1979 and 1990/1, average household income rose 36% in real terms. Today, almost 70% of families own a car; 81% have central heating; 87% have a washing machine, and 88% a telephone. Britons take about 20 million holidays abroad each year, four times the 1970 level. Even among the poorest, half have a telephone and central heating, and significant numbers own a car and their own home.

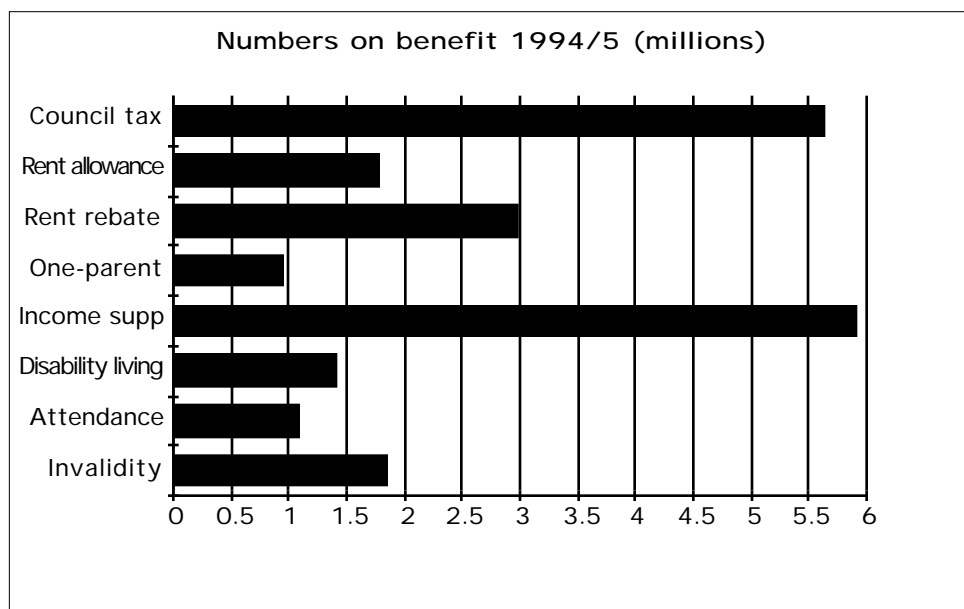
And yet, the costs of income support are high and rising. The number of people dependent on it has risen by 40% — 2.85 million — since 1990 alone.¹³ Nearly half of all individuals live in households claiming at least one of the three major means-tested benefits.¹⁴

¹¹ House of Commons Social Security Committee, *Review of Expenditure on Social Security: Third Report* 24 May 1995, ppxi-xii.

¹² Peter Lilley, *Mais Lecture* 23 June 1993.

¹³ Chris Smith, *Hansard* 20 February 1996, col 202.

¹⁴ House of Commons Social Security Committee, *Review of Expenditure on Social Security: Third Report* 24 May 1995, pxxviii.



Source: *Social Security Departmental Report 1995*, p104

These numbers are expected to grow even more. By the end of the century there will be 1.6 million lone parents on income support, and perhaps 1.5 million on incapacity benefit. If we assume unemployment will be 2 million, that means there will be 5 million people drawing benefit out of a workforce of 29 million.

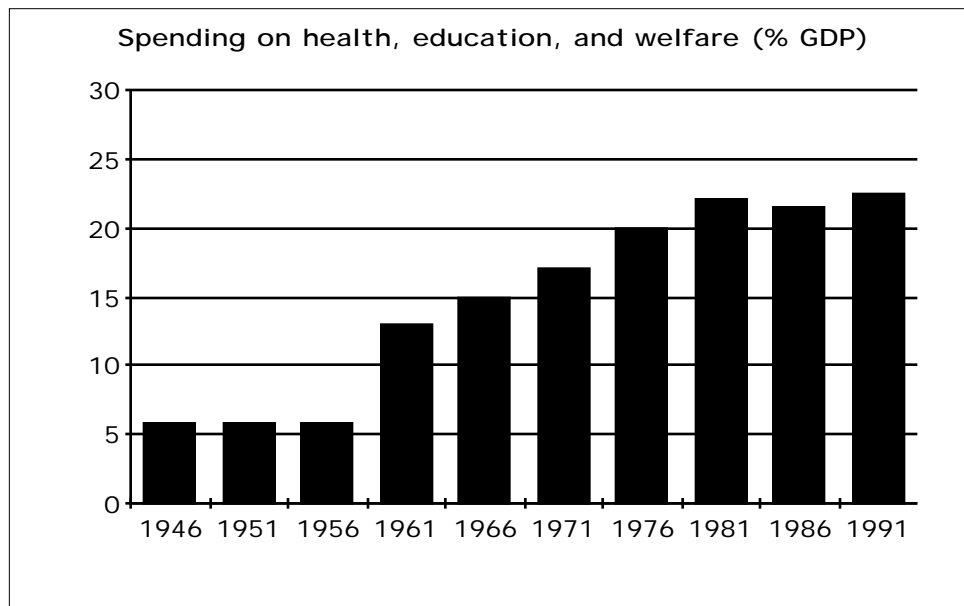
The yearly expenditure on all social security benefits in 1949-50, when the Beveridge plan was first up and running, was £597 million. If we indexed that figure up to today's prices, it would come to just £10 billion (or £20 billion if we uprated it in line with earnings rather than prices.¹⁵ And yet today we actually spend over £90 billion.

No wonder that people are asking: If the welfare state were really doing its job in eliminating poverty, why should the spending and the numbers on benefit continue to grow?

¹⁵ Sir Michael Partridge, "Social Insurance: From Beveridge Into the 21st Century", in *Social Insurance: The Way Forward*, edited by Richard Silburn (Benefits Research Unit, University of Nottingham, 1995).

2. The cost of the welfare state

The cost of the welfare state — health, education, and social security — is approaching a quarter of the gross domestic product of the nation. The pace of its growth is indeed terrifying. Just four decades ago, the same services cost barely a twentieth of gross domestic product.



Source: John Hills, *The Future of Welfare* (Rowntree, 1993)

Since 1949, when the welfare state was first fully up and running, spending on social security has risen sevenfold in real terms.¹⁶ And government spending itself has risen prodigiously over that period.

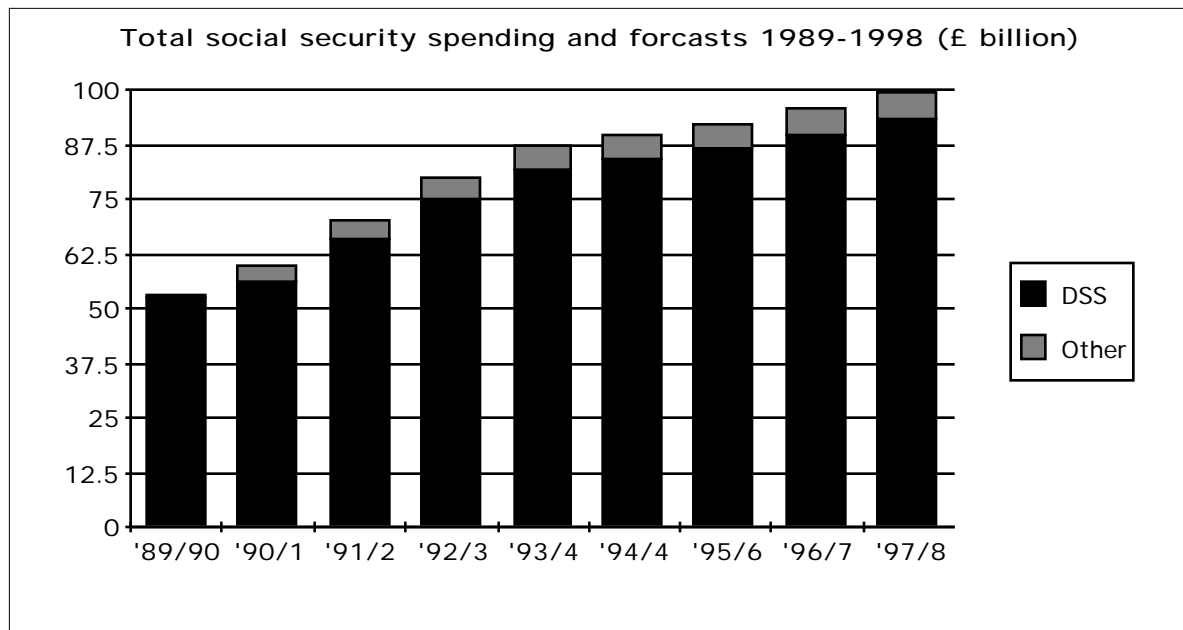
The Department of Social Security alone now absorbs roughly 40% of public expenditure. Its budget, twice the size of the next largest department (Health) and three times that of Defence, stood at £84.5 billion in 1994/5 — equivalent to 12.6 % of GDP or a cost of £15 per working person per day¹⁷ — and is forecast to reach £93.6 billion by the end of the century. With another £6 billion or more for local-authority benefits, the grand total of social security spending could be £100 billion by the year 2000.

¹⁶ Peter Lilley, *Winning the Welfare Debate*, Social Market Foundation 1995, p13.

¹⁷ Frank Field, "Introduction", in Peter Lilley, *Winning the Welfare Debate* (Social Market Foundation, 1995) p5.

Far from suffering "cuts" under the Conservatives, the social security budget has risen more than three-quarters *in real terms* since 1979.¹⁸ The numbers eligible for benefit has rocketed too, from 1 in 12 on benefit to 1 in 6.¹⁹

It is not that we have all become suddenly poorer. In 1979, some 9.5 million people were on low income — defined by the DSS as 60% of the 1979 average. By 1989 there were only 8.5 million, and falling. Average pay rose 40% over the period 1979-92.²⁰ Rather, it seems that our the welfare state has a momentum of its own.



Source: *Social Security Departmental Report*, 1995, p101.

Some optimists argue that the costs of the welfare state, though rising, are quite sustainable for an economy that is growing steadily richer. The Rowntree report²¹ argued that even if we went back to indexing the pension along with earnings, by 2050 we would have to spend only another 5% of GDP on it — a figure closely matched by the World Bank's 4.8% estimate.²²

This target looks rather more daunting, though, when translated into more direct terms: an extra £31 billion, equivalent to another 20p on

¹⁸ House of Commons Social Security Committee, *Review of Expenditure on Social Security: Third Report* 24 May 1995, p1x.

¹⁹ Chris Smith, *Hansard* 20 February 1996, col 202.

²⁰ Peter Lilley, *Winning the Welfare Debate*, Social Market Foundation 1995, p25.

²¹ John Hills, *The Future of Welfare*, Joseph Rowntree Foundation, 1993.

²² World Bank, *Averting the Old Age Crisis*, Oxford University Press, 1994.

income tax, or a rise in VAT to 30%. The implications for a tax hike of that size on work incentives are obvious.

Other countries

Other welfare-state countries are having to make similar adjustments. Contribution rates have been raised in France, Belgium, Germany, Greece, Spain, Italy; and France — where the new policy proposals prompted severe civil unrest. Germany, Italy and the Netherlands have all moved to index benefits to prices rather than earnings, as we have done in the UK.

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

By 2030, the national debt of France and of Germany are expected to double, largely thanks to their generous social programmes; Japan, with its fast-growing elderly population, faces a tripling of its debt. The United Kingdom, on the other hand, where a majority of those retiring now have access to a funded personal or occupational pension, will have paid off its debt,

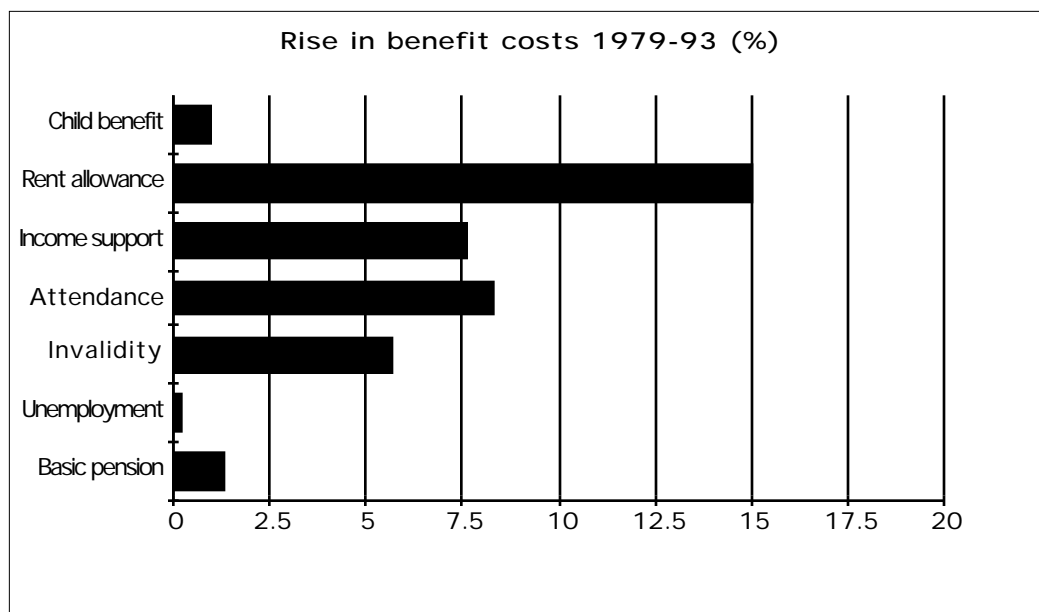
Other countries, it must be said, are in a far worse position than we are. The EC as a whole faces a growing pensions bill as the proportion of people over 65 bulges by 25%-40% between 1990 and 2010, except in the UK where the increase comes later.²³ By 2040, the UK is forecast to have exactly 3 people of working age for every pensioner. Spain and France will have only 2.6; Italy, Denmark and the Netherlands less than 2.5; and unlucky Germany only 2.

²³ Department of Social Security, *Containing the Cost of Social Security*, HMSO, 1993.

3. The alarming growth of specific benefits

Virtually all expenditure on social security benefits is what the DSS calls 'demand-led'.²⁴ This means that there is no fixed sum of money that has to be shared out to beneficiaries. An exception is the social fund, which *is* capped; but in general, if more people qualify for benefits, or more who qualify come forward to claim them, then spending rises. This factor, of course, makes the rules and the incentives so important: if people can rearrange their lives in order to qualify, and gain from doing so, the total burden on the taxpayer can become even larger.

Much of the recent growth of expenditure comes from three areas: housing benefit, lone parents on income support, and invalidity benefit.



Source: DSS figures

Over recent years there has been a very large increase in the various benefits that are designed to help with housing costs. Since its introduction in 1988, housing benefit has more than doubled. Income support for mortgage interest grew from £31m to £1.1bn in just 15 years:²⁵ but media stories of the DSS paying mortgage interest of £1000

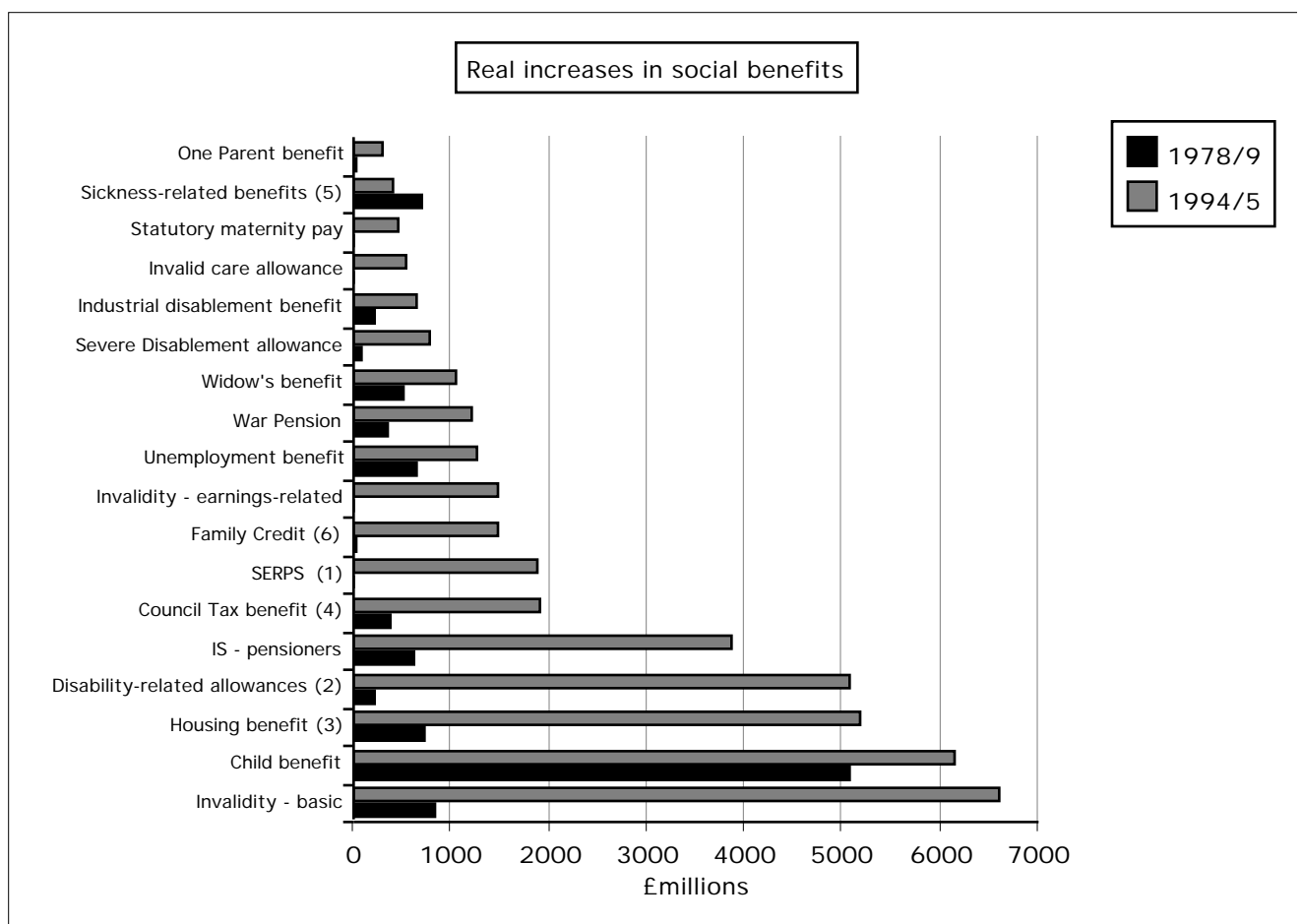
²⁴ *Social Security Departmental Report*, March 1995, p10.

²⁵ Peter Lilley, *Winning the Welfare Debate*, Social Market Foundation, 1995, p46.

a month and more has led to some cutbacks. At the other end of the scale, the growth of rent allowances, at 15%, is particularly large. It seems likely that rent rebates will also rise in the future, perhaps as much as 8%, due to rising local-authority rents and reduced central subsidies to housing associations.

Another significant rise in cost has been attendance allowance (up 8.3% between 1979 and 1993). This reflects in particular the growth of the elderly and aged population who may need friends and relatives to look after them at home. Together with the costs of long-term care and medical care — since more than 40% of the NHS budget is spent on people over 65²⁶ — this cost is likely to grow fast in the future.

There are, however, doubts about the official figures which provoke even deeper disquiet. *Daily Telegraph* journalist James Bartholomew points out that state benefits change over the years, allowing the DSS to argue



Notes:

- (1) the equivalent in 1979 was "Supplementary Benefit".
 - (2) Disability Living Allowance and Attendance Allowance are the modern versions of AA and Mobility Allowance in 1979.
 - (3) rent rebate and rent allowance combined
 - (4) previously Rate Rebate and then Community Charge Benefit.
 - (5) Statutory Sick Pay introduced 1983/84. Re-imbursement of employers Statutory Sick Pay costs abolished from April 1994. Claimant numbers for Sickness Benefit only.
 - (6) previous equivalent Family Income Supplements in 1979.
- [Inflation adjustment factor: 2.84118]
Source: James Bartholomew

that long-term comparisons are impossible. However, if we compare the cost of the various benefits today with the cost of their earlier versions that we aimed to relieve broadly the same problems, the rising cost of some benefits becomes alarming indeed.

Who gets social benefits?

The elderly. In his Mais lecture of 1993,²⁷ the Secretary of State for Social Security noted that spending on **the elderly**, by far the largest recipient group, had risen by over a third since 1979.

It is not just the state pension that costs the money, though pensions are by far the biggest item. Support for pensioners in care homes had jumped from a 'mere' £10 million to £2,500 million. And already by 1990 we had 1.7 million over-60s on income support, 2 million getting rent rebates and allowances, and 3.6 million on community-charge benefit.²⁸

Meanwhile, the maturing state earnings-related pension scheme will grow rapidly in cost. SERPS today costs about £1 billion. The Government Actuary (1990) forecast that by 2040, it will be costing £15-£16 billion in real terms.

The sick and disabled. Spending on the **long-term sick and disabled** had also trebled. (However, the new incapacity benefit, being more closely targeted, should not grow so fast as invalidity benefit, which rose by an average of 11% per year in the early 1990s, from 1.2 million people in 1990 to 1.9 million in 1995.)²⁹

Single parents. The lecture went on to report that spending on families with dependent children had risen by three-quarters since 1979, to £13 billion in 1993. Almost all that growth is attributable to

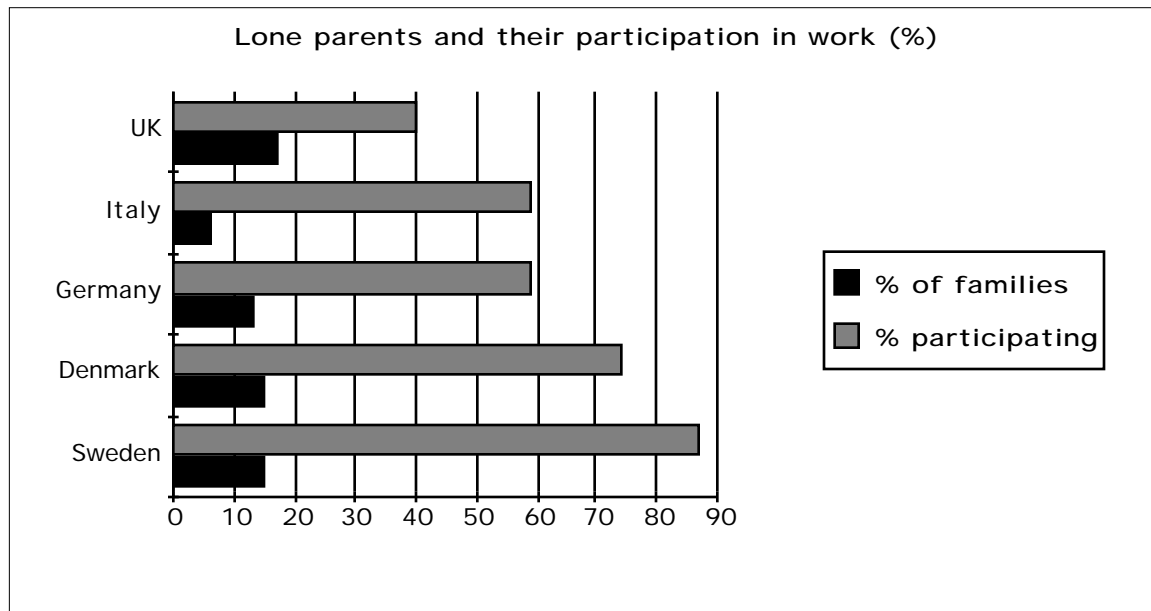
²⁷ Reprinted in Peter Lilley, *Winning the Welfare Debate*, Social Market Foundation, 1995, pp9-22.

²⁸ Phil Coggan, *Financial Times*, 19 December 1991.

²⁹ *Social Security Departmental Report*, March 1995, p12.

single parent families. Expenditure on them had trebled, with over a million such families in receipt of benefit.

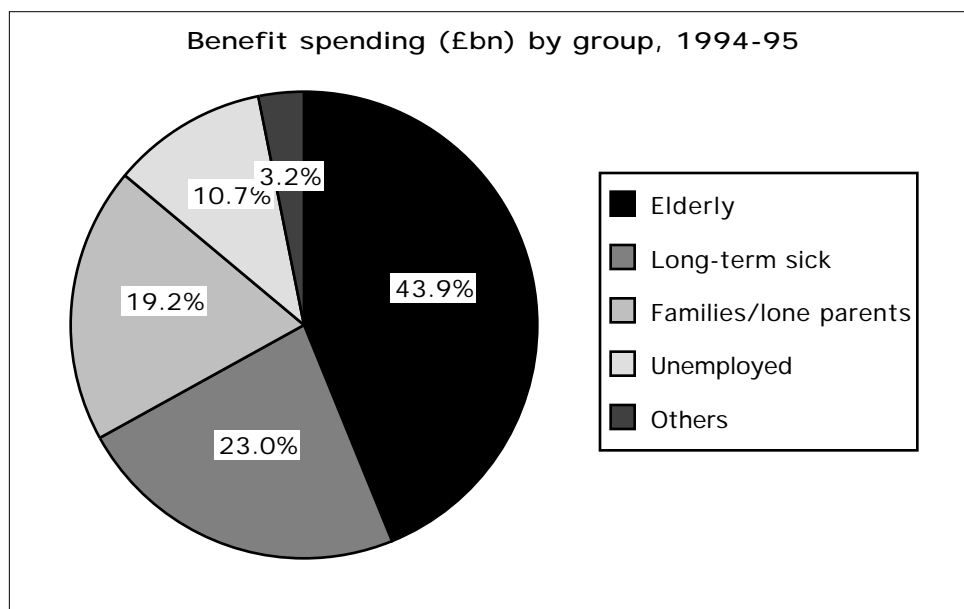
As the chart shows, the UK has more single-parent families than other European countries, and fewer of them in full-time or part-time work than most. This may be partly because the UK has tended to provide cash benefits rather than subsidized child-care that helps lone-parents to take work (as Sweden, Finland, Denmark, France Germany, Belgium, and Italy have done).



Source: OECD data

Given these trends, reasonable forecasts suggest that by the year 2000, the UK will have 1.6 million lone parents on income support.

The unemployed. The fourth largest group is **unemployed people**; here at least the numbers seem to be falling at last, and the change towards jobseekers allowance is expected to put a downward pressure on costs.



Source: *Social Security Departmental Report*, p10

Forecasting social security expenditure is difficult. Even quite small percentage errors in forecasts can involve considerable amounts of money.³⁰ A number of important factors can affect the outcome, namely:

- **demographic** (the size and age structure of the population)
- **economic** (unemployment, earnings, prices, growth etc)
- **social** (divorce rates, lone parenthood, household size etc)
- **policy** (new benefits, changes in entitlement rules etc).³¹

Of these factors, only the first is in principle predictable, since birth and mortality are relatively slow to change. The pension, too, is the largest segment of benefit expenditures. Demographic factors must therefore be the starting point for any forecasting about the future cost of social benefits.

³⁰ *Social Security Departmental Report*, March 1995, p19.

³¹ *Social Security Departmental Report*, March 1995, p20.

4. There's none of us getting any younger

It is well known that the UK population is getting older, and much has been written about the effect of this on future pension and benefit expenditures. Although the UK is indeed better placed than many other countries to deal with this factor, the scale of it is still alarming.

More people, dependent longer

Demography has put increasing burdens on the working population — burdens that can only continue to increase over the next half-century, and perhaps beyond.

Grey growth. When Lloyd George introduced pensions for the over-70s, few people of the time expected ever to draw them. In 1901, life expectancy was only 45 for men and 49 for women; today it is around 73 years for men and 79 years for women, and it continues to rise at about 2 years per decade. Crude death rates have nearly halved in the last 150 years, with the standard mortality ratio down from 344 to 75.

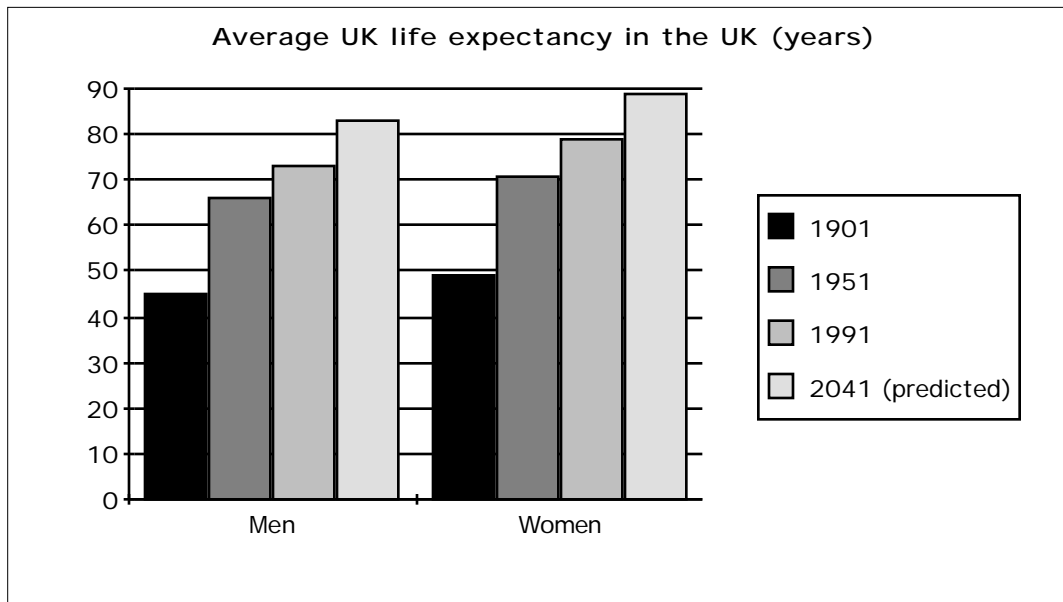
All of this means that there are two million Britons over 80, and one million over 90. The Queen sent eight times as many 100th birthday telegrams in 1993 as she did in 1963.

When today's 51-year-olds retire, there will be 11.7 million pensioners; when today's 41-year-olds retire, there will be 13.5 million. Those aged 31 today will have 15.8 million pensioner colleagues; today's 21-year-olds will be 16.3 million strong on retirement.³² That is a big increase from the 10.5 million pensioners there are today.

Longer dependency. Our retirement may not be quite as long as our working lives, but it is catching up fast. On average, according to the World Bank, men in the UK can expect to draw pension for 13.6 years, women for 21.3 years. (In France, where the retirement age is 60, men can expect to average 18.7 years and women another 23.9 years in retirement; women in Italy can retire at 55, and may expect to live 26.3 years beyond that.)³³

³² Government Actuary, *National Insurance Fund Long Term Estimates*, January 1995.

³³ World Bank, *Averting the Old Age Crisis*, Oxford University Press, 1994, p371.



Source: *Social Trends* 1995

The payer-pensioner balance

Since our state pension system is a pay-as-you-go system, however — where today's pensioners live off the contributions of today's taxpayers — the worry is not the absolute numbers of the elderly but the balance of pensioners and contributors.

The World Bank estimates that 20.8% of the UK population is over 60, rising to 23% by 2010, 25.5% by 2020, and 29.6% by 2030 as the post-war baby-boomers swell the figures.

Already our over-65 age group is a quarter of the size of the 16-64 group — a bigger proportion than anywhere except Norway and Sweden.³⁴ Worse, there are fewer youngsters on the way. Women are having fewer children — down from an average of 2.4 in the 1950s-1960s to 1.9 today. This is 10% below the rate of 2.1 births per female needed to stop the population from shrinking.³⁵

So the 'dependency ratio' — the number of people of working age per pensioner — will worsen badly in the future. When Beveridge was designing his welfare state, there were five people of working age per

³⁴ World Bank, *Averting the Old Age Crisis*, Oxford University Press, 1994, p343.

³⁵ Office of Population Census and Surveys, *Monitor: National Population Projections* January 1994.

pensioner.³⁶ By 1990 there were only 3.4. The balance will slip to 3.1 workers per pensioner in 2010 and only 2.4 workers per pensioner in 2030.³⁷ We are not alone: the OECD estimates that dependency ratios in the 20 richest countries will double between 1990 and 2040, requiring a 15% rise in payroll taxes to pay for pensions.³⁸

Real position is worse. Even more disastrous for UK pensioners, many of those *potential* contributors are not actually paying up. A third of school leavers will now spend several more years in higher education (as only a ninth of them did in 1979). Half of the 60-64s have retired early (only a fifth of them did in the early 1970s).³⁹ Others are unemployed or on benefits. And the group which pays most towards pensioners' upkeep, the 25-50 age group, will shrink by a sixth, to only 31% of the EC population, by the time today's 41-year-olds retire in 2020.⁴⁰

So the real dependency ratio is much worse than the figures suggest. By 2030, for every inactive adult (retired, disabled, or chronically sick, for example), there is likely to be only 1.5 adults in work or actively seeking work, according to the DSS.⁴¹

And if our tax and benefit system induces people to start work later, retire earlier, and spend more time on benefit, the outlook for those on state pension must be grim indeed.

The shrinking state pension. The UK, however, has already moved to defuse its "demographic time bomb" by the 1980 move to link state pensions to prices, rather than earnings. In other words, we have defaulted on our promises to pensioners. It has saved a large amount of money — £8 billion in 1994/5 alone — and helped secure the future of the system.

But at what cost to pensioners? The indexing change cuts 2.4% off the worth of the pension each year.⁴² There are more pensioners, but we spend only 4% of our GDP on state pensions today, compared to 4.7%

³⁶ Sir Michael Partridge, "Social Insurance: From Beveridge Into the 21st Century", in *Social Insurance: The Way Forward*, edited by Richard Silburn (Benefits Research Unit, University of Nottingham, 1995).

³⁷ Department of Social Security, *Options for Equality in State Pension Age*, 1991.

³⁸ Barry Riley, "The Broken Pension Promises", *Financial Times*, 11 February 1995.

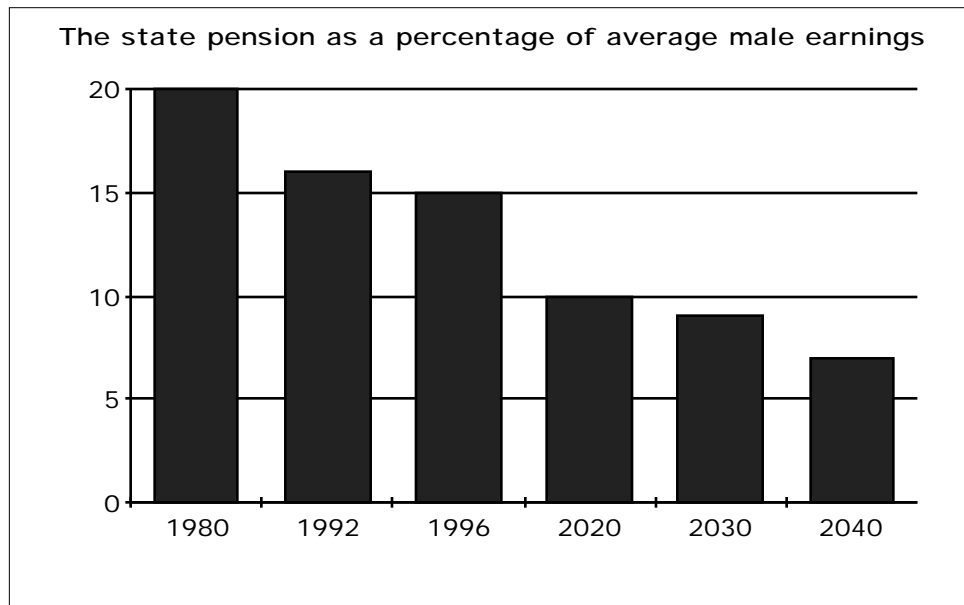
³⁹ *Employment Gazette*, April 1991.

⁴⁰ Department of Social Security, *Containing the Cost of Social Security*, 1993, p9.

⁴¹ Sir Michael Partridge, "Social Insurance: From Beveridge Into the 21st Century", in *Social Insurance: The Way Forward*, edited by Richard Silburn (Benefits Research Unit, University of Nottingham, 1995).

⁴² Barry Riley, "The Broken Pension Promises", *Financial Times*, 11 February 1995.

twelve years ago.⁴³ The basic state pension is now, officially, not enough to live on, being less than the income support level.⁴⁴



A new problem. Indeed, the indexation change has simply given us a new problem. We have been getting richer, and our expectations have been rising. Yet those millions of future pensioners who had expected a state pension of reasonable size will now be bitterly disappointed. Unless they have made some other provision, they could well become a charge on income support. This has led some, like Frank Field, to propose a new compulsory pension contribution to make up what the state basic pension has lost.

Of course, some 60% of those who retire already have some form of additional pension.⁴⁵ Nearly £600 billion is invested in private pensions in the UK, more than the rest of Europe put together.⁴⁶

Occupational schemes. About half the total workforce — 63% of employed men and 55% of employed women — participate in workplace schemes. But there are problems. Membership has fallen slightly. Of the 8 million who pay into such schemes, 3 million contribute at the

⁴³ House of Commons Social Security Committee, *Review of Expenditure on Social Security* 24 May 1995, p.xlvi.

⁴⁴ The Retirement Income Inquiry, *Pensions 2000 and Beyond*, Institute for Fiscal Studies, 1996, p.9.

⁴⁵ Norman Fowler, *Hansard*, 20 February 1996, col214.

⁴⁶ Peter Lilley, *Politeia Inaugural Lecture*, 7 February 1996.

minimum level.⁴⁷ Although there are 6.5 million part-timers (mostly women), many of these workers are often not covered at all. And job mobility (54% of workers have changed jobs in the last three years) is adding cost to these schemes as they struggle to deal with the growing numbers of ex-employees who are entitled to small benefits.

Personal pensions. More than a hundred companies now offer personal pensions, and about 5 million people have them.⁴⁸ They are personal, portable, and flexible, making them particularly popular among the self-employed and frequent job-movers. But because they are individual plans, administration charges can be high. They can be complex and confusing, leading to complaints of mis-selling and bad advice (although there is bad advice in the state system as well).⁴⁹ And people often contribute far less than the 7%-15% of salary that experts recommend.

All in all, it is questionable whether simply extending the present system is a real answer to the pensions gap. It probably makes sense to look for some comprehensive new savings and insurance vehicle, as the Adam Smith Institute has suggested with its Fortune Account plan.⁵⁰

Other demographic benefit-magnets

There have been many changes in society since Beveridge drew up his great plan in the 1940s. There is a much greater diversity in family lifestyles, and more fluidity in working practices. A centralized off-the-peg benefit system cannot expect to cover the customized needs of a diverse population. And in trying to do so, it faces enormous costs and could well be encouraging what it is trying to reduce and relieve.

Changing family lifestyles: Changes in family structure have imposed particularly fast-growing costs on the benefit system. Between 1951 and 1987 the annual divorce rate has risen five-fold, from 2.6 per 1000 couples to 12.7 per 1000. Some 56% of divorces are to couples with children aged under 16.⁵¹ If trends continue, some

⁴⁷ Barry Riley, "The Broken Pension Promises", *Financial Times*, 11 February 1995. See also House of Commons Social Security Committee, *Review of Social Security Expenditure*, 24 May 1995, pxxii.

⁴⁸ Debbie Harrison, *Financial Times*, 14 July 1995.

⁴⁹ Norman Fowler, *Hansard*, 20 February 1996, col216.

⁵⁰ Eamonn Butler and Madsen Pirie, *The Fortune Account*, Adam Smith Institute, 1996.

⁵¹ Office of Population Censuses & Surveys, *Updates* No 14, February 1996, p1.

37% of today's marriages will end in divorce, and one in five children will have divorced parents by the time they are 16.⁵²

The numbers of children born to single parents has risen sharply too. As a result, the proportion of families with dependent children headed by a lone parent rose from 8% in 1971 to 22% in 1993. Benefit payments to lone parents have reflected this rise, up from £2.4 billion in 1979 to £6.6 billion in 1991, with further growth expected.

Growing dependency

The growing numbers of retired people may have serious implications for the cost of pensions, but the very large growth of those who are very elderly and those in need of long-term care has even more serious implications for public and private budgets.

In Beveridge's day there were only three-quarters of a million over-80s, Now there are over two million. By 202 there will probably be over three million, and by 2030 some four million, double even today's figure.⁵³

Going down the age-range a bit, the number of people over 75 grew, by about 750,000 to nearly 4 million between 1981 and 1992. A further rise of 325,000 is expected by 1998. About one in six members of this group will need some form of long-term care; the average stay in a residential home is a little over two years.

Much of this burden is shouldered by families, but significant sums are borne by the state. In 1991 the state paid the following amounts towards the cost of long-term care:⁵⁴

NHS hospitals	£1.5 billion
Incomes support	£2.5 billion
Local authorities and homecare	£2.4 billion
Individuals, meanwhile, paid:	
Institutional care	£3.0 billion
Private homecare and charges	£0.7 billion

The largest element is informal care by relatives and friends at home. If this care had to be paid for, its value could exceed £40 billion. And it seems likely that more of it will indeed have to be paid for: the rise in

⁵² John Hills, *The Future of Welfare*, Joseph Rowntree Foundation, 1993, p31.

⁵³ Sir Michael Partridge, "Social Insurance: From Beveridge Into the 21st Century", in *Social Insurance: The Way Forward*, edited by Richard Silburn (Benefits Research Unit, University of Nottingham, 1995).

⁵⁴ S R Nuttall et al., *Financing Long-Term Care in Great Britain*, Institute of Actuaries, 25 October 1993.

divorce makes potential carers less willing to look after the parents of an estranged spouse; while growing geographical distances between families makes them less able to. The pressure on the state system is clearly going to grow.

5. More fundamental doubts

Our scattergun system

Many people question whether it is right to spend taxpayers' money on those who do not really need it. Thus about three-quarters of child benefit, payable to *all* mothers, goes to families who really have little or no need of state support. The pension, likewise, is payable to everyone with a full contribution record (though about 6% of men and 30% of women do not qualify for the full pension). Yet some pensioners are very wealthy indeed, and pensioner incomes generally are rising,⁵⁵ up by 51% since 1979.⁵⁶

UK benefits attempt to target the needy, but are still scattergun in effect. Those in the bottom 30% of incomes received 68% of benefit expenditure in the 1980s, but those in the top 30% still received 8% of it. Income support, rent rebates and family are the best-targeted; while child, widows and industrial injuries benefits are the least focused.

Bad targeting and perverse incentives

Because benefit is based on uniform entitlement rules, it is hard to steer resources to the most deserving.

A recent example of the problem that has captured media attention is the plight of elderly people who need residential care. Attempting to steer resources to the poorest, the state denies help to anyone with assets over a certain amount. But in doing so it perverts incentives: people who live thriftily, save for their retirement, perhaps buy their council house or a few privatization shares, are thereby disqualified from state help; while those who never save or plan ahead receive it.

Equally there have been celebrated cases in which people on very modest means have saved into a small pension plan, only to find on retirement that every extra penny it yields them is taken off their other benefits. They might as well not have bothered.

Whatever its virtues in helping to target resources, any means-tested benefit will have this disincentive downside: that if there is a choice,

⁵⁵ Retirement Income Inquiry, *Pensions 2000 and Beyond*, Institute for Fiscal Studies, 1996, pp36ff.

⁵⁶ *Hansard*, 20 February 1996, col160.

people will be less inclined to provide for themselves and more inclined to make demands on the state.

Some see a way out by making benefits universal and then taxing away the money which goes to the better-off families. But this is no answer either, because it simply spreads the disincentive: the more that is spent on benefit, the higher must be the taxes to pay for it. High benefits and high taxes are a sure way to push people out of work and on to benefit.

This is the classic poverty trap. If people lose in benefit everything that they earn from work, it is as if they face a tax rate of 100%. Because the disincentive effect of that is clear, the DSS has tried to adjust benefit tapers — at significant extra cost — so as to promote incentives to work, to save, and to self-provide. Their admission that 'marginal deduction rates of over 100% are now very rare' indicate that they have not altogether succeeded.⁵⁷

Despite the DSS initiative, some 600,000 of the lowest paid face effective marginal tax rates of 70% and above. In particular, many lone parents, mostly women who are typically lower-paid than men, find it hard to get a job that will pay enough to raise their prospects significantly, which is why only 43% of them are employed (compared to 62% of married women).⁵⁸

While we have been taxing those who do take work, we have been subsidizing those who refuse it. By the mid-1980s, the rules requiring unemployed people to look for and take available work were only feebly enforced. Between the early 1970s and then, the number of people referred for refusing work declined by two-thirds and the proportion who were then denied benefit fell from 80% to 33%.⁵⁹

The risk in providing jobs. There are disincentives on employers too. Already the European social chapter obligations (from which the UK opted out) and higher social-insurance costs are having a clear effect on employment and inward investment.

In Italy, France and Sweden, employers contribute over 30% of their total labour costs towards social insurance. Spain, Austria, Belgium, Finland, the Netherlands, Portugal, Norway and Germany all pay over 20%. The UK is among the lowest at 15.1%.

⁵⁷ Department of Social Security Report, March 1995, p16.

⁵⁸ John Hills, *The Future of Welfare*, Joseph Rowntree Foundation, 1993, p27.

⁵⁹ Peter Lilley, *Mais Lecture*, 23 June 1993.

High social costs force employers into a bigger risk when they think about taking on new workers. Undoubtedly, many will decide not to expand as rapidly as they could. This in turn keeps the unemployed population high, and adds to social costs in a never-ending spiral.

Already half the unemployed job seekers in the EC are out of work for 12 months or more, compared to only 6 months in the United States, where work incentives are much stronger.⁶⁰ In the 20 years up to 1973, US unemployment rose from 5% to 7%, though the number in work increased by 30 million. In the European Community, unemployment rose from 3% to 10%, and the number in work rose by only 8 million — and 5 million of those in the public sector.⁶¹

Insurance and welfare

The welfare state disguises the important differences in the principles of saving, insurance, and welfare which it is supposed to embody. This in turn makes clear and rational policy or reform quite impossible.

We talk of social 'insurance' and a national insurance 'fund'. In reality there no fund, while the 'insurance' is paid not just by the 'premium' that we call 'national insurance contributions' but from general taxation too.⁶² The insurance principle has been eroded on the benefits side too: in 1993, for example, only 23% of unemployed men received unemployment benefit, the remainder largely dependent on means-tested welfare benefits.⁶³

Indeed three-quarters of what we tend to call the 'welfare' system is in fact not welfare at all, in the sense of being a transfer from the rich to the poor. Rather it is a lifetime transfer between the same people, made through a rather inefficient forced saving plan. Three-quarters of the welfare budget is paid in by people through taxation, only to be drawn out again by exactly the same people later on.⁶⁴

Thus the state pension and certain other benefits are neither insurance nor saving, but a straight interpersonal transfer system. The morality of the pay-as-you go welfare state is that of the chain letter. Money from today's contributors goes straight into the pockets of today's claimants.

⁶⁰ DSS, *Containing the Cost of Social Security*, p10.

⁶¹ Peter Lilley, *Mais Lecture*, 23 June 1993.

⁶² *Department of Social Security Report*, March 1995, p6.

⁶³ Robert Walker, Andrew Shaw and Lisa Hull, "Responding to the Risk of Unemployment", in *Rise, Insurance and Welfare*, (ABI, 1995 pp37-52).

⁶⁴ John Hills, *The Future of Welfare*, Joseph Rowntree Foundation, 1993.

To some extent, this confusion of welfare, insurance, and savings principles has been deliberate. On the one hand, welfare benefits carry less stigma if they can be called 'social insurance'⁶⁵ (although some commentators argue that stigma is an important factor in prompting people to get themselves out of the benefit trap).

The poor do badly. Less creditably, however, politicians can steer more resources to their own supporters, including the articulate middle classes, if the process is dressed up as 'welfare'. Interest groups among beneficiaries too can often get a better deal for themselves if they present it as a welfare issue rather than as one of sectional interest. Not surprisingly, then, the middle classes, with their free health and education, their child benefit and other rewards, do remarkably well out of the 'welfare' state, while poorer people do badly.

The welfare state discriminates systematically against minorities, many of whom find themselves already discriminated against in the labour market and poorer than the average in consequence. The package of benefits on offer is, by its nature as a political creation, aimed to satisfy the average and typical population rather than at the special needs of minorities.

Poorer people also tend to start working earlier in life, and to die earlier: so they pay taxes for longer, but draw retirement benefits for a shorter time. Since their contributions have not been saved and invested, there is nothing to pass on to their families when they die. Wealthier people can afford to take out PEPs, TESSAs, and other savings plans that can be passed to relatives in life or on death. But the amount of money which the poor are forced to pay in contributions eats deeply into any money that they might have had for saving and investment for themselves and their families.

All this increases the disparity between rich and poor. The rich have their savings. The state is supposed to save on behalf of the poor, but in fact it spends their money straight away — with three-quarters of it going to people who are not in any welfare need, and many of whom are actually very well-off. The system is administered by politicians and officials who themselves are by no means poor. If the poor could actually save for themselves the money that is presently confiscated by the state — and pass any unused savings to their children and

⁶⁵ John Hills, *The Future of Welfare*, Joseph Rowntree Foundation, 1993, p33.

relatives —the economic balance would tilt dramatically in their favour.⁶⁶

Though the very poorest escape National Insurance Contributions, they form a regressive tax on the moderately poor. NICs pretend to be an insurance premium, roughly similar for everyone, though the National Insurance system they supposedly finance provides welfare benefits as well as insurance benefits. So our welfare spending is being financed by a regressive tax, masquerading as insurance, that falls most heavily on the moderately poor. Being a tax on employment, NICs also close off opportunities which hurt minorities and the poor in particular.⁶⁷ By contrast, the money saved in a funded system becomes available for investment in business, and stimulates economic growth and employment opportunities.

Fraud and the temptation to defraud

If the system itself is built on a fraud, at least some of the growth in certain welfare programmes can be traced to the growth of fraud among claimants. In 1993/4 some £650 million of such fraud was detected.

Early studies suggested that £1 billion is lost annually through the most common frauds: people claiming to be unemployed while actually receiving undeclared income, or claiming to be single parents when actually living as a couple. Housing benefit frauds account for another £1.5 billion loss. So by 1998-99 social security fraud measures are expected to save £2.5 billion per year.⁶⁸ In other words, anything up to a fifth of the money we spend on means-tested benefits is being claimed fraudulently.⁶⁹

However, there is no doubt that the scale of social security fraud is much larger than this: indeed, almost everyone seems to know of someone who is cheating. The system is highly susceptible to fraud, of course. It is an anonymous system in which those assessing claims probably have no personal knowledge of claimants and their circumstances. In some cases people can adjust their individual and family arrangements specifically in order to qualify for benefit under these impersonal rules. Charities and friendly societies, by contrast, often take a very deep personal interest in their beneficiaries, know

⁶⁶ See Peter J Ferrara, *Social Security Reform: The Family Plan* (Washington DC: The Heritage Foundation), p43.

⁶⁷ See Peter J Ferrara, *Social Security Reform: The Family Plan* (Washington DC: The Heritage Foundation), pp41-5.

⁶⁸ 1995 Red Book, p130.

⁶⁹ Alistair Burt, *Hansard*, 20 February 1996, col266.

them personally, and may act in a discretionary way as they strive to get beneficiaries to lift themselves off dependency.

Other people's money. People go through many changes in their lives. They are young, but they grow old. They may start life with little, and end it wealthy. Sometimes they are fit, sometimes not. But our welfare state has divided them into two distinct groups, separated by a stiff and rule-bound officialdom.

The group that pays in — "contributors" therefore regards itself as quite separate from the group that receives the proceeds — "beneficiaries". The one attempts to minimize its contributions, while the other attempts to maximize its benefits. Since it's all "other people's money", people see no harm in cheating "the welfare".⁷⁰

Rights rather than need. A problem for state welfare systems is that they have to be driven by bureaucratic rules rather than discretion. A charity or an individual benefactor may exercise discretion in deciding whom to help or not to help, based on a judgement of whether that person is truly 'deserving' and whether the donated aid is likely to help the person or simply increase his or her reliance.

No system that is administered by a bureaucracy can incorporate such personal judgements. Instead, the authorities must lay down a set of rules for the conduct of the bureaucratic function. Thus eligibility for benefits is decided on the basis whether claimants qualify against various measures — income, assets, employment etc.

The moral problem of this is that these measures are merely proxies for need, which is an inherently subjective notion. Two claimants in identical circumstances will be treated identically, no matter what fundamental differences there are in terms of their attitude to our support, the effect it has on their future attitudes, their relative willingness to use our support to better their own circumstances, and the likelihood of each being helped by it in the longer term.

Worse, it can lead to people deliberately adjusting their personal circumstances in order to qualify for benefit. This is by no means limited to the poor: there is the celebrated example of elderly homeowners giving away their homes and assets to family members in order to qualify for free long-term residential care.

⁷⁰ Frank Field, *Making Welfare Work* (London: Institute of Community Studies, 1995)

So strong is the idea, nonetheless, that everyone who qualifies by the rules is entitled to our support, that it has proved difficult to place any conditions on state benefits. It seems reasonable to suggest that people drawing a welfare benefit should be expected to do something to get themselves off it — by accepting education or training, for example — or in return for it — by working in the community in their free time, for instance. Such conditionality is perfectly normal in the charitable world; but it seems impossible for politicians to inject into the state system. Perhaps they wonder who will be blamed for the plight of anyone who rejects the conditions, and worry that it may be the politicians rather than the individual.

Enormous complexity

Not only is the social security system enormous, it is complex too. There are dozens of different benefits, in three separate categories: contributory, income-related, and others.

Among the contributory benefits, which depend on past payments into the system, are the retirement pension, widows' benefits, incapacity benefit. Among income-related benefits are income support, housing benefit, council tax benefit, disability working allowance and family credit. The other benefits depend on various qualifying conditions and include war pensions, attendance allowance, disability living allowance, severe disablement allowance and child benefit.

But this is by no means a complete list. Jobseekers' allowance has both a contributory and an income-related element. Then there is the social fund, which goes mostly but not exclusively to those who qualify for income-related benefits. Nor must we forget the Christmas bonus, mobility allowance, industrial injuries disablement benefit, invalid care allowance, the independent living fund, motability, statutory sick pay, sickness benefit, one-parent benefit, statutory maternity pay and maternity allowance, war widows' pensions, guardians' allowance and the child's special allowance.

This diversity, and the sheer number of different rules and conditions involved, make it remarkable that even DSS workers can understand the system and advise claimants correctly. Employers, who are being forced to take on more and more of the administration of benefits, certainly cannot be expected too: so it is not surprising that employers make mistakes in the payment of between 25-30% of statutory sick pay and statutory maternity pay, for example. In 1993, overpayments were reported as £718,000, underpayments as £415,000.⁷¹

⁷¹ *Daily Telegraph*, 23 January 1993.

Administrative burden

The cost of administering this arsenal of welfare weapons is enormous, amounting to £4.4 billion in 1994-95, or 5.2% of benefit expenditure. Particularly costly to administer was unemployment benefit (17.5% of benefit expenditure), with income support and council tax benefit coming in close at over 10% each.⁷²

The DSS alone employs 88,000 full-time-equivalent staff, three-quarters of them dealing directly with benefits. That is one-sixth of the civil service. This staff is processing over 53 million benefit claims at any one time, all of which takes an annual investment of £400 million in information technology.⁷³

People argue that the cost of administering a private alternative to the state system would inevitably be greater: but this argument is false.

Certainly, the marketing and administrative costs of personal pensions, say, are much larger than those of the National Insurance system. This is partly because they must be sold and administered individually. But it is also in part due to the enormous burden of regulation on the selling of financial products. To comply with the "best advice" rules, a large volume of information must be collected about every prospective customer and several providers, products, and quotations canvassed. Only a few of these prospective customers may eventually decide to make a purchase: but those few must carry all of this compulsory marketing cost for the many who do not.

Institutional schemes, such as company pensions or group personal pensions, can keep costs lower by collecting premiums *en bloc* and offering standard benefit packages. Indeed, the overall costs of institutional providers is not very different from the cost of administering the state's pension benefits.⁷⁴

If the alternatives to the state system can be kept simple in design, if competition is allowed to prevail, if regulation is kept to a minimum, and if systems are devised to allow contributions can be collected across large numbers of subscribers at once, then their cost could well match those of the National Insurance system, or fall below it.

⁷² *Department of Social Security Report*, March 1995, p58.

⁷³ Sir Michael Partridge, "Social Insurance: From Beveridge Into the 21st Century", in *Social Insurance: The Way Forward*, edited by Richard Silburn (Benefits Research Unit, University of Nottingham, 1995).

⁷⁴ Letter from Philip Warland (Association of Unit Trusts and Investment Funds) to Hon Bernard Jenkin MP, 29 February 1996.

Meanwhile, on the other side of the equation, there is no doubt that the benefits offered by a funded system would grow far more quickly than those offered by the state's pay-as-you-go system, which can expand only as fast as taxation can be raised.

Political nature of the system

Our present welfare state is a politicized system: it is designed and run by politicians, in response to political pressures ahead of actuarial security. Because the lifetime of a government is limited, benefits can be expanded today in the knowledge that some other government in the future will have the problem of paying the bill.

Benefits have scant link to past contributions, and some have no link at all. Likewise there is no linkage of benefits to past prudence, nor even present need: benefits are denied those who have taken the trouble to save through their lifetimes, while other benefits are paid universally whether recipients need them or not.

At worst in such a political system, benefits become proportionate to the political muscle of each particular beneficiary group. Already, an entire new profession has arisen: men and women who campaign for the abolition of poverty, but who would be ruined personally if that goal were ever achieved.

This makes any rational restructuring of the benefit system difficult, and some reforms impossible. Any change will produce winners and losers. While the winners will probably accept their good fortune quietly, the losses can now pose a serious obstacle to change. Whether or not the overall change is rational, we can rely on the representatives of the losers to put their demands forcefully: in the media, in the streets, in Parliament, and (increasingly) in the courts.

Unsound funding principles

Many companies provide a pension scheme for their employees. In every case, the trustees of that scheme have to make sure that they maintain a fund large enough to meet all of the future pension entitlements of each of their members.

The government, by contrast, is under no such obligation. There is no fund which guarantees the future pensions of today's working and retired population. The government possesses no fund at all from which to meet its pension liabilities to its own citizens. The size of that unfunded liability is hard to calculate, because it depends on

future changes in life expectancy; but it can be fairly estimated at around £300 billion.⁷⁵ Nor are the funds to meet any long-tail insurance risks that might befall the population.

Future tax take is not secure. Supporters of this pay-as-you-go system say that it is nonetheless both secure and stable because the government can be assured of future revenue from taxation by which the obligations of the day can be met. However, large-scale demographic changes do in fact impose relatively greater or lesser burdens on the different generations as one shrinks and the other grows.

Unexpected economic shocks and unemployment can also interrupt the flow of tax receipts. Since such events raise the demand for income-replacements benefits too, they make the squeeze on state pension financing even more acute.

Nor can the pay-as-you-go system spread these risks very widely: the whole burden falls on domestic taxpayers. The assets of a funded system, by contrast, can be invested across the globe, so that the risk can be spread and therefore reduced.

All in all, it has to be said that the future stream of taxes that are required to keep a pay-as-you-go system in operation are by no means secure. At the extreme, a future generation of taxpayers could decide that the burden was no longer affordable. Given the changes in benefit and eligibility structures that have already taken place, it one might conclude that this has already started to happen.

Poor value. The pay-as-you-go system is also poor value for money. UK private pension plans have achieved returns of about 7%-8% in real terms; insofar as the rate of return on National Insurance contributions is measurable (being a mixture of savings and insurance principles that are hard to separate) the rate of return would appear to be about 2%,⁷⁶ broadly comparable to that achieved by Singapore's funded but state-run pension system.⁷⁷

⁷⁵ Jane Falkingham, *A Unified Pension System in the UK*.

⁷⁶ Eamonn Butler and Madsen Pirie, *The Future of Pensions* (Adam Smith Institute, 1983).

⁷⁷ Mukul Asher, in *Singapore Versus Chile: Models for Pension Reform* (Adam Smith Institute, 1996)

This poor value is inevitable: a tax-funded system can grow only so fast as the tax burden grows; whereas a funded system can grow as fast as any investment sector in the world.⁷⁸

⁷⁸ Peter J Ferrara, *Social Security Reform: The Family Plan* (Washington DC: The Heritage Foundation, 1982, pp23-5.

6. A time for change

After many years of high-profile debate, the public seems now to understand the difficult financial and incentive problems facing the social security system, and to be willing (or at least resigned) to accept reforms that may be unpleasant but which could protect the future security of pensions and other benefits.

The virtual absence of public complaint about the proposal to raise the retirement age for women from 60 to 65 took politicians by surprise; in the event there was every indication that the public would have accepted a rise in the pension age for everyone, perhaps up to the age of 67 that pertains in several other countries, as a way of securing the future of the pension system.

On the other hand, there is irritation that benefits that people thought they could look forward to after contributing into a 'cradle to the grave' welfare system have not in fact materialized, or have been hedged around with conditions that make them inaccessible to many.

Our changing lifestyles make a welfare system designed in the 1940s not just inappropriate but counter-productive. It is not because we are poorer that so many people of working age now draw social benefits of one sort or another; perhaps this out-of-date system is actually bolstering the evils that it aimed to bring down.

Already people are escaping as best they can. Individuals and employers contribute more funds each year towards private pensions plans than the government spends on state pensions.⁷⁹ Probably the bulk of UK industry is now owned by pensions funds on behalf of their members.

Right now we should accept that times have changed, and that new approaches are needed. We must seek ways of promoting on the motives of self-help and self-improvement instead of undermining them. To give people more control over their own lives and their own savings. To explore how the state can help people save and protect themselves, instead of crowding out such efforts with its regressive and its nationalization of welfare.

It is certainly time to think the unthinkable about the welfare state.

⁷⁹ Peter Lilley, *Hansard* 20 February 1996, col.196.

7. A system of private provision

We should not think just of pensions, or just of insurable benefits, or just of welfare transfers, in isolation. Any reformed system must tackle all of these intertwined elements.

This is why the Adam Smith Institute has been working on proposals for the reform of state pensions and other benefits, along the lines described in its 1995 report *The Fortune Account*. The ideal is a comprehensive change: but one which can be broken down into manageable elements and introduced at a manageable rate.

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.

The proposal is for a simple vehicle, into which people can save for their basic retirement pension, and which will insure them for unemployment, incapacity, long-term care, and other lifetime contingencies — a simple and complete alternative to National Insurance. Perhaps we should go further, and allow some of their savings to be used for non-pension lifetime expenses such as house-purchase, college fees, medical expenses, and so on. That, at heart, is the Fortune Account.

Political parameters

The following principles seem to set the political limits for any Fortune Account mechanism. They may not always agree with the commercial requirements that such a scheme should be cheap to administer and attractive for investors. But if we know those commercial and political boundaries, we can at least limit our thinking to the sorts of scheme that are likely to be practicable.

Easily understood. *The Fortune Account must be as simple and straightforward as a building-society account.* People queue up to open building-society accounts: they do not queue up to buy personal pensions, because the law has made them so complicated. The Fortune Account must be a plan for the millions, not for the millionaires.

Comprehensive cover. *Fortune Accounts will enable people to build up a retirement fund over their lifetime, and to insure themselves for lifetime risks such as disability and unemployment.* They might also help people to save for non-pension items such as house purchase or a relative's college education.

Personally owned. *Each fund that is built up by the contributions of members must be the property of those members.*

Portable. *Accounts should remain active, and the property of the individual, no matter how often that individual changes job.* Women may expect to hold five or six jobs throughout their lifetime; men can expect to hold seven or eight.⁸⁰ So it is very important, for the convenience of the individual and for reducing the costs on providers, that plans should move with the individual.

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.*

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, at least annually, which indicates 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.* As Chile shows us, even a financially unsophisticated population can understand, and make rational choices about, a well-designed and simple pension system, given proper information.

Transferability. *Any account holder should be able to transfer his or her account to a new management company, at least annually and without charge.*

Known minimum insurance benefits. *The risk benefits offered by the Fortune Account managers must be at least as good as those on offer by the National Insurance system, and covering the same contingencies — or something reasonably close that can be more effectively managed by the industry.*

Contingencies to be covered. *The NI-style risks to be covered should include incapacity, unemployment, maternity, death-in-service benefits and long-term care.* Some of these are presently not structured in a properly

⁸⁰ Retirement Income Inquiry, *Pensions 2000 and Beyond* (Institute for Fiscal Studies, 1996) Vol.2 pp26-7.

actuarial manner and private-sector providers would have to review what could be covered, and how, before any scheme was finalized.

Choice on retirement. *There is no reason to insist that individuals convert their retirement sum into a lifetime annuity on retirement. We should give people the option of how to draw on their savings in retirement.*

The annuity rule produces large differences in the pensions of people who retire at different times, depending on the state of the financial markets at the time; it denies any chance of unused moneys being bequeathed to family; it is greatly resented. Individuals may instead prefer to draw down their retirement sum gradually. We should allow them to do so, provided they always retain a sum large enough in principle to fund an annuity.

Flexible retirement age. *We should allow people to retire when they want to,* provided they have a fund large enough to prevent them becoming a charge on the public in later years. Thus those wanting to retire earlier would have to make larger contributions into their Fortune Account; those wanting to retire later could contribute smaller sums.

Rolling-over other savings. *Ideally, members should be able to roll over their other savings, such as PEPs, TESSAs, shareholdings and occupational and personal pensions, into a Fortune Account.* Actuaries may argue about the formulae required to achieve this, but it is certainly feasible in principle and may make the individual's savings much easier to understand, particularly for those who have changed jobs often. On the other hand it might add to complexity and cost, and may prove politically desirable but commercially impossible.

Competing fund management. *Investors should enjoy the benefits of price and service competition between fund managers.* The UK already has enormous expertise in financial services and pensions management: we should use that skill, not set up some new state agency to manage a simplified and unified pensions/insurance scheme.

Depoliticization. *The new system should be actuarially sound, with a direct link between contributions and the actuarial value of the benefits earned.* Government-run systems are always subject to Public Choice pressures, being forced to reflect the political power of different interest groups, rather than actuarial soundness. The new system should be market-based, therefore, with politicians being limited to setting the regulatory rules.

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.

Simple tax and regulation. *The structure of tax reliefs, and any regulatory rules, must encourage simplicity and promote the emergence of easily-understood basic products.* This in turn will help providers standardize their offerings and so keep charges down. The tax reliefs need not necessarily reflect current practice — the promise of tax-free benefits might attract more low-income people to save than the present relief on premiums, for example — though this may be simpler.

Straightforward contribution limits. *Instead of a percentage of earnings, tax relief should be limited to a specific amount (say £3000pa — use it or lose it).* This is much easier for individuals and employers to understand and calculate, and cheaper to administer.

Anyone can contribute. *The tax-relief should apply even if the money comes from someone else,* Thus a spouse, partner, relative or friend could contribute to the account of another, using up the tax relief. This will be of greatest value to women with a patchy work record, and unmarried or gay couples, whom the present rules do not help.

Additional voluntary contributions. *Individuals should be able to add more than the tax-relief limit to their accounts at any time,* though there would be no tax relief on these contributions or their roll-up. Once more, the cost of this additional complexity might rule it out, but if affordable this flexibility should be an attractive feature for investors.

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.* Part of it could be gifted in a person's lifetime too, provided the holder retains a fund large enough (in principle) to purchase an annuity at an adequate level so that he or she is in no danger of becoming a charge on the taxpayer. There would be no capital taxes on funds gifted into the Fortune Account of another person.

Start from existing institutions. *We should explore whether any of the 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 PEPs or TESSAs into lifetime savings plans and wrap insurance cover around them; or we might allow occupational pension fund managers to extend their services to non-employees and team up with insurance providers for the lifetime risk elements.

Separate welfare provision. *The function of income support, and other strictly welfare functions, would have to be continued by the taxpayer.* Instead of needing to pay its own benefits directly, however, the state can achieve the same ends by topping up the Fortune Accounts of deserving individuals.

Regulation and security. *Some regulation will be needed to assure people that their life savings are safe and that their Fortune Accounts provide good value for money.* Options include an industry self-insurance mechanism, and government guarantee to investors if funds could not pay adequate benefits, and Chilean-style regulation of investment risks: although all have their drawbacks. We may wish to restrict such regulations to the funding of the basic levels of benefit, with less or no regulation on the amounts built up through AVCs.

Minimum rate of return. *Politicians may expect fund managers to maintain secure reserves* in order to boost returns to account holders should their investment performance fall below a target rate of return.

Other regulation. *Because the Fortune Account is easy to understand, regulation should be minimized.* For example, there need be no 'best advice' condition on selling (the paperwork for which actually deters people from saving at present).

Compulsion. *Everyone would have to be covered by the state system, or have a Fortune Account.* We need not get embroiled in arguments about compulsion, because we are not compelling people to add to their existing provision, simply allowing them to switch from the present (compulsory) NI system to a different method of provision. Nevertheless there would be a case for making Fortune Accounts compulsory for those entering the workforce, possibly all under-30s. and closing the state system to them.

Recognition for past contributions. *People who opt to leave the state system and take out a Fortune Account should receive some form of recognition for their past National Insurance Contributions.* Of course, the government is in no position to hand out large cash pay-outs all at once, so this is probably best done through a bond, maturing on retirement, that can be traded or credited into a Fortune Account.

Funding the transition. *We must devise politically and economically acceptable ways of financing our escape from the chain-letter state pension system — without loading it onto the new.* In today's unfunded system, allowing contributors to leave means there is less revenue to pay

current beneficiaries. These are liabilities of the old system, not the new.

One option is to target our available funds solely on the needy, mean-testing the state pension if necessary. Or we might deny state pension entitlement to under-45s who opt out (they would still retire better off by leaving and putting their future contributions into a private fund), while giving recognition bonds to those who are older.

Allow the system to grow. Just as we can allow Fortune Accounts to spread as more and more people opt into them, so we can build towards the full Fortune Account concept from separate elements. For example, we could start the system as a straightforward unified pension system, and once we were confident that it worked, allow people to add savings for other purposes and to bolt on insurance cover for the lifetime risk benefits. Such piecemeal transition might be attractive politically, though it will of course add to administrative costs.

Commercial parameters

Low bureaucratic costs. The Fortune Account must be inexpensive to market and to administer, so that holders' funds are not dissipated into bureaucratic costs. At present the National Insurance system is cheap to administer because it covers everyone with a standard package; and being compulsory it faces no selling costs. If people are to leave the National Insurance system and make their own Fortune Account provision, costs must be kept down to comparable levels.

There are four elements of cost that we must strive to keep down through good design of the Fortune Account concept: marketing costs, complexity, the regulatory burden, and running costs.

Inexpensive to sell. Fortune Account customers must not share a heavy burden of promotional and marketing costs. Financial services regulation presently makes every sale expensive: a large amount of information has to be collected on each potential customer, and voluminous product information and personal quotations have to be given to each. Each person who buys a financial product therefore has to share the large cost of unsuccessful sales.

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, but there is more difficulty (and less point) in extending compulsion to those nearing retirement.

Given that at least some Fortune Account scheme membership will be voluntary, then, it seems important to keep the marketing costs down by simple product design and simple regulation.

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. It suggests that 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.

This should not preclude them from saving more than the minimum, paying for superior insurance cover, or using different providers for different parts of their package. But the basic packages must be simple.

Regulation. *The Financial Services Act is not appropriate for the regulation of Fortune Accounts.* It loads significant costs onto the marketing of financial products. Instead the aim should be simply to licence sound Fortune Account packages which are as good as or better than the state can provide, and which anyone can therefore purchase with confidence.

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.* Collecting the monthly or weekly Fortune Account contributions of millions of individuals, for example, could be very costly. At the risk of loading yet another burden on employers, they could act as consolidators for their workforces (already in pensions, employer schemes can match the state's costs); but even so, many millions of self-employed people still remain.

Perhaps the best way to consolidate the collection of premiums would be to use the existing National Insurance mechanism. Thus Newcastle would collect contributions from employed and self-employed people in the normal way: but instead of passing it all to the Treasury, they would consolidate and pass the appropriate amounts to the various Fortune Account providers that the individual workers had chosen.

It should, of course, always be possible for providers to collect premiums directly or through agents (such as employers or trade unions) if they choose to, so that the benefits of changing technology and innovation can be captured.

Like rebate-only pensions, this makes premium collection inexpensive. As packages become more complicated, however, the costs of collection would rise even under this centralized system.

AVCs and other investments. *Allowing people to make additional voluntary contributions above the minimum, and to roll into their Fortune Account fund other investments such as PEPs, TESSAs, and personal or occupational pensions, may be desirable politically but could add significantly to costs.* This would be especially true if the Financial Services Act provisions still applied to the rolled-in investments; or if there were different levels of regulation on minimum and additional fund balances or voluntary contributions.

Cafeteria plans. *Individuals should be able to use the full range of provider expertise by building up their Fortune Account package benefit by benefit.* Some existing providers specialize in savings and pensions, others in health insurance (eg BUPA), unemployment provision, long-term care benefits, and disability insurance. Making people purchase all their Fortune Account benefits from a single provider would deny them this range of expertise and would seriously restrict the market to a few very large companies.

Giving people this choice will add to costs; but this should not be allowed to evoke unfavourable comparisons with the National Insurance system, where costs are low because no choice is permitted.

This cafeteria-style system might also make the Fortune Account easier to introduce politically because it could be done in stages. For example, we might insist that a Fortune Account should at least parallel the state basic pension and earning-related pension, and allow people to opt out of that part of their National Insurance Contributions; then we might add the option of adding disability insurance in return for a further concession; then long-term care insurance; then unemployment benefit, and so on.

One provider per benefit. *While we should allow people to choose different providers to make up their overall package, however, it may be harder to allow people to use more than one provider for any individual element* — say, to have three different pension providers or two health insurers within the package. This would increase the cost of splitting premiums yet further, and would make it hard to ensure that an individual's package actually added up to provide entitlements of the desired minimum level.

